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ANALYSIS OF THE CURRENT STATUS
OF THE CONSOLIDATED RETURN ELECTION
UNDER FEDERAL INCOME TAX

A Dissertation
Submitted to the Graduate Faculty of the
Louisiana State University and
Agricultural and Mechanical College
in partial fulfillment of the
requirements for the degree of
Doctor of Philosophy

in
The Department of Accounting

by
Donald Larry Crumbley
B.S., Pfeiffer College, 1963
M.S., Louisiana State University, 1965
August, 1967
"The art of taxation consists in so plucking the goose as to procure the largest quantity of feathers with the least possible amount of hissing."

An old French maxim sometimes attributed to Colbert
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Last, but not least, I owe my wife, Donna, an abiding debt for countless major and minor tasks in the preparation of this dissertation.
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ABSTRACT

Proficient and adequate tax planning in relation to the effects of income taxes on business operations is essential for modern management. The federal income tax impact has become one of the most significant financial burdens of United States corporations. There is nothing sinister in a corporation arranging its affairs so as to minimize the income tax burden. One manner by which management can decrease the income tax charge is to elect to file consolidated tax returns.

Prior to 1964 the consolidated tax return election was merely an academic or accounting concept and very few corporations made the election unless it was evident that this election would result in specific tax benefits. However, Congress has eliminated the two percent penalty tax and provided a specific six percent additional levy on multiple surtax exemptions. Moreover, the Commissioner has consistently attempted to limit multiple corporations to one surtax exemption. These developments should increase the number of consolidated return elections.
A tax plan is essential if the full benefits of this special election are to be obtained and unfavorable taxation is to be avoided. The consolidated return Regulations have been revised and the taxpayer must be cognizant of the many substantial changes. This election is not always advantageous for multiple corporations and the election should be made only where there are distinct tax advantages.

The loss offset privilege and the one hundred percent intercorporate dividends exclusion are the two major advantages of consolidation. Conversely, the loss of multiple surtax exemptions, multiple estimated tax payments exemptions, and multiple accumulated earnings credits are the major disadvantages of the election. However, this election should not be made until the alternatives available to corporations have been compared with this special election. These alternatives include: separate filing where the corporation claims multiple surtax exemptions, branch filing, and separate filing where the corporation elects to exclude one hundred percent of intercorporate dividends.

Since corporations lose the multiple surtax exemptions during consolidation, the most desirable procedure is to elect multiple surtax exemptions for a number of years in order to obtain the benefits of these multiple exemptions.
During this period dividends can be accumulated by the individual affiliates. In a future year the group can avoid the effective 7.2 percent tax on intercorporate dividends by filing a consolidated return and distributing the accumulated earnings. Since multiple surtax exemptions cannot be re-elected for a five-year period, the earnings can be passed through the tier of affiliates as business considerations permit.

As for the loss offset privilege, any losses that occur during the years in which a multiple surtax exemptions election is in effect are limited by the separate return limitation year. Thus, an affiliated group should not elect consolidation when there are large amounts of loss carryforwards available but should make the election before any of the affiliates have incurred large amounts of losses. Even here, however, the group should consider merging the loss corporation with another profit member in order to offset the losses. This action enables the taxpayer to obtain the benefits of both the loss offset privilege and multiple surtax exemptions.

The consolidated tax return election is not perfect but a thorough knowledge of the consolidated return area will allow it to be utilized by many multiple corporations.
Despite the complexity and defects of consolidated returns, this optional method of taxation results in a more realistic measure of the earnings of affiliated groups and decreases the income tax burden in many situations.
CHAPTER I

INTRODUCTION

Combinations of business entities have occurred from the time that the corporate form of business organization became prominent. The current reports of most publicly owned companies in the United States include financial statements reporting the consolidated results of operations and financial position for the overall business activity. These consolidated statements provide the only means of ascertaining the true financial position and results of operations of a group of related companies.

Consolidated financial statements go beyond the legal bounds and present the position of the affiliated units as a single unit. The separate, legal corporate entities are disregarded in order to reach the realities of the related companies. Thus, the purpose of consolidated statements is to portray, "primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single
company with one or more branches and divisions.\textsuperscript{1}

Valuable information can be obtained and presented by combining the financial data and preparing consolidated statements for the entire group. Consolidated statements are more meaningful to many users than separate statements and they are generally necessary for a fair representation when one company has a controlling financial interest in one or more companies.

A consolidated balance sheet sets forth all assets and liabilities of the parent and its subsidiaries, except that accounts representing intercorporate items are eliminated. By eliminating all of the intercompany obligations and adding together all other assets and liabilities, a picture of the group as a single economic unit is obtained. Likewise, a consolidated income statement presents results of operations of the parent and its subsidiaries after eliminating any intercompany sales, dividends, expenses, profits, and losses between the related companies. The effect of such an income statement is to determine the true net income or loss of a single unit conducted by means of more than one corporation.

The tax laws recognize this economic entity principle and permit an affiliated group of corporations to elect to file a consolidated income tax return. Statutory reason for such an election is summarized in the words of Senator Simmons: "...the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and the government."\(^2\) Thus, this optional method of taxation results in a more realistic measure of earnings for affiliated groups than do separate returns.

**Purpose of the Study**

Proficient and adequate tax planning for the effects of income taxes on business operations is essential for modern management. This necessity for tax planning is partly attributable to the fact that the Federal income tax charge has become one of the most significant financial burdens of United States corporations. For the period July 1, 1963, to June 30, 1964, 1,323,180 United States corporations reported a total taxable income of $54,302,147, paying $26,266,974 federal income taxes into the United

For companies reporting a net profit, in the aggregate, federal income tax expense exceeded every other single corporate deduction, except cost of sales and depreciation.³

This factor of materiality alone is reason enough to warrant a critical evaluation of the tax planning principles of corporate taxation. Management is a decision-making process, and few business decisions have as serious and varied consequences as taxation. There is nothing sinister in a corporation arranging its affairs in order to minimize the tax burden. Taxes are enforced exactions and are not voluntary contributions. To demand more taxes under the disguise of morals is mere cant.⁴ Thus, management should attempt to reduce the income tax charge.

One method of minimizing the income tax burden is to elect to file consolidated tax returns. Congress has eliminated the two percent penalty tax on consolidated returns and has provided a specific six percent additional levy on multiple surtax exemptions. Moreover, the


Commissioner is consistently attempting to limit multiple corporations to one surtax exemption. These developments have increased both the number of consolidated return elections and the number of subsidiaries included within these returns. The 7,300 consolidated returns filed in 1964 were 1,500 more than in 1963, but 2,000 less than the highest year, 1928. One out of every eight corporate returns filed in 1964 was filed by a member of a controlled group. Of the 182,000 returns filed by controlled groups, 104,000 (ca. 57%) elected multiple surtax exemptions and the other 78,000 used the single group exemption. Out of the remaining 43% using a single surtax exemption, 45,300 of the corporations were included within a consolidated group. The 38,000 subsidiaries included in these consolidated returns reflect a 42% increase over 1963.5

In anticipation of the increased use of the consolidated return election, the Treasury Department recently revised the consolidated return Regulations. Although all of the revised Regulations have not been published, many substantial changes have been made in the rules for filing consolidated returns. This study analyzes these changes. Filing

consolidated returns is more costly for some affiliated groups and more beneficial to other groups as a result of these changes. The area is fertile for tax planning suggestions. Thus, the study develops tax planning principles that yield the most favorable tax advantages while limiting the disadvantages. This research indicates how management can use this special election and reduce the total income tax burden.

The new revised provisions are in general agreement with generally accepted accounting practice. However, a number of changes would improve the soundness of the new provisions, simplify the administration of the new Regulations, and eliminate hardships imposed by some of the new rules. Recommendations are included within this study that would make this optional election adhere more closely to the entity concept of consolidation.

Survey of the Study

Specifically, the first section of this study briefly discusses the hectic and frequently precarious legislative history of consolidated tax returns. The tax concept is analyzed as it evolved from an embryonic period of hostility into a climate that actually encourages the filing of consolidated returns.
Against this backdrop, the major provisions of the current law dealing with the election and filing of consolidated tax returns are analyzed, and the eligibility requirements, both statutory and nonstatutory, for filing consolidated returns are discussed. The administrative rules for electing and filing consolidated returns are also analyzed. A discussion of accounting periods and methods, the declaration of estimated tax, and the agent for the subsidiaries conclude this section.

The next two sections discuss the problems involved in computing consolidated taxable income. In order to avoid a lengthy discussion, basic computational differences between consolidated return filing and separate return filing are identified and discussed. The presentation does not include a complete and exhaustive discussion of the consolidation process, but these two sections present some of the highlights of this process in order to clarify certain points and to provide a more complete explanation of the process. Tax planning suggestions are also provided in order that management may minimize the income tax burden.

Next, the study discusses the various alternatives available to an affiliated group. A consolidated return election offers overall tax savings in many situations, but there are numerous dangers and disadvantages that must not
be overlooked. However, a mere listing of the advantages and disadvantages of consolidation as compared to separate filing is no longer appropriate. Consolidated filing must be compared with separate returns utilizing multiple surtax exemptions and separate returns utilizing the one hundred percent intercorporate dividends election. Also, serious consideration must be given to merging the affiliates and operating through a single entity. This study makes such a comparison and points out when each alternative will result in the most advantageous consequences.

Finally, the new revised provisions are in general agreement with generally accepted accounting practices. However, the last section suggests a number of changes which would make the Regulations adhere more closely to the entity concept of consolidation.

Limitations of the Study

Although the consolidated return election has been in the tax laws since 1918, the recent revisions of the consolidated return Regulations has drastically changed this special corporate election. Many of the court cases, revenue rulings, and published material that have decided questions, eliminated ambiguities, described the basic principle, and helped the tax practitioner in dealing with
clients, are no longer applicable. The writer has made assumptions and conclusions drawn from old case law and interpretations and superimposed these upon the new consolidated return concepts in order to provide the general practitioner with adequate tax planning ideas.

The new Regulations are not complete. Provisions dealing specifically with specialized corporations such as life insurance companies or with the personal holding company tax and the accumulated earnings tax have not been promulgated. In most cases this study avoids these areas in which there is an absence of Regulations.

An affiliated group electing consolidated returns remains subject to many Code provisions applicable to the ordinary corporate form. In order to avoid a lengthy discussion, basic computational differences between consolidated returns and separate returns are identified and discussed.

Any attempt to develop tax planning principles for consolidation requires a comparison and analysis of three other alternatives—separate filing claiming multiple surtax exemptions, branch filing, and separate filing electing the one hundred percent intercorporate dividends election. Each of these other alternatives are complex and must be given only superficial discussion within this study.
Definitions and Special Uses of Terms

Throughout this dissertation several terms are used in an abbreviated manner in order to avoid repetition of rather long, descriptive nomenclature. All references to "Code" or to "Section" refer to the Internal Revenue Code of 1954, which constitutes Title 26 of the United States Code as amended to July 6, 1966. The term "Regulations," unless otherwise identified, refers to the Regulations issued under Code Section 1502.

The Regulations are amended as of December 31, 1966, and the term "Proposed Regulations" refers to Regulations that have been proposed by the Commissioner but have not been finalized. Regulations are normally not statutory in nature, but the Regulations for consolidated returns are peculiar in that Congress has delegated power to the Commissioner to prescribe Regulations legislative in character.

For a more thorough understanding of this study, it is beneficial for the reader to become familiar with the following definitions:

**Group.** The term "group" refers to an affiliated group of corporations filing consolidated returns.

**Member or affiliate.** Both member and affiliate mean a corporation (including the common parent) which is included
within a group.

**Subsidiary.** A subsidiary is a corporation other than the common parent which is a member of an affiliated group.

**Separate return year.** The term "separate return year" refers to a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return with another group.

**Separate return limitation year (SRLY).** A SRLY refers to a taxable year during which a subsidiary was not a member of the group or a taxable year during which a subsidiary and the remaining members of the group claimed multiple surtax exemptions.

**Consolidated return year.** The term "consolidated return year" means a taxable year during which a consolidated return is filed or required to be filed by the group.

**Consolidated return change of ownership (CRCO).** A CRCO refers to a situation where there has been a fifty percentage point change in ownership of the parent corporation (measured for the ten major shareholders after the change) and the change in ownership is due to the purchase or redemption of stock.

**Reverse acquisition.** A reverse acquisition refers to a situation where a corporation acquires a new subsidiary (or substantially all of the assets of a corporation) in
exchange for more than fifty percent of its stock.

**Built-in deduction.** A built-in deduction is defined as a deduction or loss that is economically accrued in a SRLY and can be used only if the sustaining member generates enough income to absorb the deduction.

**Excess loss account.** An excess loss account is a potential taxable account which must be taken into income, to the extent not subsequently reduced by positive adjustments or contributions to capital, when the parent disposes of the subsidiary's stock.
CHAPTER II

HISTORICAL DEVELOPMENT OF CONSOLIDATED TAX RETURNS

The concept of combining the financial data from two or more entities for informational purposes, with ownership of the entities being irrelevant, was developed by the accounting profession many years before it was recognized for tax purposes. National Lead Company and General Electric Company issued consolidated reports prior to 1900. The first published reports of both Bethlehem Steel Corporation and United States Steel Corporation in the early 1900's included consolidated balance sheets and income statements.

One of the first important articles on consolidation appeared in 1906. Arthur Lowes Dickinson asserted that a consolidated balance sheet was essential in the parent-subsidiary situation to present the financial position accurately. He felt that only a consolidated statement would disclose the true facts. Mr. Dickinson was concerned that a subsidiary might incur a liability for the parent corporation but the liability would not be disclosed...
on a separate parent statement: "A balance sheet of the holding company prepared without regard to the condition of the subsidiary companies would be entirely misleading to the stockholders and the public and would state falsely both the earnings and the position of the company."^1

Whereas accounting consolidation arose out of the necessity to present meaningful financial information about related corporations, tax consolidation had its origin as a measure to prevent tax avoidance. Corporations attempted to evade the progressive excess profits tax and keep out of high tax brackets by subdividing the income and filing separate returns. However, consolidated returns have not been limited to the excess profits tax period. Congress later recognized that an affiliated group is a single economic entity and, therefore, an appropriate unit for taxation.

The hectic and frequently precarious legislative history of consolidated returns can be conveniently divided into several distinctive periods. The tax concept has evolved from its embryonic period of hostility into a climate that actually encourages the filing of consolidated returns.

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Today, the consolidated tax return election is offered as a brake on the expansion of the use of multiple surtax exemptions to gain tax advantage. This historical development of consolidated tax returns is discussed in this chapter.

**Compulsory Era (1917-1918 Acts)**

The genesis of consolidated returns was without specific statutory authorization. Instead of being created by statutes, consolidated tax returns were first instituted by Regulations as an instrument of administrative control in deterring tax avoidance by closely-related corporations. The Revenue Act of 1917 introduced the first excess profits tax in order to raise revenues for World War I. The excess profits tax was the first corporate tax in the United States to apply a schedule of graduated, progressive rates. Consolidation was initiated by the Commissioner to prevent evasion under these progressive rates.

Consolidated returns were not optional to the taxpayer but were compulsory whenever required by the Commissioner. In an attempt to evade taxation and keep out of the high tax brackets, corporations could make separate returns to divide up their income. Corporations could also avoid taxation by shifting the greater portion of income to foreign subsidiaries. By giving the Commissioner the power to
consolidate accounts, it was hoped that much of this tax evasion could be prevented. "Whenever necessary to more equitably determine the invested capital or taxable income, the Commissioner may require corporations classed as affiliated to furnish a consolidated return of net income and invested capital."²

Two or more corporations were considered affiliated under these Regulations if one corporation owned or controlled all or substantially all of the stock of another corporation or corporations (parent-subsidiary affiliation) or if substantially all of the stock of two or more corporations was owned by the same individual or partnership (brother-sister affiliation). Furthermore, the corporations had to be engaged in the same or a closely related business.⁴ Although there was some doubt about the validity of the non-statutory consolidated return requirement in the Regulations under the 1917 Act, Congress ratified Article 77 of Regulations 41 in the 1921 Act.⁴ The

²Reg. 41, Art. 78, 1917.
³Reg. 41, Art. 77, 1917.
⁴1921 Act, Section 1331; Reg. 62, Art. 1735.
courts later upheld the validity of the Regulations and the constitutionality of the 1921 Act.\(^5\)

The demands of World War I required significant increases in the income tax rate. The burden of the war debts continued to be heavy and the Revenue Act of 1918 raised the tax rates to the highest level up to that time. It was in this climate that statutory authority was granted to consolidated returns for the first time at the insistence of the Treasury Department. The Senate inserted the consolidated return election into the Revenue Act of 1918.\(^6\)

While adding the consolidation provision to the 1918 Act, the Senate Finance Committee had the following to say:

Moreover, a law which contains no requirement for consolidation puts an almost irresistible premium on a segregation or a separate incorporation of activities which would normally be carried on as branches of one concern. Increasing evidence has come to light demonstrating that the possibilities of evading taxation in these and allied ways are becoming familiar to the taxpayers of the country. While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion


\(^6\)1918 Revenue Act, Sec. 240.
of taxes or because of its effect upon the revenue, but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the government.\(^7\)

Under this first statute, consolidated returns were mandatory for purposes of income tax as well as for excess profits tax. The major purpose of the 1918 Act was to incorporate the previous system of taxation set up by the Regulations in 1917. This system of taxation was the taxing of a group of related companies as a single economic unit. However, Congress did not merely accept the 1917 Regulations but made several changes in the consolidation provisions. Congress made determinative for affiliation purposes substantial ownership or control of the stock, not actual control of the related companies.\(^8\) Also, the affiliated corporations were not required to be engaging in the same or related business.\(^9\)

The distinguishing feature of this first provision was the compulsory stipulation. Under this 1918 Act, consolidated returns were mandatory rather than optional with the


\(^9\) 1918 Revenue Act, Sec. 240(b).
Commissioner (as in the case of the Regulations under the 1917 Act), or optional with the affiliated group (as was to be the case for 1922 and subsequent years). The courts held that Congress had the authority to require compulsory consolidation of affiliated corporations.¹⁰

**Voluntary Era (1921-1926 Acts)**

The Revenue Act of 1921 reverted to a uniform, flat-rate tax and the chief reason for the filing of consolidated returns seemed to have disappeared. The demise of the excess profits tax, however, did not cause consolidated returns to be eliminated. Instead, there was a shift from the policy of compulsory consolidated returns as a measure to prevent tax avoidance to the present policy of consolidated returns that are initially optional with the taxpayer.

Congress felt that consolidated returns were no longer necessary to prevent evasion under the high excess profits rates. The election to file consolidated returns was retained on a permissive basis.¹¹ Congress felt that

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instances would arise where it would be unreasonable to divide (for tax purposes) a business conducted as a unit, even though the business was operating through several corporations. The rationale was that the owners of the business would not realize a gain unless the affiliated group as a whole earned a profit. Although the filing of a consolidated return was initially optional to the taxpayer, the election once made, was binding for subsequent years.\textsuperscript{12}

The Revenue Act of 1924, a major tax reduction act, included a clarifying change relating to consolidated returns. The House of Representatives suggested making the definition of affiliation more specific by requiring ownership of at least eighty-five percent of the voting stock of an affiliate in lieu of the previous vague test of ownership or control of "substantially all" of the stock of an affiliate.\textsuperscript{13} The Senate changed the percentage to ninety-five percent, and the House agreed to the change.\textsuperscript{14}

The Revenue Act of 1926, which further reduced the tax rates applicable to individuals and increased the corporate

\textsuperscript{12}\textsuperscript{1921} Revenue Act, Sec. 240(a).
\textsuperscript{13}\textsuperscript{H.R. Rep. No. 179, 68th Congress, 1st Sess., p. 24 (1924).}
\textsuperscript{14}\textsuperscript{H. R. Rep. No. 844, 68th Congress, 1st Sess., p. 22 (1924).}
rate from 12¼ percent to 13¼ percent, contained only a minor change in the treatment of consolidated returns. The Act further modified the definition of affiliation by introducing (in lieu of a test based solely on voting stock) a test based on the ownership of at least ninety-five percent of all stock other than "non-voting stock which is limited and preferred as to the dividends."\(^{15}\)

Narrow Escape and Penalty Tax (1928-1933 Acts)

By 1928 there was considerable litigation involving the composition of the affiliated group and the definition of consolidated income that could not be satisfactorily resolved. To assist in restoring order to the consolidation area, a Joint Committee on Internal Revenue Taxation recommended that affiliation be limited solely to parent-subsidiary relationships in order to simplify the administration of consolidated returns.\(^{16}\) The House of Representatives, upon the recommendation of the Ways and Means Committee, went further than mere restriction and voted to abolish the privilege of filing consolidated returns.\(^{17}\) The Senate

\(^{15}\)1926 Revenue Act, Sec. 240(d).


Finance Committee, however, was not to be outdone. They restored the right to file consolidated returns to the 1928 Act.\textsuperscript{18}

The Senate Committee voiced the following rebuttal that described the rationale behind the consolidated returns election:

The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. . . . The failure to recognize the entire business enterprise means drawing technical legal distinctions, as contrasted with the recognition of actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies. It would be just as unreasonable to demand that an individual engaged in two or more businesses treat each business separately for tax purposes.\textsuperscript{19}

As is the case with all legislation in dispute between the two august governing bodies, the legislation in question


\textsuperscript{19}Ibid.
was sent to a Conference Committee. Through the art of compromise, the Conference Committee retained the right to file consolidated returns but two major changes were incorporated into the 1928 Act. First, the brother-sister affiliations were eliminated; and second, all corporations that had been members of the affiliated group at any time during the taxable year had to consent to all of the regulations promulgated by the Commissioner before the privilege of filing consolidated returns would be granted.

In addition, the 1928 Act stipulated that insurance companies should not be included in the same consolidated return with ordinary corporations. The difference in the method of taxing insurance companies as compared to ordinary corporations was the reason for the exclusion.

The first comprehensive Regulations dealing with consolidated returns appeared during 1928. Treasury Regulation 75 was an elaborate exposition of consolidation practice as it had theretofore developed.

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20. 1928 Act, Sec. 141(d).
21. 1928 Act, Sec. 141(a).
The decreases in the Federal revenues occasioned by the Great Depression and the absence of corresponding decreases in Federal expenditures brought about the Revenue Act of 1932. The tax rates of both individuals and corporations were increased and several technical changes were made in order to bolster the declining revenues. One of these changes reduced the carry-forward of net operating losses from two years to a single year, and in the subsequent National Industrial Recovery Act of 1933, the loss carryover provision was eliminated entirely.

When the separate corporations lost the right to carry forward operating losses, the offsetting of losses under consolidation became a valuable technique. Several senators and congressmen also charged that consolidated returns had adverse effects upon the economy. They maintained that consolidated returns encouraged the growth of holding companies. These holding companies, in turn, gained tax advantages over separate business competitors by being able to offset the losses of some affiliates against the earnings of others. Alleged tax savings were said to result from these loss offsets and also from the indefinite postponement of tax on intercorporate transactions.

The House of Representatives recommended an additional tax of 1\% percent upon the income of consolidated groups,
partly to compensate for the tax savings allegedly obtained through offsetting losses and partly to discourage holding companies. The tax differential was eliminated by the Senate because consolidation was a recognized accounting practice and necessary to determine the true net income of a group of affiliated companies.\textsuperscript{24} In the Conference Committee, the two legislative bodies agreed upon a penalty tax rate of \(3/4\) of one percent for the privilege of filing consolidated returns.\textsuperscript{25}

In 1933, the National Industrial Recovery Act extended the penalty tax to 1934 and 1935 and increased the rate to one percent.\textsuperscript{26} Although there originally may have been some correlation between the rate of tax and the tax savings from consolidating a group of corporations, any relationship disappeared after subsequent revisions, compromises, and complications in the corporate taxing system.


\textsuperscript{26}National Industrial Recovery Act, Sec. 218(e).
Low Ebb of Congressional Popularity (1934-1939 Acts)

As a result of the significant impact of the depression on federal revenues, legislative pressure to abolish consolidated returns reached its peak in 1933-34. The House Ways and Means Committee appointed a subcommittee to investigate methods of preventing avoidance and evasion of the Internal Revenue laws. When this Subcommittee reported in late 1933, it recommended the abolishment of consolidated returns, which the subcommittee stated had proved to be "of substantial benefit to the large groups of corporations in existence in this country."²⁷ The Subcommittee was critical of the fact that a consolidated return allows the loss of one affiliate to reduce the net income and tax of another affiliate. "In the past, when any corporation could carry forward a net loss from one year to another, the consolidated group did not have such a great advantage over the separate corporation. Now that this net loss carryover has been denied, the advantage of the consolidated return is much greater on a comparative basis."²⁸

Another effect that the Subcommittee criticized dealt with the ability of consolidation to postpone the payment

²⁸Ibid.
of taxes. "This is because there is no profit recognized for tax purposes in intercompany transactions, and profits on a product of the consolidated group, passing through the hands of the different members of the group, are not taxed until the product is disposed of to persons outside the group." ¹²⁹

The Treasury Department was invited to comment on this proposal to abolish consolidated returns and the Acting Secretary of the Treasury characterized the proposal as "a backward step." ³⁰ He asserted that many sound and legitimate business reasons exist for multiple incorporation of businesses. The normal operations of a multiple corporate group entail arrangements for business contracts, property transfers, intercompany loans and services, and shifts of income from one corporation to another. Many of these contracts which do shift income from one member to another are perfectly reasonable in themselves and cannot be proven to be evasions. ³¹

¹²⁹Ibid.
³⁰Statement of the Acting Secretary of the Treasury regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means, December, 1933, p. 12.
³¹Ibid.
In another part of his statement the Acting Secretary expounded the Treasury Department's position on the principles of consolidated returns:

... the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, including therein the income and deductions of the parent and every subsidiary, with all intercompany transactions eliminated. Such a consolidated statement is simply a recognition of the actual fact that the separate corporations, though technically distinct legal entities, are, for all practical business purposes, branches or departments of one enterprise. ... The principal reason given in the Subcommittee's report for the abolition of the consolidated return is that this would prevent the loss of one subsidiary from being absorbed by the income of another or of the parent. For reasons already stated, this result is not likely to follow as a practical matter. Subsidiary corporations now showing losses in separate statements, could arrange by intercompany contracts and by a readjustment of accounting methods, to obtain a fair share of the profits of the affiliated group. There is no way to prevent the bulk of such contracts because the Treasury cannot hold that a contract which enables a company to make a profit is necessarily unfair or evasive. Moreover, full recognition of intercompany transactions would often result in deductible losses as well as taxable gains. The fact that consolidated returns have been regarded as absolutely essential to check these practices in the past is sufficient basis for the belief that these evils will recur in the future. ... \(^{32}\)

The Ways and Means Committee set aside the recommendation of its Subcommittee and agreed with the Treasury Department about retaining consolidated returns. But on

\(^{32}\)Ibid.
the other side of Capitol Hill, the Senate abolished consolidated returns altogether. In conference, the Senate's view prevailed, but the House conferees persuaded their Senate counterparts to agree to a minor exception permitting railroads to file consolidated returns. Congress felt that exception should be made in the case of railroads since they were forced to incorporate separately in each state and were under Federal supervision. Railroad consolidation was severely penalized, however, for the additional penalty tax was increased to two percent.

The separate two percent additional tax was almost immediately eliminated by the 1935 Act and a flat rate of 15 3/4 percent was imposed upon consolidated income in lieu of the graduated corporate income tax rate (the rates ranged from 12½ percent on income up to $2,000 to 15 percent on income over $40,000). Although effective for years beginning after 1935, the flat rate was not used since it was superseded by provisions in the 1936 Act. The 1936 provisions had the same effective date and did not

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33 1934 Revenue Act, Sec. 141(d).
34 Ibid., Sec. 141(c).
35 1935 Revenue Act, Sec. 102(b).
differentiate in the rate of tax between corporations filing separate returns and those filing consolidated returns.\textsuperscript{36}

The 1936 Act expanded the definition of railroad corporations to include a street, suburban, or interurban electric railways.\textsuperscript{37} Two years later, in the 1938 Act, the definition of railroad corporations was extended to include trackless trolley systems and street or suburban bus systems operated as a part of street or suburban electric railway or trackless trolley systems.\textsuperscript{38} Presumably, Congress felt that these corporations should also be allowed to file consolidated returns since they were forced to incorporate separately in various states and were under Federal supervision.

The Revenue Act of 1939 consolidated and codified the internal revenue laws of the United States. The Act simply adopted the consolidated return provisions in the 1938 Act in substantially the same form, except for one minor change. The consolidated return privilege was extended to Pan-American trade corporations under the 1939

\textsuperscript{36}1936 Revenue Act, Secs. 13, 14 and 141.

\textsuperscript{37}Ibid., Sec. 141(d)(3).

\textsuperscript{38}1938 Revenue Act, Sec. 141 (d)(3).
Act. Pan-American trade corporations were domestic corporations that met certain tests as to the active conduct of a trade or business in Central or South America and were affiliated with domestic corporations engaged in the active conduct of trade or business within the United States.\(^3^9\)

**Period of Revival (1940-1951 Acts)**

During the 1940's Congress again began to look with favor upon the consolidated return privilege. The Second Revenue Act of 1940 was framed and drafted in a very short time solely as a revenue-producing measure. An excess profits tax was adopted in the Act because of the approaching war. Although only railroad companies could file consolidated returns for the regular income tax, consolidated returns could now be filed by ordinary corporations in determining the newly created excess profits tax liability.\(^4^0\) This privilege was optional to all corporations except several types of corporations exempt from the excess profits tax. These exceptions were China Trade Act corporations, foreign corporations, personal service

\(^3^9\)1939 Revenue Act, Sec. 225.

\(^4^0\)Second Revenue Act of 1940, Sec. 201.
corporations, insurance companies, and corporations entitled to the benefits of Section 251 of the 1939 Code (by reason of deriving income from United States possessions).

There was confusion and bewilderment on the part of the taxpayers who could not understand why affiliation was proper for the excess profits tax but was not proper for all other tax purposes. However, the Revenue Act of 1942 restored to affiliated corporate groups the privilege of filing consolidated returns for purposes of the normal tax and surtax, as well as for the excess profits tax. The change was merely a matter of harmonizing the income tax with the excess profits tax. There was one major problem: an additional tax on the privilege of filing consolidated returns in an amount equal to two percent of the consolidated surtax net income.41

The Revenue Act of 1942 made several other minor changes. Pan-American trade corporations could no longer elect to consolidate income after December 31, 1941.42 The exceptions to the definition of "includible corporations" were expanded to cover corporations exempt from

411942 Revenue Act, Sec. 159(a).

42Ibid., Sec. 159(b).
income tax and regulated investment companies. On the other hand, the list of exceptions was restricted by eliminating corporations exempt from excess profits tax and personal service corporations.

In the 1943 Act several specific types of corporations which were exempt from excess profits tax could no longer be considered as "includible corporations" unless they first filed for a consent to consolidate income. This provision prevented a domestic subsidiary from losing its excess profits tax exemption when the other members of its affiliated group filed consolidated returns.

The 1950 Revenue Act originated in the House of Representatives as a bill to reduce excise taxes and to close some loopholes. The Act was converted into a bill to provide additional revenues when the Korean War started and it became apparent that there would be substantial increases in defense and related expenditures. Prior to 1950, Western Hemisphere trade corporations were

431943 Revenue Act, Sec. 131.

44Western Hemisphere trade corporations are domestic corporations all of whose business is done in North, Central, or South America, or West Indies and which satisfy certain other requirements relative to nature and proportion of total income derived from sources outside the United States. These corporations are allowed a special deduction that is computed as follows: Taxable Income - (Taxable Income x 14/48).
discharged from the surtax, and the Consolidated Returns Regulations stipulated that their income should not be included in computing the consolidated surtax net income against which the two percent penalty tax was applied.\textsuperscript{45} The 1950 Act specifically provided that the portion of consolidated surtax net income attributable to Western Hemisphere trade corporations should not be subject to the two percent penalty tax.\textsuperscript{46} This 1950 amendment preserved the tax-exempt status of Western Hemisphere trade corporations while at the same time, the 1950 Act substituted a credit against normal tax and surtax for the previous surtax exemption of Western Hemisphere trade corporations.\textsuperscript{47}

As a result of the military action in Korea, the Excess Profits Act of 1950 was immediately passed. This second act in 1950 imposed on corporations a thirty percent tax on a figure called "adjusted excess profits tax net income." The excess profits tax was drafted to tax only those profits that were above the normal pre-war profits.

- The Excess Profits Tax of 1950 made a number of changes in the provisions concerning filing of consolidated returns.

\textsuperscript{45}Reg. 104, Sec. 23.30(d), amended by T.D. 5244, C.B. 1943, p. 439.

\textsuperscript{46}1950 Revenue Act, Sec. 121(b).

\textsuperscript{47}\textit{Ibid.}, Sec. 122(c).
One provision gave groups of affiliated corporations the opportunity to make a new decision as to whether or not they desired to file a consolidated return. The primary effect of this amendment was to give such groups an option to file a separate return for their Western Hemisphere trade corporation (thereby receiving an exemption from the excess profits tax). Under the 1950 Excess Profits Tax Act certain corporations (Western Hemisphere trade corporations and similar corporations operating in other parts of the world) were treated as "includible corporations" (and thus subject to the excess profits tax) only if they filed consents to be so treated. If they did not consent, these corporations were automatically excluded from consolidated return treatment.

An affiliated group of corporations filing a consolidated return was allowed to apply only one specific credit against its excess profit net income in arriving at its adjusted excess profits net income. This excess profits credit and the unused excess profits credit adjustment of the affiliated group could not exceed $25,000 for the entire group.

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48 Excess Profits Tax Act of 1950, Sec. 301.
49 Ibid.
50 Ibid.
Regulated public utilities, computing their excess profits credit under the special excess profits tax provision for such corporations, were exempt from the definition of "includible corporations" unless they filed for consents to compute their excess profits credits without regard to such special credit provisions. These consents were applicable for as many consecutive years as consolidated returns were filed.\textsuperscript{51}

Despite the provision discussed in the previous paragraph, it was possible for regulated public utilities to be "includible corporations." If two or more regulated public utilities filed for consents to compute their excess profits credits under the special excess profits tax provisions for such corporations, they were permitted to be treated as "includible corporations" solely for purposes of forming an affiliated group of such regulated public utilities. These consents were also applicable for as many consecutive years as consolidated returns were filed.\textsuperscript{52}

Immediately following the Excess Profits Tax Act of 1950, the Revenue Act of 1951 permitted a corporation,

\textsuperscript{51}Ibid.

\textsuperscript{52}Ibid.
otherwise exempt from excess profits tax by reason of
doing business abroad, to withdraw its consent to be
included in a consolidated return.\textsuperscript{53}

The important provision involving consolidated returns
in the 1951 Act was a specific limitation on the use of
multiple corporations. The substantially lower rate on
the first $25,000 of corporate net income created an
incentive for doing business in a number of different
corporations. The House of Representatives tried to
combat multiple corporations in the 1951 Bill by providing
that a controlled group should be entitled to divide
between them only one $25,000 surtax exemption and one
excess profits credit.\textsuperscript{54} The Senate Finance Committee
believed the Bill was too broad and deleted the entire
provision. The Senate Committee pointed out that it was
frequently necessary to incorporate separately in various
states and it was advisable to limit liability in the
development of new and risky businesses.\textsuperscript{55} Furthermore,
any future study "should emphasize the importance of

\textsuperscript{53} Revenue Act of 1951, Sec. 613.

\textsuperscript{54} H.R. Rep. No. 586, 82nd Congress, 1st Sess., pp. 23,
72 (1951).

\textsuperscript{55} S. Rep. No. 781, 82nd Congress, 1st Sess., p. 69
(1951).
correcting the true cases of avoidance without working a hardship on legitimate business organizations."\textsuperscript{56}

A new provision emerged from the Conference Committee as the result of a compromise. The new provision disallowed the surtax exemption of a transferee corporation directly or indirectly receiving property other than money from another corporation if the transferor or its stockholders were in control of the transferee and the transferee was inactive or was formed to acquire the property, or if the transfer was from five or fewer individuals who control the transferee and another corporation. The surtax exemption, however, would not be disallowed if the transferee corporation could establish by a clear preponderance of evidence that the securing of such exemption was not the major purpose of the transfer. Control was defined as eighty percent of the voting power of all stock or of the total value of all stock.\textsuperscript{57}

\textbf{Allocation of Tax Liability (1954 Code)}

The internal revenue laws had not been thoroughly re-examined and analyzed in about forty years. Hearings on general revision were held by the House Ways and Means


\textsuperscript{57}Revenue Act of 1951, Sec. 121(f).
Committee throughout 1953. During the hearings on August 3, 1953, many witnesses urged the repeal of the two percent penalty tax and the establishment of an annual election to file either a separate or a consolidated return. The Bell Telephone System thought the ninety-five percent ownership requirement should be reduced to fifty percent. President Eisenhower, in his Annual Budget Message, asked Congress to remove the penalty tax on consolidated returns over a three year period. Congress did not believe the elimination was appropriate in view of the present revenue needs. The 1954 Code, however, did have a number of modifications in the consolidated returns provisions.

The ownership requirement was drastically reduced from ninety-five percent to eighty percent. The House Committee believed that a change would make it possible for a greater number of multicorporate businesses which in effect operate as economic units, to report their income for


tax purposes as a single taxpayer.\textsuperscript{60} Regulated public utilities were exempt from the two percent tax differential since they were required to file consolidated returns. Also, the 1954 Code revision eliminated the references to the excess profits tax from the consolidated return provisions and eliminated the excess profits tax-related provisions. A subchapter R corporation (a partnership or proprietorship electing to be taxed as a corporation) was added to the list of types of corporations exempt from the definition of "includible corporations." A further minor change was the application of the personal holding company tax provisions on a consolidated basis under certain circumstances.

A unique situation almost transpired in the 1954 revision. The 1954 Code, in the form in which it passed the House of Representatives, would have written the Consolidated Return Regulations into the statute. In proposing this the Ways and Means Committee said:

\begin{quote}
Since these regulations have been generally accepted and have become stabilized, your committee has inserted them into the law, changing them only to the extent necessary, to reflect changes your committee has made elsewhere in the Code.\textsuperscript{61}
\end{quote}

\textsuperscript{60}\textit{Ibid.}

\textsuperscript{61}\textit{Ibid.}
In disagreement, the Senate Committee on Finance replied:

Under the House Bill, the consolidated return regulations were inserted into the statute. While your committee recognizes that these regulations have been generally accepted, your committee believes that it is more appropriate to have these detailed rules in the form of regulations rather than in the statute. In this form they may be readily amended without necessary Congressional action. This is particularly desirable in view of the many revisions of the income tax laws in this bill which must be reflected in these regulations.  

The views of the Finance Committee prevailed.

A new section was added in the 1954 Code. The House Ways and Means Committee recognized the absence of a method allocating the consolidated tax liability among the reporting corporations.  

There are at least three types of federal agencies or units which are interested in the allocation of consolidated taxes: the Treasury Department, the Securities and Exchange Commission, and various federal public service bodies, such as the Federal Power Commission and the Interstate Commerce Commission. The legislators

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63 The allocation in the past was supposed to be allocated in proportion to consolidated taxable income of each profit company in the group. I.T. 4085, 1952-1 C.B. 68.
provided three alternative rules for the computation of the earnings and profits of a corporation with respect to consolidated tax returns, and provided that groups may select any other reasonable method with the approval of the Commissioner.\(^6^4\) The methods suggested by the Ways and Means Committee were eventually included as Section 1552 of the 1954 Code.


The Revenue Act of 1955 merely added life insurance companies taxed under Section 811 to the list of types of corporations excepted from the definition of "includible corporations."\(^6^5\) The major income tax changes in 1958 were embodied in the Technical Amendments Act of 1958. As indicated by the use of the word "technical," many of the changes were merely corrections in language and other similar technical changes of very limited effect. The impact of the Act on consolidated returns was comparatively small. Subchapter S corporations were added to the list of corporations that were not allowed to file consolidated returns.\(^6^6\)

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\(^{6^5}\) Revenue Act of 1955, Sec. 5(a).

\(^{6^6}\) Technical Amendments Act of 1958, Sec. 64(d)(3).
The same Act increased the accumulated earnings credit from $60,000 to $100,000.67 In 1959 both Subchapter S corporations68 and life insurance companies taxed under Section 81169 were removed from the list of corporations that cannot be "includible corporations."

Two years later in 1961 real estate investment trusts were excluded from the definition of "includible corporations."70 However, the major change in 1961 involved the Western Hemisphere trade corporation deduction. The provision, specifying that the portion of consolidated surtax net income attributable to Western Hemisphere trade corporations should not be subject to the two percent penalty tax, was deleted. Instead, the consolidated taxable income is computed without regard to partially tax-exempt interest on obligations of the United States.71

Potential Era (1964 Act)

The Revenue Act of 1964 was the longest and most complicated tax law since the Internal Revenue Code of

67 Ibid., Sec. 205(a).
68 Revenue Act of 1959, Sec. 2(c).
69 Ibid., Sec. 3(f)(1).
70 Revenue Act of 1961, Sec. 10(j).
71 Ibid., Sec. 234(a).
1954 was adopted. President Kennedy recommended to Congress in February, 1963, a proposal to reverse the existing normal tax and surtax rates. The reversal would give small corporations with taxable income of $25,000 or less the benefit of a greater rate reduction than larger corporations would receive. He also recommended the elimination of the advantage of multiple surtax exemptions available to the large businesses operating through a chain of separately incorporated units. A single $25,000 surtax exemption would have to be divided among the members of the controlled group of corporations. The Treasury recommended that the dividends received deduction be increased to 100 percent for intercorporate dividends among parent-subsidiary corporations and that the additional two percent tax on consolidated returns be repealed.

The House Ways and Means Committee switched from the harsh single surtax exemption to a penalty tax system designed only to prevent multiple groups from increasing their tax advantage as a result of the normal and surtax


rate reversal. In order to retain the privilege of multiple surtax exemptions, each corporation in a controlled group was subject to a six percent additional tax on its taxable income not in excess of $25,000.74

In order to facilitate the adjustment to the six percent penalty of electing multiple surtax exemptions, Congress eliminated the two percent differential tax on consolidated returns. "Many affiliated parent-subsidiary groups, which now file separate returns in order to take advantage of multiple surtax exemptions, may find it advantageous in the future to file consolidated returns."75 Thus, the elimination of the two percent penalty tax placed corporations filing consolidated returns on the same footing for tax rate purposes as a single corporation operating through divisions. The elimination of the two percent additional tax and the penalization of the use of multiple surtax exemptions should greatly increase the number of taxpayers filing consolidated returns.

The two percent penalty tax was removed to encourage the filing of consolidated returns in order to serve as a brake on the expansion of the use of multiple surtax

74I.R.C. Sec. 1562.

75Hearings, supra, note 72, p. 81.
exemptions to gain tax advantage,76 but there was a more theoretical reason recognized by Congress. "The bill removes the special two-percent penalty tax on the privilege of filing a consolidated return, in part because the return of commonly controlled corporations as a single economic unit for tax purposes is in accord with the reality of the situation."77 Congress saw "no reason why where a group of commonly controlled corporations are willing to have their operations consolidated for tax purposes, the mere presence of more than one corporate organization in the group should result in any penalty tax."78

Congress felt that it would be inequitable to repeal the consolidated return two percent tax without also providing a 100-percent intercorporate dividends received deduction for corporations meeting the same test of ownership but which, for one reason or another, cannot or do not wish to file a consolidated return.79 Normally, a

77 Ibid.
78 Ibid.
79 Ibid., p. 75.
corporation receiving a dividend from a domestic corporation has an eighty-five percent dividend-received deduction; in other words, only fifteen percent of the dividend is taxable to the recipient. The elimination of this 7.2 percent intercorporate dividend tax in this type of parent-subsidiary relationship will extend to these groups one of the tax advantages generally available only to affiliated groups which file consolidated returns. "This amendment is designed to facilitate the adjustment to the elimination of multiple surtax exemptions in cases where the affiliated group does not, or cannot, file consolidated returns."  

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80 The effective rate is 7.2 percent (48 percent x 15 percent).

81 Hearings, supra, note 72, p. 81.
CHAPTER III

ELECTION TO FILE CONSOLIDATED TAX RETURNS

The preceding chapter showed how the consolidated return election entered the tax system and how it progressed to the present form. Once an election has been made, an affiliated group is subject to a myriad of rules and regulations. This chapter presents in meaningful form the major provisions of the current law dealing with the election and filing of consolidated tax returns, and discusses the eligibility requirements, both statutory and nonstatutory, for filing consolidated returns. The administrative rules for electing and filing consolidated returns are also analyzed. A discussion of accounting periods and methods, the declaration of estimated tax, and the agent for the subsidiaries will conclude the chapter.

Eligibility Requirements

In general, a consolidated return election is available only to certain groups of domestic corporations and
some specific Canadian or Mexican corporations called includible corporations. These corporations must be connected through stock ownership with a common parent corporation (which itself must be an includible corporation). The entire chain of affiliates is called an affiliated group.¹

The first task in determining the eligibility requirements of an affiliated group is to determine if the group is a controlled group. There are four classes of controlled corporations: a brother-sister controlled group, a combined controlled group, an insurance controlled group, and a parent-subsidiary controlled group.² A brother-sister controlled group consists of two or more corporations in which an individual, an estate, or a trust owns at least eighty percent of the total combined voting stock. This brother-sister controlled group cannot be an affiliated group.³ A combined controlled group is a group of three or more corporations in which one corporation is a parent corporation in a parent-subsidiary

¹I.R.C. Sec. 1501.
²I.R.C. Sec. 1563.
controlled group and is also a member of a brother-sister controlled group. An insurance controlled group is limited to certain types of insurance companies. Neither the combined controlled group nor the insurance controlled group may be an affiliated group.

In regard to consolidated returns, the parent-subsidiary controlled group is the most significant group. A parent-subsidiary controlled group is an arrangement in which a parent corporation owns at least eighty percent of the total combined voting power of all classes of stock entitled to vote, or at least eighty percent of the total value of shares of all classes of stock. The parent-subsidiary group is the only controlled group that may be an affiliated group and, therefore, is the only group which is permitted to file consolidated returns.

It should be noted, however, that all four types of controlled groups must apportion one surtax exemption among each member of the group or elect multiple surtax exemptions at the cost of an additional six percent tax on the first $25,000 of taxable income. But controlled

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4I.R.C. Sec. 1563(a)(1).
groups that are also affiliated groups have two additional alternatives available to them; they may elect to file consolidated returns, or elect to receive a 100 percent dividends received deduction.

The parent-subsidiary controlled group is the only controlled group that may file a consolidated return, but not all parent-subsidiary controlled groups are allowed to make the election. Only an affiliated parent-subsidiary controlled group is allowed to file consolidated returns. There are differences in the respective definitions of control in the affiliated parent-subsidiary controlled group and the nonaffiliated parent-subsidiary controlled group.

An affiliated parent-subsidiary controlled group consists of one or more chains of corporations connected through stock ownership. This control, for purposes of establishing the existence of an affiliated group, is defined as the ownership of at least eighty percent of the total voting power of all classes of stock entitled to vote, and at least eighty percent of each class of the nonvoting stock. The nonvoting stock is stock that is limited and preferred as to dividends.\(^5\)

\(^5\)I.R.C. Sec. 1504(a).
It may appear that for consolidated return purposes the definition of an affiliated group parallels the definition of a parent-subsidiary controlled group. However, a close examination will disclose a number of significant differences which make the definition of a parent-subsidiary controlled group broader and more inclusive than the definition of an affiliated group. The principal differences between the two definitions are as follows:

1) Stock held under an option is considered to be owned by the optionee for purposes of a parent-subsidiary controlled group.

2) Certain stock held by persons who are not members of the parent-subsidiary controlled group is excluded in computing the eighty percent requirements.

3) The eighty percent stock ownership test of a parent-subsidiary controlled group may be met either on voting power or on total value of stock; whereas, the affiliated group test is based on eighty percent of total voting power and eighty percent of each class of the nonvoting stock.

Includible Corporations. Since affiliated parent-subsidiary controlled groups are the only groups that are permitted to consolidate income, the second task in
determining eligibility to file a consolidated return is to ascertain which corporations are included within an affiliated group. All domestic corporations, except those specifically excluded by statute, qualify as includible corporations for consolidation purposes. Furthermore, Canadian or Mexican corporations that are organized solely for the purpose of complying with the laws of Canada or Mexico may, at the option of the domestic parent corporation, be considered as includible corporations. An includible corporation is defined by the statute to mean any corporation, except:6

1) corporations exempt from income tax under Section 501, such as charitable corporations, fraternal societies, or labor organizations;

2) life insurance companies and mutual insurance companies other than marine;

3) foreign corporations;

4) corporations entitled to the benefits of Section 931 by reason of receiving a large percentage of their income from sources within possessions of the United States;

6I.R.C. Sec. 1504(b).
5) corporations organized under the China Trade Act, 1922;

6) regulated investment companies and real estate investment trusts; and

7) unincorporated business enterprises electing to be taxed as domestic corporations under Section 1361.7

In regard to corporations entitled to the benefits of Section 931, a recent Revenue Ruling8 states that corporations meeting the requirements of both Section 921 and Section 931 may not be considered an includible affiliate within the meaning of the Code regardless of whether or not they choose to take advantage of the Section 931 exclusion. The Internal Revenue Service has stated that the legislative history of the predecessor of the Section 931 exclusion indicated clearly that Congress was describing a class of corporations to be

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7 Beware, Section 1504(b)(7) is not effective after January 1, 1969; P.L. 89-389, Section 4(b).

8 Rev. Rul. 65-293, 1965-49 C.B. 10. If eighty percent of a domestic corporation's gross income is from sources within a possession of the United States, the income from the possession is exempt from federal income tax. Fifty percent of the gross income must be received from the active conduct of a business, and the corporation must meet the eighty percent test for three successive years. The purpose of this exemption is to encourage the economic development of possessions of the United States. I.R.C. Sec. 931.
excluded from the term "includible corporations." A corporation doing business in possessions of the United States and satisfying the requirements of Section 931 is in a class of corporations specifically excluded from the term "includible corporations." Since the exclusions were intended to be mandatory, the fact that the corporation does not choose to take advantage of Section 931 does not change its status for purposes of consolidated returns.

Despite the provision excluding life insurance companies, a law subsequent to the forementioned provision allows two or more insurance companies to consolidate income if they comprise the entire group. That is, two or more domestic insurance companies of the same taxable character will qualify as includible corporations for their own group.\(^9\) Also, associations\(^10\) and trusts\(^11\) which are taxable as corporations may be includible corporations.

\(^9\)I.R.C. Sec. 1504(c); See also Ohio Farmers Indemnity Co. v. Commissioner, 108 F.2d 665 (6th Cir. 1940).

\(^10\)Pierce Oil Corp., 32 B.T.A. 429 (1935); California Brewing Association, 5 B.T.A. 347 (1926).

Foreign corporations generally do not qualify as includible corporations, but under certain limited circumstances a corporation organized under the laws of a contiguous foreign country (Mexico or Canada) may qualify. These special foreign corporations must be maintained solely for the purpose of complying, with respect to title and operation of property, with the laws of the country in which it is organized. The foreign affiliate may qualify only if 100 percent of its capital stock, other than directors' qualifying shares, is owned or controlled by a domestic corporation. A corporation meeting this 100 percent test may be treated as a domestic corporation, and, if it meets the usual eighty percent affiliation test, it will qualify as an includible corporation. In regard to Mexican corporations, the I.R.S. has taken the position that the ownership of real estate is the critical test for determining whether or not the subsidiary was formed to comply with local law. A favorable ruling might also be issued if the subsidiary has a long-term lease on real property in Mexico.

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12I.R.C. Sec. 1504(d); Booth Fisheries Co. v. Commissioner, 84 F.2d 49 (7th Cir. 1936).

Once a foreign corporation has satisfied the two preceding tests, its income can be consolidated with an affiliated group. This inclusion in a consolidated return makes the foreign affiliate eligible for percentage depletion. Also, taxes paid to a foreign country or to a possession of the United States by a foreign subsidiary included in a consolidated return are treated as if they were paid by a domestic corporation for purposes of the foreign tax credit. Furthermore, a foreign corporation included in a consolidated return is eligible to qualify for treatment as a Western Hemisphere trade corporation. A domestic parent and its foreign subsidiaries may each make deductible contributions on behalf of their employees to qualified employees' profit-sharing trusts of the affiliated group.

The question is sometimes raised as to whether a tax practitioner should follow the basic rule that an affiliated group cannot file consolidated returns if the common parent corporation is an ineligible corporation under Section 1504(b). Surprisingly, the answer to this

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question is negative.

A consolidated return cannot be filed where the affiliated group contains an ineligible common parent and subsidiaries owned directly by the parent. For example, if a China Trade Act corporation owns eighty percent of two subsidiaries ($S_1$ and $S_2$), the group cannot file consolidated returns.

Assume, however, that one of the subsidiaries ($S_1$) has the required eighty percent control of another subsidiary ($SS_1$). The first subsidiary ($S_1$) is deemed to be the common parent of an affiliated group that contains only itself and its subsidiary ($SS_1$). A consolidated return can be filed for this affiliated group ($S_1$ and $SS_1$), but the incomes of the ineligible common parent and its other subsidiary are not included in the consolidated income. The other subsidiary ($S_2$) may also acquire eighty percent of another corporation ($SS_2$), and this group is also eligible to file consolidated returns. For consolidated return purposes, both of these eligible affiliated groups are considered separate groups because they do not have an eligible common parent.

The lesson in tax planning is clear: An ineligible common parent which wishes to create additional includible
subsidiaries should give careful consideration as to whether the new subsidiaries should be owned by the parent or by one of its present subsidiaries. Using the same example as in the preceding paragraph, assume that group $S_1$ and $SS_1$ had substantial earnings and group $S_2$ and $SS_2$ had losses. The losses of $S_2$ and $SS_2$ could not be applied against the earnings of $S_1$ and $SS_1$ because the two groups are two separate affiliated groups. However, if $S_1$ and not the ineligible parent, had owned the stock of $S_2$, one consolidated return could have been filed by the four eligible corporations and the losses would have been offset against the earnings.

**Stock Ownership.** The ownership of at least eighty percent of the voting power of all classes of stock and an equivalent percentage of each class of the nonvoting stock is required as a condition to affiliation. The term "stock" does not include nonvoting stock that is limited and preferred as to the dividends.\(^{17}\) Treasury stock is similarly ignored,\(^ {18}\) and stock held by a subsidiary of the issuing company is treated as treasury

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\(^{17}\)I.R.C. Sec. 1504(a).

\(^{18}\)Borg v. International Silver Co., 11 F.2d 147 (2nd Cir. 1925).
How many links are necessary to constitute a chain of includible corporations? The statute merely defines an affiliated group as one or more chains of includible corporations, and there have been no court cases concerning the number of links necessary to constitute a chain. In litigation on the similar definition of a controlled group, a taxpayer argued that a parent and a single subsidiary did not constitute a chain. The Tax Court relied on the reason and purpose of the statute and held that a parent and one subsidiary do constitute a chain.  

Determining whether preferred stock, under particular circumstances, is nonvoting or voting stock may cause many problems in applying the ownership test. If the preferred stock is "nonvoting stock which is limited and preferred as to dividends," it will be excluded in

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22 I.R.C. Sec. 1504(a).
determining the eighty percent affiliation test. In determining whether the stock is limited as to dividends, collateral agreements as to dividends are considered.\textsuperscript{23} Contingent voting rights are generally ignored until the contingency materializes. The principle is well established that if full voting rights are conditional upon the occurrence of some future event, then such stock will be considered nonvoting.\textsuperscript{24} The rationale underlying this rule is that the holders do not have any real participation in the management of the company until default has occurred. Suppose, however, that nonvoting preferred stock acquires full voting rights as a result of passed dividends. In this case, if the holders of the preferred stock possess equal voting rights with the common stock, the preferred stock must be considered in determining whether the requisite ownership tests have been met.\textsuperscript{25}

The Tax Court has held, however, that where the holders of nonvoting preferred stock can convert it into

\textsuperscript{23}Pioneer Parachute Co., Inc. v. Commissioner, 162 F.2d (2nd Cir. 1947).

\textsuperscript{24}Pioneer, supra, note 23; Vermont Hydro-Electric Corp., 29 B.T.A. 1006 (1934).

\textsuperscript{25}Pantlind Hotel Co., 23 B.T.A. 1207 (1931); Vermont, supra, note 24.
common stock on demand, the preferred stock should be treated as voting stock.\textsuperscript{26} Also, voting preferred stock must be taken into consideration in determining affiliation even though it is redeemable at any time.\textsuperscript{27}

In general, voting stock is deemed to be any stock that participates in the election of directors. In one case the Tax Court ruled that the privilege to elect one out of seven directors was sufficient cause for classifying preferred stock as voting stock. The First Circuit Court overruled the Tax Court and held that preferred stock which possessed voting rights other than in the election of directors of the company is nonvoting stock: "Congress . . . had in mind stock which had no vote in the election of directors of the corporation."\textsuperscript{28} The Internal Revenue Service later ruled that "participation in the management of the subsidiary corporation through election of the board of directors is considered the criterion of voting power."\textsuperscript{29}

\begin{itemize}
  \item[^26] Pantlind, supra, note. 25.
  \item[^28] Erie Lighting Co. v. Commissioner, 93 F.2d 883 (1st Cir. 1937), rev'g 35 B.T.A. 906 (1937).
  \item[^29] I.T. 3896, 1948-1 C.B. 72.
\end{itemize}
It is possible for voting rights to be so limited that the stock is considered to be nonvoting stock\textsuperscript{30} but, in the absence of specific evidence, stock will not be presumed to be nonvoting merely because the holders have failed to exercise their voting rights.\textsuperscript{31} Also, if the preferred stockholders are entitled to vote under the laws of the state in which the corporation is organized, the stock is treated as voting stock even though the corporation's articles of incorporation provide that its preferred stock has no voting power.\textsuperscript{32}

A recent Revenue Ruling\textsuperscript{33} held that unexercised warrants to purchase stock do not constitute stock ownership for purposes of consolidated returns. It was ruled that the warrants should not be taken into consideration in determining whether the corporations involved constitute an affiliation. In the example cited by the I.R.S., the parent owned slightly over eighty percent of

\begin{itemize}
  \item \textsuperscript{30}Shillito Realty Co. v. Commissioner, 39 F.2d 830 (6th Cir. 1930).
  \item \textsuperscript{31}Atlantic City, supra, note 27.
  \item \textsuperscript{32}Rudolph Wurlitzer Co. v. Commissioner, 81 F.2d 971 (6th Cir. 1936), cert. den. 298 U.S. 676, 80 L.Ed. 1937, 56 S.Ct. 940 (1936).
  \item \textsuperscript{33}Rev. Rul. 64-251, 1964-1 C.B. 338.
\end{itemize}
the only class of stock of the subsidiary. The subsidiary later issued warrants to investors for the purchase of a certain amount of its treasury stock which, if added to the outstanding shares of the subsidiary's stock, would dilute the parent's interest to less than eighty percent. The warrants were exercisable anytime within five years and conferred no rights or liabilities as shareholders prior to exercise of the warrants.

The Code's stock ownership rules stipulate direct ownership of the requisite percentage of stock. In general, stock must be owned directly (or through a nominee) and beneficially by the corporation. The ownership tests are applied in terms of a percentage of voting power, rather than in terms of a number of shares. Such ownership requirement cannot be satisfied by beneficial ownership, by domination or control over the owners, or by the legal means to enforce control. Direct ownership still exists even if the stock has been transferred into

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34 I.R.C. Sec. 1504(a).


the name of a nominee. In addition, direct ownership was found to exist although part of the stock of the subsidiary had been placed in the name of an individual to enable him to pledge it as collateral for a personal loan (he gave the proceeds to the parent corporation). The Tax Court indicated that the ownership of stock through a voting trust was not the equivalent of direct ownership for purposes of the stock ownership requirement for consolidated returns.

Direct ownership must be beneficial ownership. A parent corporation is not entitled to file a consolidated return with another corporation owned by its president even though the president purchased the stock from the other corporation with the parent's funds. The Tax Court rejected the argument that the parent was the beneficial owner of the shares owned by the president under a resulting trust, and asserted that the president's use of corporate funds to buy stock of the other

37Macon, D. & S. R. Co., 40 B.T.A. 1266 (1939); Farmers & Merchants Bank, 10 B.T.A. 447 (1928).

38Dome Co., 26 B.T.A. 967 (1932).


corporation (the funds were taxed to him as constructive dividends) did not convert the parent corporation into a stockholder of the other corporation.

A similar case held that a corporation holding stock of another company as trustee for its own preferred stockholders did not directly own the stock in question.\textsuperscript{41} Likewise, a corporation contracted to purchase a portion of its own stock, and the stock was held in escrow as collateral security for the purchase price. The Second Circuit Court held that the stock held in escrow should be considered in determining whether another corporation owned the necessary percentage of the outstanding stock to establish affiliation.\textsuperscript{42} A parent corporation had direct ownership of the stock of another corporation when it purchased the stock under terms which placed the stock in escrow as security for the purchase price and the parent corporation retained all rights of ownership, including voting rights. Thus, stock ownership is considered direct as long as the corporation has all of

\textsuperscript{41}\textit{West Boylston Manufacturing Co. of Alabama v. Commissioner}, 120 F.2d 622 (5th Cir. 1941).

\textsuperscript{42}\textit{Doernbecher Manufacturing Co. v. Commissioner}, 80 F.2d 573 (9th Cir. 1935).
the ownership rights in the stock. This is true even if the stock is placed in escrow as a security device.

In another case, the formality of transferring stock to a new owner on the corporate books was held not to be a prerequisite of direct ownership. Likewise, the failure of a newly organized subsidiary to issue its stock to its parent does not defeat affiliation. On the other hand, an option to purchase stock does not represent ownership.

It is possible that direct ownership of the stipulated percentage of stock is not enough to satisfy the stock ownership test. In one interesting case, it was ruled that the ownership of the entire capital stock did not constitute the required control. The parent owned only a nominal amount of capital stock in relation to debt owned by nonmembers, and the Tax Court held that there was insufficient "equity interest in the subsidiary to meet the stock affiliation requirements of the statute."

46 Bay State Securities Co., 3 B.T.A. 43 (1925).
Advances from the prior parent "have all the earmarks of capital contributions—and hence could constitute another class of stock." Thus, the Tax Court indicated that the thin incorporation concept can be applied to a subsidiary in determining whether or not the eighty percent ownership test is met.

Affiliated Status. "Affiliation is a question of fact and a statutory status, the determination of which depends upon the evidence in each case. . . ." The existence of affiliation is determined separately for each year: "... the failure of a taxpayer to establish for one year the facts prescribed by the statute cannot operate to prevent a full presentation of the facts for a subsequent year." If there are no changes in the facts or the law, the same result should be expected from one year to the next.

48 Ibid., p. 352
49 West Huntsville Cotton Mills Co., 22 B.T.A. (1931); See also, Wadhams & Co. v. U.S., 7 AFTR 9010 (Ct. Cl. 1929); Detour Dock Co., 22 B.T.A. 925 (1931); New Jersey Machinery Exchange, 4 B.T.A. 628 (1926).
51 Canyon Lumber Co., supra, note 50.
52 550 Park Avenue Corp., 20 B.T.A. 288 (1930).
A consequence of the fact that affiliation must be determined anew each year is that the Internal Revenue Service is not bound by its rulings as to affiliation in later years.\(^{53}\) Furthermore, the mere fact that the I.R.S. requires the filing of a consolidated return in one year does not allow a taxpayer to establish affiliation in the next year.\(^ {54}\)

An affiliated group continues in existence if the common parent corporation remains as the common parent and at least one subsidiary remains affiliated. It does not matter whether the subsidiary was a member of the group in a prior year nor whether one or more corporations have ceased to be subsidiaries at any time after the group was formed.\(^ {55}\) In *Union Electric Company of Missouri v. U.S.*, the Court ruled that an affiliated group terminates during the year when the parent no longer has a subsidiary affiliated with it.\(^ {56}\)


\(^{54}\) West Huntsville Cotton Mills Co., 22 B.T.A. 1216 (1931).

\(^{55}\) Reg. 1.1502-75(d)(1); Rev. Rul. 57-294, 1957-2 C.B. 176.

\(^{56}\) 305 F.2d 850 (Ct. Cls. 1962).
The common parent remains the common parent irrespective of a mere change in its identity, form, or place of organization. An affiliated group will not necessarily be terminated even though the parent ceases to exist, if:

1) the members of the affiliated group succeed to and become the owners of substantially all of the assets of the former parent, and

2) there remains one or more chains of includible corporations connected through stock ownership with a common parent which is an includible corporation and which was a member of the group prior to the date the former parent ceases to exist.

Apparently this new Regulation precludes the termination of an affiliated group by a downstream merger, an "F" reorganization, or a "D" reorganization with other members of the group.

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57 Reg. 1.1502-75(d)(2)(i); See I.R.C. Section 368(a)(1)(f).

58 Reg. 1.1502-75(d)(2)(ii).

59 However, Rev. Rul. 55-724, 1955-2 C.B. 581 stipulated that a merger of a parent into a subsidiary created a new affiliated group. This old ruling is apparently no longer valid.
If a common parent of one group merges into the common parent of another group, the smaller group may be treated as terminated and the larger held to continue even though in form the larger common parent is merged into the smaller.\(^{60}\) This reverse acquisition occurs when a corporation (L) acquires the stock of another corporation (C) in a transaction in which C becomes a subsidiary in a group of which L is the common parent, or Corporation L acquires substantially all of the assets of C. In either case, the stock or assets acquired by L are actually paid for by the stock of L and if C's shareholders own more than fifty percent of the fair market value of L's outstanding stock, a reverse acquisition has taken place. Thus, if a reverse acquisition transpires, any affiliated group of which C was the common parent (the C group) is considered to remain in existence (with L becoming the common parent), but any group of which L was the common parent is treated as having terminated.\(^{61}\)

\(^{60}\)Reg. 1.1502-75(d)(3)(i). This reverse acquisition concept was introduced in the recent Regulations; it is the third of a trilogy of concepts limiting the use of loss carryovers in consolidated returns.

\(^{61}\)Ibid.
The opposite result may transpire in an acquisition. The C group may be treated as continuing in existence with L becoming the common parent, and the L group ceases to exist.

The first test is to determine if L and any members of L's group have continuously owned, for a period of at least five years ending on the date of the acquisition, an aggregate of at least twenty-five percent of the fair market value of the outstanding stock of C. If the answer is positive, the second test is in order. This test requires the determination of the percentage of the fair market value of the outstanding stock which belongs to L after the acquisition. This percentage of ownership of outstanding stock can be calculated by the use of the following formula:

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\frac{\text{Fair Market Value of Outstanding Stock of C}}{\text{Fair Market Value of C's Stock Owned by L}} = \frac{C_i}{m} \times \frac{\text{Fair Market Value of C's Stock Owned by L}}{\text{Fair Market Value of Outstanding Stock of C}}
\]

*Each factor in the formula is before acquisition.

The third test is to determine whether or not the former individual stockholders of C own, immediately after acquisition, more than ten percent of the fair market
value of the outstanding stock of L as a result of owning stock of C. If C's former stockholders own more than ten percent of the fair market value of the outstanding stock of L after acquisition (as a result of owning stock of C), the group of which C was the common parent remains in existence and L is the common parent. The group of which L was the common parent ceases to exist. 62

For example, assume that corporation L has owned corporation C's stock having a fair market value of $100,000 for six years, and that L acquires the remaining stock of C from individuals in exchange for stock of L. Furthermore, immediately before this acquisition the total outstanding stock of C had a fair market value of $150,000, and the total outstanding stock of L had a fair market value of $200,000. Which group will cease to exist after the acquisition, and which company will be the parent?

The first test results in a positive answer. L has continuously owned, before the acquisition, an aggregate of at least twenty-five percent of the fair market value of C. ($\frac{100,000}{150,000} \geq 25\%$). In the second test, L is treated as owning forty percent of the fair

market value of its own outstanding stock as determined by the following:

$$\frac{\$150,000}{\$200,000 + \$50,000} \times \frac{\$100,000}{\$150,000} = 40\%$$

Finally, the application of the third test shows that the former individual stockholders of C do own more than ten percent of the fair market value of the outstanding stock of L as a result of owning stock in C (40% > 10%). Therefore, the group of which C was the common parent will be treated as continuing in existence with L as the common parent. The group of which L was the common parent before the acquisition ceases to exist.

Since the term "reverse acquisition" is a broadly defined term, tax practitioners should examine carefully any transaction in which there is a significant change in ownership of the common parent of an affiliated group to see if a reverse acquisition has occurred. Some of the most likely candidates for special scrutiny are the following:

1) statutory mergers (C into L),
2) Section 351 transactions (C's shareholders give their stock to L in exchange for L's stock),
3) asset acquisitions (L gets C's assets in exchange for L's voting stock), and
4) a stock reorganization (L obtains eighty percent of C's stock in exchange for L's voting stock).

Mere inactivity on the part of a corporation does not necessarily exempt it from being an affiliate. The failure to issue stock may not defeat affiliation, but the lack of a sound business purpose may deny an affiliation.

**Sound Business Purpose.** The doctrine of business or corporate purpose had its genesis in the landmark case of *Gregory v. Helvering*. This case involved a corporate reorganization which precisely met the language of the tax law. The Supreme Court held that escape of taxation cannot be the sole motive for a transaction, but that a business or corporate purpose must be present. This principle laid down in the *Gregory* case is not limited to corporate reorganizations, but applies to Federal taxing statutes in general. A business purpose

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65 69 F.2d 809 (2nd Cir. 1934), aff'd 293 U.S. 465 (1935).

is required in many areas, and the Commissioner has not overlooked the temptation to apply it in the consolidated return area. Although a corporation may technically be a member of an affiliated group for purposes of filing a consolidated return, it may be denied such status if there was no business purpose for its acquisition, or if the principal purpose of the acquisition was to avoid taxes.

The sound business purpose test has been applied mainly in situations where an acquisition was undertaken for the purpose of obtaining the benefits of built-in advantages, such as net operating loss carryovers. The recent Regulations contain a trilogy of concepts designed to limit the use of loss carryovers in consolidated returns, but certain acquisitions of a loss group may avoid these three snares. Thus, the Commissioner may still use the business purpose test to deny the privilege of filing consolidated returns where the privilege was used solely to secure built-in benefits. However, there have been no court cases subsequent to the issuance of

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68These three concepts, Separate Return Limitation Year (SRLY), Consolidated Return Change of Ownership (CRCO), and Reverse Acquisition are explained in Chapter V.
the new Regulations. Therefore, all analyses involving sound business purposes and consolidated returns must be tempered with the realization that all court cases preceded the three new concepts that limit the use of carryovers in the consolidated return area.

The landmark case that superimposed the business purpose test upon consolidated returns was J. S. and A. B. Spreckels Co. The stock of the taxpayer and the stock of another corporation, J. C. & A. B. Spreckels Securities Company, were owned by the Spreckels family. The latter corporation in turn owned all of the capital stock of the Savage Tire Company. In 1932 the tire company contracted to sell its plant at a loss of $192,000. In order to qualify under a new definition of affiliation and to obtain a deduction on a consolidated return for the capital loss, the taxpayer purchased the stock of the tire company from the securities company a few hours before the consummation of the sale of the plant. The Commissioner objected and the Board of Tax Appeals upheld him. The Court asserted that the

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69 41 B.T.A. 370 (1940).

70 The Revenue Act of 1928 restricted affiliation to corporations in a parent-subsidiary relationship (thereby disqualifying brother-sister corporation); Revenue Act of 1928, Section 142(c).
taxpayer's "ownership of the stock of the Tire Co. did not serve a business purpose, as distinguished from a tax-reducing purpose . . . . [and for that reason] held that the Tire Co. was not a member of the affiliated group."\(^{71}\)

Although the Court's rationale in the *Spreckels* decision was not necessarily accurate, its reasoning was as follows:

It is apparent that the privilege to file a consolidated return was granted in order that the tax liability of a group of corporations which were combined for business purposes into one business unit might be based upon the true net income of the business unit . . . . It is believed that they did not intend that the privilege be enjoyed in cases where that affiliation relied upon as the basis for the privilege to make a consolidated return is without a business purpose.\(^{72}\)

An assessment of the legislative intent, however, shows that the only prerequisite for affiliation, and the resulting qualification for consolidated returns, was the requirement of stock ownership. Congress believed that consolidated returns should be filed "where one corporation owns at least ninety-five percent of the

\(^{71}\) *J. D. and A. B. Spreckels Co.*, 41 B.T.A. 375 (1940).

stock of another corporation. . . "73 At no point did Congress give the Commissioner the power to prescribe Regulations making a business purpose a prerequisite of consolidation. 74

The application of the business purpose test to deny the right to file consolidated returns in the Spreckels case was wholly unjustified. The Court felt that the taxpayer was attempting to take advantage of a built-in loss. However, the Court would have obtained the same result without promulgating a business purpose test. The Court could have denied the deduction on the grounds that the administrative policy change in the definition of affiliated group forbade it to inquire whether the taxpayer would be entitled to the preacquisition loss of the acquired corporation by virtue of their being owned by the same interest. "Rather than being a general test of the propriety of consolidated returns, 'business purpose' should be no more than a test for determining whether preacquisition losses may be offset against the


74 Ibid., p. 15.
postacquisition income of an affiliated corporate group."

Even if the business purpose doctrine was justifiably applied in the Spreckels case, it should no longer be appropriate as a test of affiliation. The Spreckels doctrine should no longer exist because it was actually the predecessor of Section 269. "That case [Spreckels] arose before the enactment of Section 129 [now Section 269], but in effect the criteria of business purpose and tax evasion of Section 129 were applied." Section 269 of The Internal Revenue Code provides that a deduction, which is unavailable to a taxpayer except for the purpose of acquiring control or assets of a corporation, shall be disallowed if the acquisition was made for the "principal purpose" of avoiding income tax by securing the benefits of such deduction. The stated objectives of the "principal purpose" test are "to prevent the tax liability from being reduced through the distortion or perversion effected through tax avoidance devices" and "to put an end promptly to any market for, or dealings in, interests...


76 Hawaiian Trust Co., Ltd. v. U.S. 291 F.2d 769 (9th Cir. 1961).
in corporation or property which have as their objective the reduction through artifice of . . . tax liability."\(^77\)

Although the Ninth Circuit Court in 1957 affirmed the disallowance of a consolidated return on the grounds that there was a lack of business purpose,\(^78\) it recently implied that the business purpose test does not exist and that the sole criterion is whether the acquisition of a subsidiary violates Section 269.\(^79\) Also, *Naeter Brothers Publishing Co.*\(^80\) demonstrates that the business purpose test has lost much of its vitality, for in this case the Court went out of its way to find a business purpose. The business purpose of the acquisition approved by the Court was that affiliation would enable the group to submit consolidated financial statements to creditors. The presentation of total group assets and the elimination of intercompany debt and other transactions would "present a more favorable picture for purposes of obtaining bank credit."\(^81\) The Court failed to point out that

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\(^78\)American Pipe & Steel Corporation, 25 T.C. 351 (1955), aff'd 243 F.2d 125 (9th Cir. 1957).


\(^80\)42 T.C. 1 (1964).

\(^81\)Ibid., p. 7.
these same financial statements could be prepared for the group even if they were not affiliated for tax purposes. Many businesses maintain two separate financial records—one for tax purposes and one for business purposes. Consolidated financial statements simply combine the financial data of two or more entities for informational purposes and ownership of the entities is irrelevant.

The Tax Court stated in 1958 that stock ownership was the only test of affiliation. "The statutes prescribe no test of affiliation other than stock ownership. Even if Fox's primary interest was to reduce his own tax liabilities by offsetting the probable losses from the Post [Post Publishing Company] against the expected income from the dividends and gas leases through the means of a consolidated return, that is a legitimate purpose and the action is authorized by the statutes."82

The Supreme Court had the following to say in 1955:

But the rule that general equitable considerations do not control the measure of deductions or tax benefits works both ways. It is as applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is

82John Fox, 27 T.C.M. 205 (1958).
fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an expected windfall.\textsuperscript{83} \textsuperscript{1} emphasis added/}

It would appear that the Supreme Court retreated, somewhat, from the stand it took in the Gregory case.\textsuperscript{84} The Gregory doctrine or the doctrine of purpose was, of course, promulgated to prevent taxpayers from hiding behind statutory language that may have had literal but no real relevancy.

There are some discouraging signs which indicate that the business purpose principle is still a test of affiliation. First, Congress indicated, while passing Section 269, that it was a supplement to the sound business purpose doctrine. "Since the objective of this section is to prevent the distortion through tax avoidance of the deduction, credit, and allowance provisions, the section does not abrogate or delimit, but supplements and extends, the present provisions of the code, and the principles established by judicial decisions, having the effect of preventing the avoidance


\textsuperscript{84}The Supreme Court may have simply been confused and reverted to pre-Gregorian language.
of taxes."\(^{85}\) Second, a precedent was established in the *Spreckels* case, and an array of court cases have recognized and reinforced the business purpose test.\(^{86}\)

Since stock ownership is the only statutory test of affiliation, there is some doubt as to whether the *Spreckels* doctrine should continue to be used as a test of affiliation. The Commissioner has the power to "prescribe such regulations as he may deem necessary."\(^{87}\) Therefore, he can use the "principal purpose" test of Section 269 to deny the acquiring corporation (or its affiliated group) the opportunity to offset income with preacquisition losses of a subsidiary which was acquired merely for tax purposes.\(^{88}\) It does not seem equitable to allow the Commissioner to make a twofold attack on affiliation by giving him the power to deny affiliation


\(^{87}\)I.R.C. Sec. 1502.

\(^{88}\)The Commissioner has been having some success in denying postacquisition losses, as opposed to preacquisition losses.
on the grounds that no business purpose was served and to determine if the principal purpose of purchasing a subsidiary was avoidance under Section 269.

**Tax Planning for a Sound Business Purpose.** This assertion that ownership is the only test of affiliation may be purely academic since most of the courts are applying the business purpose doctrine to affiliated groups. A more realistic approach, therefore, is to assume that the doctrine is applicable and take the necessary steps to avoid the Commissioner's attack. The natural question is: what actions and precautions can be taken by an affiliated group to assure that the consolidated returns election will not be disallowed?" 

The taxpayer must show that the affiliation serves a business purpose and that the principal purpose for purchasing the affiliate was not to avoid income taxes. "Though, of course, it is well recognized that a corporate entity will ordinarily be respected, it is equally settled that this is not true under many circumstances, and where upon examination of all the circumstances it becomes clear that a true business function was not served

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by the corporate entity, it should not be respected."\textsuperscript{90} However, "conditions must exist which warrant the conclusion that a particular organization served \textbf{no actual business purpose}."\textsuperscript{91}

A sound business purpose for the acquisition of a company must be present at the time of the purchase. The taxpayer must prove that the purpose existed at the date of the acquisition. "The controlling intention of the taxpayer is that which is manifested at the time ... not subsequently declared intentions which are merely the products of afterthoughts."\textsuperscript{92} Thus, the weight of authority as to whether a group can affiliate depends upon the intent of the purchase. This intention is gleaned from the surrounding circumstances.

Adequate tax planning necessitates the creation of supporting documentation which evidences the business reasons for an acquisition. It is probably wise not to rely on only one or two purposes, for the presence of a number of factors will materially strengthen the position of the taxpayer in the event of a judicial proceeding.

\textsuperscript{90}Thomas K. Glenn, 3 T.C. 328 (1944).

\textsuperscript{91}Hebert v. Riddell, 103 F.Supp. 369 (D.C. Cal 1952).

\textsuperscript{92}Smoot Sand and Gravel Corp. v. Commissioner, 241 F. 2d 197 (4th Cir. 1957).
Diversification may be a legitimate business purpose and the most common reason for acquiring a subsidiary. Diversifying by getting into the aluminum window and aluminum partition business was upheld by the Tax Court as a sound business purpose. Likewise, the Ninth Circuit reversed a lower court and upheld consolidated returns where the principal purpose of an acquisition was to sell butane not then used by the acquirer. However, in *American Pipe and Steel Corporation* the taxpayers wanted to use an affiliate as an outlet for the disposition of surplus gas tanks. The newly acquired outlet would also improve the taxpayer's position in the sale of pipe and casting in real estate developments. The Tax Court disallowed these business purposes and the Ninth Circuit affirmed the decision. These purposes would probably have been upheld, however, if the purchased assets had not been sold immediately after the acquisition.

If a subsidiary is purchased for a legitimate business purpose, the purpose should actually be pursued and the

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94 *Hawaiian Trust Co., Ltd. v. U.S.*, *supra*, note 79.

95 *American Pipe & Steel Corporation*, *supra*, note 78.
subsidiary should not be immediately liquidated. The Ninth Circuit in *Hawaiian Trust Co., Ltd. v. U.S.*[^96] was impressed because the affiliated group did not plan to liquidate the new acquisition at the time of the purchase. Likewise, in another case the Tax Court noted that the taxpayer waited from 1954 to 1958 before the subsidiary was sold.[^97] In two cases liquidation arrangements were made before the acquisition and liquidation occurred several days thereafter.[^98] A third case reveals that the purchased assets were sold immediately after acquisition.[^99] In all three of these cases the courts would not accept the business purposes. Thus, plans should not be made to liquidate a subsidiary until at least several years after its acquisition.

Whenever a purchased subsidiary has prior operating losses it is imperative for the taxpayer to have confidence in his ability to restore the affiliate to a level


[^99]: *American Pipe & Steel Corporation*, supra, note 78.
of profitable operations. "It does not appear that any serious effort was ever made to operate Mellody Mills at a profit, and, in fact, the mounting operating losses of the corporation indicate otherwise."\(^{100}\) In one case the taxpayer was aware of the losses and felt that they were the result of the "unbusinesslike methods" of prior management. The acquiring taxpayer believed that with the facilities of the parent these "unbusinesslike methods" could be overcome and that the operations could be put on a profitable basis. Members of the parent's staff spent a considerable amount of time at the affiliate in an attempt to make it successful. The business purpose was upheld.\(^{101}\)

In a similar case, the Tax Court was impressed by the fact that postacquisition losses were reduced from the preacquisition losses.\(^{102}\) Also, the First Circuit asserted, in another case, that no attempt was made to restore a subsidiary to profitable operations. The Court was displeased with the fact that the parent company had

\(^{100}\)Book Production Industries, Inc., 24 T.C.M. 353 (1965).

\(^{101}\)Virginia Metal Products, Inc., supra, note 93.

had no experience in the subsidiary's type of business.\textsuperscript{103}

It would appear that a parent must show evidence that the losses are temporary and an attempt must be made to restore the affiliate to profitable operations. "There is no indication that the petitioner had any plan or bona fide intention to recognize or rehabilitate the subsidiary with a purpose of continuing the business. . . . Congress . . . undoubtedly had in mind a true affiliation which would serve a business purpose."\textsuperscript{104} The introduction of a cost accounting system, reduction in operating expenses, improvements in technology, and elimination of overlapping business operations are only some factors that should indicate that the goal is to rehabilitate a subsidiary. But the belief in financial soundness of a subsidiary merely because similar operations were operating successfully throughout the United States at this time, does not establish a business purpose.\textsuperscript{105}

To allow the parent to establish a new business, to prevent the bankruptcy of the acquired subsidiary, and

\textsuperscript{103}R. P. Collins & Co., Inc. v. U.S., supra, note 86.

\textsuperscript{104}\textit{Hunter Manufacturing Corp.}, 21 T.C. 424 (1953).

\textsuperscript{105}\textit{Elko Realty Co.}, 29 T.C. 1012 (1958), aff'd 260 F.2d 949 (3rd Cir. 1958).
to prevent losses to persons who had invested in the acquired company have been upheld as business reasons for acquiring a subsidiary. However, "the acquisition of the additional shares to enable it to liquidate its subsidiary promptly and without possible interference from minority stockholders was not a legitimate business purpose." Also, the avoidance of labor problems does not establish a business purpose for the acquisition and treatment of a subsidiary as a member of an affiliated group. In Book Production Industries, Inc., a labor consultant suggested that a particular division should be separated from the main plant in order to avoid labor trouble. The separation was undertaken, but the court ruled that advice given to avoid a union drive could not be transferred into a business purpose for affiliation.

Consolidation was upheld where it presented a more favorable picture for purposes of obtaining bank credit. The mere fact that an insurance company had requested

10824 T.C.M. 339 (1965).
consolidated balance sheets and income statements was sufficient to withstand the attack of the Commissioner.\footnote{110} A taxpayer should, however, avoid asserting that a consolidated return is being filed in order to permit the parent to retain more profits which can be advanced to an unprofitable subsidiary (as a result of offsetting the parent's earnings against the subsidiary's losses).

The best tax plan may be to disregard the tax aspects of an acquisition until after the purchase has been effected. Although this seemingly paradoxical statement is the antithesis of the general tax planning advice, in \textit{Hawaiian Trust Co., Ltd. v. U.S.}\footnote{112} no consideration was given to the tax aspects of an acquisition at the time of the purchase. The Ninth Circuit Court was impressed by the fact that the company waited until the following month before obtaining advice on the tax aspects of the transaction.

Notwithstanding the preceding case, contemporary evidence of motivation should be preserved. "Nowhere in

the record can we find any convincing indicia of business motive, good faith, intent, or anything else that might erase the surface impression of a tax dodge." The minutes may be an excellent place to show the motivation of a transaction. "The usual place to find such a policy expressed is in the corporate minutes. No such expression exists here." The business advantages of a particular transaction can be explained in the minutes, but any tax advantages should be omitted.

"An ounce of prevention may save a pound of worry," is appropriate advice for the business purpose area. Management should have a sound business purpose for any course of action, and if a purpose is lacking, a tax adviser will have difficulty in developing, retroactively, an acceptable motivation for a completed transaction.

Administrative Rules

Now that the eligibility requirements have been explained, it is appropriate to explain the rules and regulations that an affiliated group must follow. The

113 Roughan v. Commissioner, 198 F.2d 253 (4th Cir. 1952).

114 Earle v. Woodlaw, 254 F.2d 119 (9th Cir. 1957).

consolidated return Regulations should be mentioned since the rules governing consolidated returns are derived mainly from the Regulations as interpreted by the courts and the Internal Revenue Service.

Consolidated Return Regulations. The Internal Revenue Code gives the Commissioner broad authority to prescribe Regulations governing the filing of consolidated returns. This broad delegation of power by Congress to the executive branch probably resulted from three factors. First, the 1928 Act extended to the Commissioner broad powers to promulgate Regulations. This was a constitutional delegation of power to the Commissioner. Second, in the same Act, Congress required all members of an affiliated group to consent to the consolidated return Regulations before a consolidated return could be filed. Third, Congress developed a laissez-faire attitude toward the consolidated return area because of the complexity of the

116 I.R.C. Sec. 1502.
117 I.R.C. Sec. 141(b), 1939.
118 S. Slater & Sons, Inc. v. White, 119 F.2d 839 (1st Cir. 1941).
119 I.R.C. Sec. 141(a), 1939.
subject—leaving to the Regulations the complex problem of adapting the income tax to consolidated returns. As a result of this delegation of power, the Commissioner has promulgated a Pandora's box of rules and regulations that fill about forty-five pages of close type. In contrast, the Internal Revenue Code contains only five or six sections dealing with consolidated returns.121

Both the statute122 and the Regulations123 require all members of the affiliated group to consent to the consolidated return Regulations. Although the statute states that the making of a consolidated return shall be considered a consent to the Regulations, the Regulations themselves require each subsidiary to file Form 1122 (a consent to the Regulations) for the first consolidated return year.124 This requirement of consent is predicated

120"The Committee believes it is impracticable to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations. Accordingly, it has found it necessary to delegate power to the Commissioner to prescribe regulations legislative in character covering them." S.R. No. 960, 70th Congress, 1st Sess., p. 15 (1928).

121I.R.C. Sec. 1501-1504, and 1552.
122I.R.C. Sec. 1502.
123Reg. 1.1502-75(a)(1).
124Tbid.
on the legal proposition that the filing of consolidated
returns is a privilege, not a right.125

Notwithstanding their consent to the Regulations,
the members of an affiliated group are not prevented from
challenging the validity of the Regulations where the
issue is one of statutory interpretation. Generally, a
taxpayer must show that the Regulations are invalid or
inconsistent with the statutes in order to successfully
make such a challenge.126 "The authority of the
Commissioner to make regulations is admittedly broad . . .
this does not mean, however, that there is power in the
Commissioner to amend the statute or to require surrender
of any part of the statutory provisions as a condition
to the grant or permission to file a consolidated
return."127

The statutory sanction for the Regulations does not
elevate them to a point where they are more applicable

125Export Leaf Tobacco Co. v. Commissioner, 78 F.2d
163 (2nd Cir. 1935), cert. den. 296 U.S. 627, 80 L.Ed.
446, 56 S.Ct. 150 (1935).

126American Trans-Ocean Nav. Corp. v. Commissioner,
229 F.2d 97 (2nd Cir. 1956); Corner Broadway-Maiden Lane,
Inc. v. Commissioner, 76 F.2d 106 (2nd Cir. 1935).

127Commissioner v. General Mach. Corp., 95 F.2d 759
(6th Cir. 1938).
than an Act of Congress.\footnote{Kanawha Gas and Utilities Co. v. Commissioner, 214 F.2d 685 (5th Cir. 1954).} A challenge was successfully maintained where the Commissioner introduced no evidence or testimony to indicate the purpose of a section in the Regulations.\footnote{Joseph Weidenhoff, Inc., 32 T.C. 120 (1959).} However, it is not wise to prepare consolidated returns in a manner contrary to the Regulations, for the successful challenges to the Regulations have not been numerous. "A clear showing must be made of authority to cut across such Regulations and to reach a result other than that spelled out by the Regulations."\footnote{American Water Works Co., Inc., 25 T.C. 903 (1956).}

**Filing of Consolidated Returns.** As was previously mentioned, the election to file a consolidated return is a privilege, not a right. For the first year that a consolidated return is filed each corporation which has been a member of the group any part of the taxable year must file a consent on Form 1122. Based on the facts and circumstances, the Commissioner, at his own discretion or at the taxpayer's request, can disregard this requirement for the filing of a consent by a subsidiary. The
Commissioner will take the following circumstances into account in making this decision:

1) Were the income and deductions included in the consolidated return?

2) Was a separate return filed by the member for that taxable year?

3) Was the member included in the affiliation schedule (Form 851)?

The common parent may also satisfy the Commissioner that the failure of the subsidiary to join in the making of a consolidated return was due to a mistake of law, or fact, or to inadvertence.

This relaxation in the filing of a subsidiary's consents may have been the result of a Tax Court decision. In Landy Towel & Linen Service, Inc., the Court held that subsidiary corporations which had failed to file consent Forms 1122 (as required by the Regulations) had nevertheless consented to the Regulations when they were

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131 Reg. 1.1502-75(b)(2).
132 Reg. 1.1502-75(b)(3).
133 38 T.C. 296 (1962), aff'd 317 F.2d 362 (3rd Cir. 1963); Edwin L. Jones, 39 T.C. 734 (1963); but see General Manufacturing Corp., 44 T.C. 513 (1965), acq. 1966-10 I.R.B. 6, for the opposite decision.
included in the consolidated return. The Court found an implicit election on the part of all members of the group to file a consolidated return and held that the filing of the consolidated return constituted an adequate consent to the Regulations.

If an affiliated group wishes to file a consolidated return, it must be filed no later than the due date (including extensions of time) for the filing of the tax return of the common parent corporation. In the event that the return is filed before the due date, it is considered as having been filed on the due date of the return. That is, the group may change the basis of its return at any time prior to the due date. However, once a consolidated return is properly filed and the due date for filing such returns has expired, separate returns cannot be filed for that year.\textsuperscript{134} When consolidated returns are contemplated by a group, it is essential that the return is filed on time or that a valid extension of time for filing the return of the parent corporation is obtained.

The filing of separate returns by subsidiary members does not disallow an election to file a consolidated

\textsuperscript{134}Reg. 1.1502-75(a)(1).
return. Likewise, when a parent has filed a separate return for the year but the due date for the return has not expired, a consolidated return election will be allowed.\textsuperscript{135}

Once an election has been properly made (whether to file a consolidated return or separate returns), it is binding.\textsuperscript{136} The election to file separate returns cannot be disaffirmed even though the taxpayer's counsel had incorrectly advised that consolidated returns were not permissible.\textsuperscript{137} A separate return was binding even though the taxpayer relied on an erroneous ruling by the Commissioner in a preceding year.\textsuperscript{138}

**Continued Filing Requirement.** Once consolidated returns have been properly elected, they must be continued as long as the group remains in existence unless permission is obtained to discontinue consolidation.\textsuperscript{139}

\textsuperscript{135}Rev. Rul. 56-57, 1956-1 C.B. 437.

\textsuperscript{136}\textit{Alameda Inv. Co. v. McLaughlin}, 33 F.2d 120 (9th Cir. 1929).

\textsuperscript{137}\textit{Ohio Mining Co.}, 20 B.T.A. 1062 (1930), appeal dismissed, 59 F.2d 1070 (6th Cir. 1932).


\textsuperscript{139}Reg. 1.1502-75(a)(2).
The recent Regulations drastically changed the rules under which affiliated groups may shift from consolidation to separate returns. A group can no longer discontinue consolidation when a new affiliate is added to the group. Now, the right to file separate returns will be solely within the discretion of the Commissioner to decide if the taxpayer has shown "good cause." There is no longer any automatic discontinuance other than the termination of the group.

Permission to change to separate returns must be requested by the parent at least ninety days before the due date of its return (including extensions). The Commissioner will normally grant permission to discontinue filing consolidated returns if:

1) The affiliated group would suffer as the net result of all Regulations and Code changes taking effect within the taxable year.

2) The group can demonstrate other adverse factors, such as changes in law or circumstances, prior changes in tax rules which previously did not affect the group, or changes affecting the consolidated net operating loss

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140Reg. 1.1502-75(c)(1)(i).
141Reg. 1.1502-75(c)(1)(ii).
or investment credit calculations.\textsuperscript{142}

To show "substantial adverse effect," four computations will normally be required—consolidated tax liability with and without the change and the aggregate separate tax liabilities of the members of the group with and without the change. The Commissioner has taken into consideration the time required to make these computations and has allowed taxpayers to file their requests for permission to discontinue filing consolidated returns up until the ninetieth day before the due date for filing consolidated returns (including any extensions of time).\textsuperscript{143}

An inequality is still present, however. If the Commissioner were to grant permission on March 14, to all calendar-year taxpayers to file separate returns, those taxpayers who filed consolidated returns without requesting an extension of time and who did not learn of the grant, would be barred from filing separate returns for such year. However, those who requested extensions of time for filing their consolidated returns would have time to discover and evaluate their right to file separate returns.

\textsuperscript{142}Reg. 1.1502-75(c)(1)(iii).
\textsuperscript{143}Reg. 1.1502-75(c)(1)(i).
With respect to new elections attributable to changes in a law or Regulations, the Internal Revenue Code has been amended practically every year during the last twenty years. In most cases, the amendments have been sufficient to cause the Commissioner to rule that a new consolidated return election was available. New elections were allowed in the years 1944 through and including 1951. Elections were also available in 1953, 1954, 1958, 1962, 1964, and 1967. In view of this past history and the congressional policy of amending the Internal Revenue Code every year or two, it is probable that an affiliated group will be able to make a new election about every three years.  

It is important, however, to watch for the new election rulings, since the new election may be limited to groups which have not yet filed returns.  

The Commissioner has rarely given his permission for an affiliated group to de-consolidate. In spite of the guidelines spelling out "good cause" in the new Regulations, it is not advisable to rely upon obtaining the Commissioner's consent. In fact, the Commissioner will

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144 Tax Management, Consolidated Returns--Elections and Filing, p. 32.

probably exercise his authority even less frequently than in the past.

Another way that the Commissioner can exercise his authority—in addition to passing on individual applications filed by affiliated groups—is to grant blanket permission to all groups that desire to shift to separate returns. 146 A different approach is to limit the blanket permission to a specific class of affiliated groups. 147 In both cases, however, there must have been a change in law or Regulations that would have a "substantial adverse effect" on the continued filing of consolidated returns. New elections, whether individual or blanket, will ordinarily be granted for the year that includes the effective date of the amendment to the law or Regulations. 148

When an affiliated group is required to file a consolidated return, the tax liability of all members of the group is computed on a consolidated basis even though separate returns are filed by one or more members or income of any member of the group was not included in the

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146 Reg. 1.1502-75(c)(2)(i).
147 Reg. 1.1502-75(c)(2)(ii).
148 Reg. 1.1502-75(c)(3).
consolidated return. \(^{149}\) Any tax assessed against a member of an affiliated group on the basis of a separate return filed by it is allowed as a credit against the tax due on a consolidated basis.\(^{150}\)

A consolidated return may erroneously include the income of a corporation or corporations which were not members of the group at any time during the consolidated return year. The tax liability of the nonmembers should be determined upon the basis of a separate return or a consolidated return of another group. A consolidated return should include only the income of the corporations which were members of the group during the taxable year.\(^{151}\)

Tax payments may have been made on the basis of a consolidated return, but the tax liability of one or more of the members included in the consolidated return should have been computed on the basis of a separate return. A portion of the amount paid with the consolidated return must be allocated to the corporations required to file separate returns. The group of corporations included in

\(^{149}\)Reg. 1.1502-75(e).

\(^{150}\)Felbro Corp., 36 T.C. 864 (1961); Reg. 1.1502-75(e).

\(^{151}\)Reg. 1.1502-75(f)(1).
the consolidated return may agree, subject to the approval of the Commissioner, upon the amount allocable to each corporation. In the absence of an agreement, the tax payments are required to be allocated to the various corporations on the basis of one of the methods in Section 1552(a). 152

The filing of a consolidated return on behalf of an eligible affiliated group starts the running of the statute of limitations. Likewise, if consolidated returns are filed and separate returns were supposed to be filed, the statute of limitations will start. 153

Separate returns filed on behalf of an affiliated group must contain adequate information on gross income, allowable deductions, and credits before the statute of limitations goes into effect. 154 The gross income and deductions of each member of the group must be separately disclosed. 155 The filing of separate returns where consolidated returns are required will start the running

152Reg. 1.1502-75(f)(2).

153Reg. 1.1502-75(g)(1); Harvey Coal Corp., 12 T.C. 596 (1947).


of the statute of limitations only if each member attaches a statement to its separate return and discloses that it was included in a consolidated return in the preceding taxable year and the reason for the group's belief that a consolidated return is not required for the taxable year.\textsuperscript{156}

To conclude this section, the method of filing returns and forms should be discussed. The income tax return of an affiliated group is made on the usual corporate income tax form, Form 1120. Form 1120 is filed in the office of the Director of Internal Revenue prescribed for the filing of separate returns by the parent corporation. Affiliated schedules, Form 851, which shows the stock relationship among the members of the group,\textsuperscript{157} must be prepared and attached to the consolidated return.

For the first consolidated return year each member of the group must consent to the consolidated return Regulations and authorize the parent corporation to file a return in its behalf. This requirement can be met by having each member execute a Form 1122 and by attaching

\textsuperscript{156}Reg. 1.1502-75(g)(2); Martin Hotel Co., 18 B.T.A. 826 (1930).

\textsuperscript{157}Reg. 1.1502-75(h)(1).
one copy of this form to the consolidated return and filing a signed duplicate copy in the office of District Director of Internal Revenue for the District in which the company would have filed a separate return.\textsuperscript{158} As previously mentioned, the Commissioner may disregard the requirement for the filing of a Form 1122 by a subsidiary.\textsuperscript{159}

The corporate officers which are authorized to execute separate returns for the individual members\textsuperscript{160} are authorized to execute the forms required to be filed with consolidated returns.\textsuperscript{161}

**Accounting Periods and Methods**

All members of a group filing a consolidated return must be on the same taxable year as that of the parent. The Service has ruled that subsidiaries' accounting periods must conform with that of their common parent corporation for bookkeeping purposes as well as for tax purposes. A change in bookkeeping practices cannot be made retroactively. A new member joining the consolidation

\textsuperscript{158}Reg. 1.1502-75(h)(2).
\textsuperscript{159}Reg. 1.1502-75(b)(2).
\textsuperscript{160}See I.R.C. Sec. 6062.
\textsuperscript{161}Reg. 1.1502-75(b)(3).
must change its taxable year to that of its parent, for tax purposes, when its income is first included in the consolidated return. However, for bookkeeping purposes a subsidiary has until the close of the next consolidated taxable year before it must conform to the parent's accounting period. Apparently, a subsidiary that is required to adopt the parent's accounting period can do so automatically.

An old ruling states that it is possible for a parent corporation to obtain permission to change its accounting period to conform to that of its subsidiaries instead of vice versa. Also, the Tax Court has indicated that a calendar year corporation does not have to change to the parent's fiscal year as a result of a brief affiliation of only three months.

There are two exceptions to the general rule that subsidiaries must change to the parent's accounting period. The first exception occurs when the affiliated group

\[162\text{Reg. } 1.1502-76(a)(1); \text{Rev. Rul. } 57-602, 1957-2 \text{C.B. 611.}\]

\[163\text{Allstate Insurance Co. v. U.S., } 329 \text{F.2d 346 (7th Cir. 1964).}\]

\[164\text{Rev. Rul. } 55-80, 1955-1 \text{C.B. 387.}\]

\[165\text{Underwriters Service, Inc., } 28 \text{T.C. 364 (1957).}\]
includes an insurance company. Insurance companies are required to be on a calendar year basis.\textsuperscript{166} If the other members are on a fiscal year basis, they, rather than the insurance company, are required to change to a calendar year. However, this change in accounting period can be postponed until after the first consolidated year in which the insurance company is included. Thus, the first consolidated return year can be filed on the group's fiscal year basis.\textsuperscript{167}

The second exception was introduced in the latest Regulations. The exception is relatively minor, for it only allows a member, with the consent of the Commissioner, to maintain a 52-53-week taxable year. This year must end within the same seven-day period as that of the taxable years of all other members.\textsuperscript{168} The exception may prove troublesome to the I.R.S. when combatting the attempts of taxpayers to obtain other exceptions to the basic rule.

A consolidated return must include the income of the common parent corporation for its entire taxable year, except income properly included in the consolidated return

\textsuperscript{166}I.R.C. Sec. 843.

\textsuperscript{167}Reg. 1.1502-76(a)(2).

\textsuperscript{168}Reg. 1.1502-76(a)(1).
of another group.\footnote{Reg. 1.1502-76(b)(1).} Before the repeal of the two percent penalty tax, it was more advantageous for a parent to dispose of all of its subsidiaries before the beginning of a new consolidated return year. This early disposal avoided imposing the two percent tax on the parent's income after the group's termination. However, there is an advantage to terminating the affiliated group after the new consolidated return year since this action will permit a consolidated net operating loss to be carried forward in its entirety against the income of the parent for the year of termination.

The income of each subsidiary for the portion of the taxable year during which it was a member of the group must be included in the consolidated return.\footnote{Ibid.} There are two exceptions to the rule requiring the income of all affiliates to be included in a consolidated return. First, where a new member is acquired within thirty days after the beginning of its taxable year, it may be considered at its option to have joined the group on the first day of its taxable year. The exercise of this option will avoid the necessity of preparing a separate
return for a period of thirty days or less.\(^{171}\) Second, a new member may join a group or an old member may leave, and the new or old member may have been affiliated for thirty days or less during the consolidated return year. In either case, the member at its option may be considered as not having been a member at all during the consolidated return year.\(^{172}\)

For example, a common parent corporation (P) filed a consolidated return for the calendar year 1966. As of the close of July 15, 1967, P acquired all of the stock of corporation S. S filed its separate returns on the basis of the fiscal year ending June 30. Assume that P files a consolidated return for 1967. S became a member of the group within thirty days after the beginning of its taxable year. Therefore, S may at its option include its income in the consolidated return for the period July 1, 1965 (the beginning of the taxable year), through December 31, 1967, in lieu of the period July 16, 1967, through December 31, 1967. Thus, the subsidiary's income for a limited period during which it did not actually belong to the group can be included in the

\(^{171}\)Reg. 1.1502-76(b)(5)(i).

\(^{172}\)Reg. 1.1502-76(b)(5)(ii).
consolidated return.

If only a portion of a subsidiary's income is properly included in a consolidated return, the remainder of the income is included within a separate return. For example, if an affiliated group is formed after the beginning of the taxable year of the parent corporation, the consolidated return must include the income of the parent for the entire taxable year. But the consolidated return must include the income of each subsidiary only from the time that it became a member of the affiliated group. That portion of the subsidiary's income which was earned when it was not a member of the group must be included in a separate return. 173 If there is a complete termination of the affiliated group before the close of the taxable year, an acquisition of a new subsidiary in the middle of a consolidated return year, or a sale of a subsidiary in the middle of a consolidated return year, a separate return must be filed for a portion of the subsidiary's income.

For example, Corporations P and S filed separate returns for the calendar year 1966. As of the close of

June 30, 1965, P acquired all of the stock of S. If P files a consolidated return for 1967, it must include its income for the entire taxable year in the return. On the other hand, S must include in the consolidated return only the income for the period July 1, 1967, through December 31, 1967. The remaining portion—income for the period January 1, 1967, through June 30, 1967—must be included in a separate return.

There is some question as to how the tax for a separate return period is to be computed. The I.R.S. has indicated in the past that, in the event of a change of annual accounting period, the income for a short period must be annualized and the tax computed on that basis. Annualization is not required for short periods unrelated to changes of accounting periods. The Proposed Regulations published on October 1, 1965, required that the income must be annualized pursuant to Section 443(b). That is, taxable income for a short period should be placed on an annual basis by multiplying the income by twelve and dividing the results by the number of months in the short period. This annualization requirement was deleted in the Final Regulations. As a

result, there are no explicit provisions in the Regulations stipulating how the tax for a short period is to be computed.

However, a recent Tax Court decision held that annualization was not required under the old Regulations. This decision and the deletion of the annualization requirement from the Regulations should support the argument that annualization is not required.

Another problem frequently encountered by a subsidiary is the allocation of income between separate and consolidated returns. The taxable income to be reported in each return should be determined on the basis of the subsidiary's income shown on its permanent records (including working papers). Those items whose allocation cannot be determined from the taxpayer's permanent records can be prorated on the basis of the number of days in the year for which its income was to be included in each such return. The formula is as follows:

\[
\text{Number of days included in return} \times \frac{\text{Total Unallocable Taxable Income}}{\text{Total Number of Days}}
\]


176 Reg. 1.1502-76(b)(4)(i).

177 Reg. 1.1502-76(b)(4)(ii); *Sprague-Sells Corp.*, 30 B.T.A. 1165 (1934).
For example, Corporation P, the parent corporation of a calendar year affiliated group filing consolidated returns, purchased all of the stock of Corporation Z, a calendar year corporation, on March 1, 1965. Z's taxable income for the entire year of 1965 is $100,000 after taking into account a capital gain of $10,000 on February 2 and a loss from hurricane damage of $15,000 on May 13. It cannot be determined by the taxpayer's permanent records how much income should be allocated to the period of March 1 - December 31, 1965. Thus, the income must be prorated, with 59/365 allocable to the separate return period and 306/365 allocable to the consolidated return period. The taxpayer should eliminate the capital gain and the loss from the hurricane and prorate the remainder—$100,000 minus $10,000 plus $15,000 equals $105,000. The income for the short period would be 59/365 times $105,000 equals $16,972.60 plus $10,000 equals $26,972.60 taxable income. The income for the consolidated return is 306/365 times $105,000 equals $88,027.40 minus $15,000 equals $73,027.40.

It should be noted that where one corporation accrued 1/12 of its property tax each month, it was limited to a deduction of a proportionate share of such taxes for a short taxable year prior to the time that it
became a member of an affiliated group. This form of allocation was brutal, for the corporation became liable for the entire year's tax during the short taxable year.\textsuperscript{178}

When should a separate return for a short taxable period be filed? Generally, a separate return should be filed no later than the due date for the consolidated return (including extensions of time) and should cover the short period only.\textsuperscript{179} An exception to this rule is made when the member is required to file its annual return before the consolidated return is due. At that point, there is no certainty that a consolidated return election will be made. Thus, the member cannot wait until the consolidated return election is made but must file its own separate return by the normal due date. The member does have an option as to the income to be included in the separate return. The corporation can include the income of the entire taxable year, or it can include only the income of the short period (on the assumption that the consolidated return election will be made).\textsuperscript{180}

\textsuperscript{178}Doric Co., 40 T.C. 985 (1963).
\textsuperscript{179}Reg. 1.1502-76(c)(1).
\textsuperscript{180}Reg. 1.1502-76(c)(2).
If a return is filed covering the entire taxable year and the consolidated return is subsequently made, an amended return should be filed no later than the due date for the filing of the consolidated return of the group. If, however, a short period return is filed and the consolidated return election is not made, the subsidiary corporation must file a substituted return by the due date of the consolidated return covering the entire taxable year.\textsuperscript{181}

Now that the accounting periods have been discussed, it is appropriate to mention the methods of accounting that affiliated members are allowed to use. Each member of an affiliated group must continue the use of the accounting method which would normally be used on a separate return basis.\textsuperscript{182} The method of accounting, however, must be allowable under Section 446 of the Code; that is, the accounting method must clearly reflect the taxable income of the subsidiary. The methods of accounting that a corporation can use are as follows:

1) the accrual method,

2) the cash receipts and disbursements method,

\textsuperscript{181}Ibid.

\textsuperscript{182}\textsuperscript{Reg. 1.1502-17(a).}
3) certain special methods (i.e., the installment method), or

4) a combination of the three preceding methods.\(^{183}\)

An inconsistent subsidiary will no longer be required to change its established method of accounting when it becomes a member of an affiliated group. The previous Regulations required an affiliated group to adopt that method of accounting which clearly reflected consolidated taxable income. This unduly strict "similar method of accounting rule" was one of the disadvantages under the old Regulations.\(^{184}\) It is entirely consistent under the present Regulations for one member of an affiliated group to be on a cash basis and another member to be on an accrual basis. Each of these accounting methods must, by itself, clearly reflect the taxable income of the separate member. The theory is that if the separate company taxable income is clearly reflected, then it is presumed that consolidated taxable income will be clearly reflected.

If a subsidiary does change its accounting method, it must secure a consent from the Commissioner before the subsidiary can compute its taxable income under the new

\(^{183}\)I.R.C. Sec. 446(c)

\(^{184}\)Reg. 1.1502-44(1955).
method. In the event of an accounting method change, certain adjustments must be made in order to prevent duplication of a deduction or omission of income. Generally, items of income and deductions that were properly omitted in prior years because of the method of accounting must be picked up in the year of change if they would not have been omitted in prior years under the changed method. Under certain circumstances, any tax attributable to a change in accounting method shall not be greater than the combined increase in tax computed as if the income due to the change of accounting method were spread equally over the year of change and the two preceding years. Any increase in tax for a prior period shall be computed on the basis of a consolidated return or a separate return, whichever was filed for the prior period.

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185 I.R.C. Sec. 446(e).
186 I.R.C. Sec. 481(a)(2). It appears that consolidated taxpayers will not be entitled to the benefits of the pre-1954 adjustments under Section 481. The Regulations clearly state that a taxpayer must initiate the change in the method of accounting, thereby causing adjustments applicable to the pre-1954 Code years to be ignored. See U.S. v. Transamerica Corp., 345 F.2d 765 (9th Cir. 1965).
187 I.R.C. Sec. 481(b).
188 Reg. 1.1502-17(b).
Declaration of Estimated Tax

The filing of a consolidated estimated tax return is required in the third consolidated return year. However, for the first two consolidated return years each member is entitled to a separate $100,000 exemption for the purpose of filing a declaration of estimated tax. The effect for the first two consolidated return years is that each member will have to make current payments on the portion of its tax liability in excess of $100,000. If the group files consolidated returns for the third year, the group does not have the option (as was the case in the previous Regulations) of filing a group declaration of estimated tax or of filing separate declarations for each member. The group must file a consolidated declaration of estimated tax and the group is allowed only one $100,000 exemption. That is, the group will have to make current payments on its combined tax liability in excess of $100,000. In either case, if the estimates are not paid, the group or the individual members are subject to a six percent penalty on the underpayment.\(^\text{189}\)

For example, an affiliated group consisting of eight calendar-year corporations files a consolidated

\(^{189}\)Reg. 1.1502-5(b).
return for the first time in 1967 covering the year 1966. Each corporation estimates its tax liability as approximately $100,000 per year: a total liability of $800,000. For 1966 and 1967 no estimates are required to be filed since no member of the group had a tax liability in excess of $100,000.

In the third consolidated return year, in 1968, the group must pay not only its full 1967 income tax, but it must also make estimated payments on account of its 1968 liability in the amount of $700,000 ($800,000 group liability minus $100,000). The estimated tax is payable in four equal installments on April 15, June 15, September 15, and December 15. The affiliated group will actually pay almost two years of taxes in the third consolidated-return year.

The consolidated declaration of estimated tax should be filed and payments made to the District Director prescribed for the filing of a separate income tax return by the common parent. A statement has to be attached to the declaration listing the name, address, taxpayer's account number, and District Director of each member.\textsuperscript{190}

\textsuperscript{190}Reg. 1.1502-5(a)(1).
The situation may arise where a consolidated return is filed, but where separate estimated tax returns were made. Likewise, separate returns may be filed, but a consolidated estimated tax return was made. This situation will create problems in allocating consolidated tax to separate companies to determine estimated tax penalties and in allocating consolidated estimated tax payments to separate companies.

Assume that a group is not required to file a consolidated declaration of estimated tax and the members estimate the tax on a separate basis. If a consolidated return is subsequently filed for that year, the amount of any estimated tax payments made for such year should be credited against the tax liability of the group.\textsuperscript{191}

Assume, however, that a consolidated declaration of estimated tax is filed. Any estimated tax paid on a consolidated basis may be apportioned to the members in any manner designated by the parent, provided that the group does not file a consolidated return.\textsuperscript{192}

\textsuperscript{191}Reg. 1.1502-5(a)(2).
\textsuperscript{192}Reg. 1.1502-5(a)(1).
Common Parent Agency for Subsidiaries

The common parent is considered to be the agent, for practically all purposes, for all members of the affiliated group and is authorized to act in its own name in all matters relating to the tax liability for the consolidated return year. No subsidiary, other than the parent, has the authority to act for or represent itself in any tax matter. For example, any election available to a subsidiary in the computation of its separate taxable income must be made by the parent corporation. This is also true for any changes in an election previously made by the subsidiary. All notices or correspondence are sent directly to the parent and are considered as if mailed to all subsidiary corporations.\(^\text{193}\)

The common parent must file for all extensions of time. Notices of deficiencies are mailed only to the parent corporation, but these mailings are considered as notice to all subsidiaries in the group. Likewise, notice and demand for payment of taxes is given only to the parent, but the notice and demand is considered as delivered to each subsidiary. The common parent should file claims for refund or credit, and any refund will be

\(^{193}\text{Reg. 1.1502-77(a).}\)
made directly to and in the name of the common parent and will discharge any liability of the Government to any subsidiary. The parent should give in its name any waivers, or bonds, and should execute closing agreements, offers in compromise, and all other documents. In each of these instances, the above documents are considered to have been executed by each subsidiary.\textsuperscript{194}

Although a notice of deficiency will generally name each corporation which was a member of the group during a consolidated return year, a failure to include a member will not affect the validity of the notice of deficiency as to the other members. A notice and demand for payment will generally name each corporation which was a member of the group, but an omission of any member will not affect the validity of the notice and demand as to the other member. Also, any levy, notice of a lien, or other proceeding to collect the amount of any assessment—after the assessment has been made—will name the corporation from which the collection is to be made. Further, the District Director may, by notifying the common parent, deal directly with any member of the group in regard to its individual liability. The individual member will have

\textsuperscript{194}\textsuperscript{Ibid.}
full authority to act for itself.\textsuperscript{195}

If a corporation ceases to be a member of an affiliated group, it should file a written notice of the cessation with the District Director with whom the consolidated return is filed. The corporation can then request the District Director to furnish it with a copy of any notice of deficiency relating to a consolidated return year for which it was a member and any notice and demand for payment of the deficiency. However, this filing of a written notification of cessation and request by a corporation does not limit the scope of the agency of the common parent. Furthermore, the failure of the District Director to comply with a written request does not limit the liability of the corporation that has ceased to be a member of the group.\textsuperscript{196}

There are two exceptions to the general rule that the Commissioner will deal only with the common parent in connection with any matter involving the tax of the group or the returns filed during a consolidated return period. These two situations involve the dissolution of the common parent corporation and proceedings before the Tax Court.

\textsuperscript{195}\textit{Ibid.}

\textsuperscript{196}\textit{Reg. 1.1502-77(b).}
If a parent corporation is about to dissolve, it is required to notify the District Director and to designate, subject to his approval, another member of the affiliated group to act as agent in its place. If the parent corporation fails to give notice, the remaining members may designate, with the approval of the District Director, another member to act as agent. Until an agent is designated, any notice or communication mailed to the common parent will be considered as having been properly mailed to the agent of the group. The District Director, if he has reason to believe that the parent corporation has terminated its existence, may deal directly with any member of the group.¹⁹⁷

The Regulations provide that only the parent corporation can file petitions and conduct proceedings before the Tax Court.¹⁹⁸ However, the Tax Court has held that this provision is invalid since it attempts to usurp the power of the Tax Court to establish its own rules of practice and procedure.¹⁹⁹ In view of this conflict between the Regulations and the Tax Court, petitions

¹⁹⁷Reg. 1.1502-77(d).
¹⁹⁸Reg. 1.1502-77(a).
before the Tax Court should be filed by each member of the group as well as by the parent corporation for itself and on behalf of all members of the group. The failure to do the former may violate the Tax Court's rules; and the failure to do the latter may create administrative problems in dealing with the Internal Revenue Service.

Waivers of the statute of limitations for consolidated return periods given by the common parent are considered to be applicable for each corporation which was a member of the affiliated group as well as to each corporation whose income was included in the consolidated income even though it is subsequently computed on the basis of a separate return. 200 There is some conflict as to whether a waiver by a common parent will extend the statute of limitations in regard to a subsidiary included in a consolidated return where the consolidated return was invalid or where the subsidiary was improperly included. A United States District Court has held that the parent's waiver is effective with respect to the subsidiary, 201 but the Board of Tax Appeals has held that a

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200 Reg. 1.1502-77(c).
waiver does not start the running of the statute of limitations for a subsidiary. 202

Chapter III discussed the procedures that must be followed in electing and filing consolidated tax returns. The next step is to examine the statutes, regulations, and judicial proceedings which govern the actual computation of consolidated taxable income. This chapter presents a concise discussion of these complex rules.

Consolidated return computations are not based on a consolidated accounting of all income and capital items as though the properties of the subsidiaries were owned by the parent. Hence, a consolidated return does not constitute a method of accounting; instead it is a method of reporting income.¹ This method of reporting income requires that the separate taxable incomes or losses of the members of an affiliated group be computed by excluding certain types of items and by taking into

¹V. C. Neal, Inc., T.C.M. 1964-220.
account special rules applicable to intercompany transactions. The consolidated results of these excluded special items are then combined with the aggregated separate incomes.

This chapter and the following one present, in detail, the problems involved in computing consolidated taxable income. Although this presentation does not include a complete and exhaustive discussion of the consolidation process, some of the highlights of this process are presented in order to clarify certain points and to provide for a more complete explanation of the process. The major portion of this chapter deals exclusively with intercompany transactions. Chapter V will present the remaining steps in the computation of consolidated taxable income.

Overall Perspective

A brief outline of the process of preparing a consolidated return is necessary if one is to obtain an overall perspective of the consolidated return area. Consolidated returns must include the income of the common parent for its entire taxable year, unless a portion of its income for the year is included in the consolidated return of another group. Consolidated returns must also
include the income of each subsidiary for that portion of
the common parent's taxable year during which it was a
member of the group (except periods of thirty days or
less which are disregarded).

A series of computations and sub-computations are
necessary whenever one undertakes the preparation of the
consolidated return and the computation of consolidated
tax liability. This process of determining the precise
amount of the consolidated tax liability can be conven­
iently subdivided into two components: separate taxable
income of the members of the group and consolidated
items. These two basic components can in turn be sub­
divided into a series of steps.

A logical starting point is to determine, in
accordance with the consolidated return rules, the separate
taxable incomes of each member of the affiliated group.
The first step is to compute separately for each member
of the group all items of income or deductions in sub­
stantially the same manner as if separate returns were
filed. That is, all items of gross income or deductions
that are not subject to adjustment or elimination are
subject to the same rules that would apply if a separate
income tax return were filed. Appendix A will assist the
reader who is unfamiliar with corporate taxation by
enabling him to obtain a clearer picture of the gross income and deductions of an ordinary corporation.

However, in calculating taxable income or loss for each member, certain items are not taken into account. These items are as follows:²

1) net operating loss deductions;
2) capital gains and losses;
3) Section 1231 gains or losses;
4) charitable contributions;
5) Western Hemisphere trade corporation deductions; and
6) dividend received and dividend paid deductions.

Aside from ignoring the six preceding types of items, the calculations for each individual company must follow special rules (relating to intercompany transactions, certain built-in deductions of each individual company, and transactions involving stock or obligations of members of the affiliated group) that are prescribed in the Regulations.³

Next, one should consolidate certain current items that were eliminated from the separate taxable incomes

²Reg. 1.1502-12.
³Ibid.
with similar items of all members. These current year items of all of the affiliates that are consolidated consist of:

1) net Section 1231 gain or loss;
2) net capital gain or loss;
3) charitable contributions; and
4) total dividends received or paid which qualify as special deductions under Sections 243-247.

Consolidated current year items, however, cannot be included in total consolidated taxable income until certain adjustments have been made for items from previous taxable years. These prior year items consist of net operating loss carryovers, net capital loss carryovers, and charitable contributions carryovers. However, carryovers may have resulted from transactions in prior separate return years or consolidated return years of the same group. Thus, the availability of these carryover deduction items, except charitable contributions carryovers, are subject to three limitations. The three concepts limiting the use of loss carryovers in consolidated returns are the "separate return limitation year" (SRLY), the "consolidated return change of ownership" (CRCO), and the "reverse acquisition." Net operating loss carryovers are further limited by a special
limitation in Section 382(a).

It is now possible to bring all of the income and deduction items together in order to compute certain limitations and, hence, determine the amounts deductible under certain categories. These limitations and deductible items can be conveniently separated into the categories of dividends received, charitable contributions, and Western Hemisphere trade corporations. Applying these limitations and deducting the proper amount will produce the consolidated taxable income. Assuming that the group has income, the regular corporate tax rates are applied with a single surtax exemption,\(^4\) and the tax liability is computed by adding the tax imposed on consolidated taxable income to the taxes imposed by Code Sections 541, 531, 594, 802, 831, 1201, and 1333. That is, other taxes which must be considered are personal holding company tax, accumulated earnings tax, alternative tax for mutual savings banks conducting life insurance business, consolidated life insurance company tax of Sections 802 and 831, alternative capital gains tax, and war loss recoveries tax.

\(^4\) The corporate tax rate for 1967 is 48% of taxable income with only 22% applied against the first $25,000.
Next, two tax credits—the investment tax credit and the foreign tax credit—must be offset against the tax computed in the preceding paragraph. Both of these credits may be composed of credits earned in the current year as well as those credits of prior years carried over or of later years carried back into the current year. Furthermore, the carryover or carryback items may be from separate or consolidated return years. But the same three limitations that apply to net operating loss carryovers or capital loss carryovers (SRLY, CRCO, and reverse acquisition) apply to foreign tax credits and investment tax credits.

Finally, after the two tax credits are deducted from the tax liability, the amount of consolidated tax or consolidated loss is obtained. The details in the computation of the group's tax liability are intricate, but there appears to be some consistency. Basic computational differences between consolidated returns and separate returns can be identified in these major areas:

1) intercompany transactions;
2) built-in deductions;
3) transactions involving stock or obligations;
4) excess loss and earnings and profits accounts, and
5) consolidated items.

The remainder of this chapter and the following one discuss these basic computational differences.

**Intercompany Transactions: Accounting**

Intercompany transactions such as the sale of merchandise, other properties, and services often occur between members of affiliated groups. Normally, an intercompany sale will involve a profit to the affiliate making the sale, and this profit should be recognized by the selling company if separate financial statements are prepared. However, for financial purposes, no profit can be recognized for consolidated statement purposes until the goods are resold to parties outside of the affiliated group. Thus, if the asset is still held by an affiliate, the sale should be viewed as a mere transfer between affiliates, and any intercompany profit emerging from the transfer should be canceled.

Elimination of intercompany profits or losses is a widely accepted accounting concept. The Committee on Accounting Procedure of the American Institute of Certified Public Accountants made the following observation in 1959:

As consolidated statements are based on the assumption that they represent the financial
position and operating results of a single business enterprise, such statements should not include gain or loss on transactions among the companies in the group. Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated; the concept usually applied for this purpose is gross profit or loss.\(^5\)

Likewise, the Committee on Accounting Concepts and Standards of the American Accounting Association expressed a similar view in 1954:

> In the consolidated financial statements, no gain or loss should be recognized as the result of transactions among affiliates. From a combined point of view, these transactions result merely in a shift of assets from one department or branch to another department or branch of the same entity.\(^6\)

There is some controversy, however, as to the amount of profit that is to be eliminated when a sale is made to a parent company by a subsidiary that is not wholly-owned. One point of view is that a minority interest is entitled to a portion of the profit reported by the subsidiary regardless of whether or not the buyer is an affiliated company or an outsider. Thus, the minority interest's share of any profit should be recognized on the


consolidated balance sheet and there should be a corresponding increase in the original cost of goods. To accomplish this objective, it is necessary to restrict the elimination of intercompany profit to the controlling interest's equity in the profit. A second viewpoint insists that no profit should be assigned either to the controlling interest or to the minority interest on transactions that are mere transfers between affiliated members. Therefore, this group would eliminate the entire profit on the sale regardless of the fractional share of the subsidiary's stock that is held by the parent.

Committees of both the American Institute of Certified Public Accountants and the American Accounting Association have taken the position that the full amount of intercompany profit should be eliminated regardless of the circumstances. The amount of intercompany profit to be eliminated should not be affected by the existence of a minority interest. The purpose of the consolidated

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8Accounting Research Bulletin No. 51, supra, note 5, p.45; Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements, supra, note 6, p. 45.
statement is to present a single company with one or more branches. This purpose is contravened if intercompany profits are split between the majority and minority interests. The elimination of only part of the profit shows a concern for the minority interest while professing that the underlying assumption of consolidated statements is to represent the financial results of an unified entity.⁹

There are two alternative methods of carrying subsidiary company investments on the books of the parent. The most common method for financial purposes is to carry the investment at historical cost.¹⁰ When this method is used, no adjustments are made to the investment account except for reductions due to permanent losses and for distributions that represent a return of capital. Increases and decreases in the subsidiary's capital resulting from profits and losses are disregarded. Under this cost method, if the investment is stock, a dividend


is treated as income to the recipient and does not affect the investment account. Recognition of subsidiary earnings are thus deferred on the books of the parent until the earnings are distributed as dividends.

Under the equity method the investment is recorded at cost, but adjustments are made immediately to the investment account to reflect subsequent changes in the book value of the subsidiary. Profits of the subsidiary increase the parent's investment account; dividends, consequently, are treated as returns of capital that reduce the investment account. The immediate recognition of profits and losses reflects the fact that the dividend policy of a subsidiary is largely under the control of its parent. Ownership of a controlling interest in the stock of a subsidiary is nearly equivalent to direct ownership of the subsidiary's assets. Thus, the accounting for an investment in a subsidiary company should parallel the accounting for an investment in a branch. In order to depict a single, unified entity, all of the profits and losses of a subsidiary should be shown on the books of the parent.

11Moonitz, supra, note 9, p. 59.
The equity method results in a more satisfactory economic portrayal of the ownership interest in a subsidiary. In fact, the American Institute of Certified Public Accountants has recently eliminated the cost method as a generally accepted accounting principle for unconsolidated subsidiaries. The Accounting Principles Board believes that the investment in an unconsolidated subsidiary should be adjusted for the consolidated group's share of undistributed earnings and losses. This promulgation is somewhat inconsistent since it represents a departure from the normal practice of reporting an asset at cost. It is also a departure from the legal requirement that retained earnings are affected only by dividends of the subsidiary and gains or losses arising from the sale of the subsidiary holdings. However, the elimination of the alternative cost method for nonconsolidated subsidiaries does result in more uniformity in income statements.

Intercompany Transactions: Taxation

Consolidated return Regulations issued in 1928 adopted the cost approach to intercompany stockholdings.  


\[13\] Reg. 75, art. 34 (1929).
Undoubtedly, the Treasury believed that consolidated corporations had to conform to basis provisions that prevailed in nonconsolidated situations. Although Congress did not stipulate how a parent's stock investment account was to be treated for basis purposes, the Senate Finance Committee in 1928 stated that the Treasury should promulgate regulations stipulating how to adjust the basis of the parents stockholdings.

In order to prevent double deductions certain modifications to the cost approach were made by the Treasury. For example, assume parent (P) acquires the stock of a corporation (S) for $200. After the acquisition S incurs an operating loss of $80 that is offset against the income of P. In a subsequent year, P sells the stock for $120 and realizes an investment loss of $80. If the second loss is allowed, P would be permitted to offset the operating loss twice against income which was earned independently of S. In order to prevent this double deduction, the Regulations required that the basis of P's stock at the time of the sale be reduced to


reflect losses of $S$ to the extent that $S$ could not have used the losses on separate returns.\footnote{Reg. 1.1502-34(b)(2)(i) (1964); see also, Charles Ilfeld Co. v. Hernandez, 292 U.S. 68 (1934).}

This cost approach had three rules for intercompany transactions. First, no elimination was required for profit or loss on intercompany transactions which were initiated and realized during a single taxable year. Second, elimination of profit and loss was required when the transaction was unrealized at the end of the taxable year of origin. A transaction is unrealized if the assets received in an intercompany sale are still owned by a member of the affiliated group at the end of the taxable year in which the sale is consummated. Third, the purchasing affiliate must use the seller's basis for purposes of valuing the asset in question. As a consequence of these rules, intercompany transactions result in paper profits or losses since they constitute no more than a shifting of assets within the group unless there is a final disposition of the asset during the year of the intercompany transaction. For realization purposes, the affiliated group is treated as a single entity, and the first taxable event occurs at the final disposition outside the group.
The cost approach is inadequate for several reasons. First, the method does not conform to the basic axiom that profits should be reported by the party which earns them. Second, the approach does not provide similar treatment of similar transactions. Third, the cost approach may allow certain income to permanently escape taxation.

These first two limitations can best be demonstrated by an example. Assume that parent (P) and subsidiary (S) are affiliated corporations filing a consolidated return. P manufactures two expensive widgets and sells both of them to S in 1966 at a gross profit of $50 per widget. S resold one widget in 1966 and another in 1967, earning a $20 profit for itself on each widget. On the widget sold in 1966, no elimination is required and P would report gross income of $50 and S gross income of $20. Since the overall transaction of the widget resold in 1967 was begun in one year and consummated in another, it is unrealized in 1966 and P's $50 gross profit must be eliminated. In 1967 when S sells the other widget to an outsider, the entire gross profit of $70 is included in S's tax liability.\(^7\)

\(^7\)Cf. Reg. 1.1502-38(b) (1955); Reg. 1.1502(b)(1)(i).
Thus, the preceding example illustrates the artificial shifting of income or loss on intercompany transactions under the cost method. This approach is inconsistent with financial reporting practices, since no respectable financial accountant would permit the entire $70 profit to be reported by the subsidiary. This artificial situation can lead to an improper allocation of the consolidated income tax liability among the affiliates that have minority shareholders. In fact, it can result in an increase or decrease in the consolidated tax liability. For example, the deductibility of a carryover of an operating loss incurred while a corporation was not an affiliated member is dependent on the amount of income earned by that particular member during a consolidated return year. Under the cost method, this $50 profit, which is not really the subsidiary's income, would be included in its income and increase the amount of the carryover loss by $50.

Suppose S is a Western Hemisphere trade corporation and is entitled to a special tax on its profits. Under the cost approach the $50 profit earned by P is treated as income to S and would be taxed at the special rate for Western Hemisphere trade corporations. Similarly, the artificial shifting of the $50 income among members can
distort the "source of income" result and change the foreign tax credit. Although the tax procedure is inconsistent with generally accepted accounting practices, it should be noted that the failure to attribute income to the correct party may, under certain circumstances, benefit as well as harm the taxpayer.

The inadequacy of the cost approach to stock transactions also results in a tax advantage to real estate investors. Under the cost approach taxpayers were able to escape taxation totally under the Beck Builders' avoidance technique. Assume that P corporation formed a subsidiary (S) by exchanging land with a basis and value of $10 for all of S's capital stock. Subsequently, P constructed an apartment building for S and S obtained one hundred percent financing and paid P the fair market value of the completed structure ($100). The construction cost to P had been $80. P's $20 gain could be eliminated as intercompany profit pursuant to the requirements of Reg. 1.1502-31(b)(1)(i), and S could receive a carryover basis of $80 for the building. Several years

19 Reg. 1.1502-38(b) (1955).
later P could sell the stock of S to an unrelated party for $10—the net value of S's assets. No gain or loss would be recognized by P since its basis was $10. Thus, by arranging its affairs P could obtain $20 profit ($100 - $80) that was not taxed. If the unrelated purchaser then liquidates S and receives a basis for the assets equivalent to the cost of the stock, the $20 construction profit would permanently escape the burden of taxation since the apartment building received a stepped-up basis on liquidation.

The Treasury attempted to resolve these problems created by the use of the cost method. The first such action was Revenue Ruling 57-201. In this instance, a parent corporation had received cash distributions from its subsidiary which owned and operated rental property. These distributions were designated as open account loans, and the subsidiary subsequently canceled the debt from its parent without payment. The subsidiary had no current or accumulated profits when the debt was

\[\text{I.R.C. Sec. 334(b)(2). The cost is allocated according to market value. The land takes a basis of $10 and the building a basis of $100 subject to a $100 mortgage.}\]

\[\text{1957-1 C.B. 295.}\]
forgiven or when the distributions were made. Normally, the gain accruing to the parent as a result of the cancellation of a debt is taxable as capital gains. However, under the existing cost approach, a gain arising in intercompany transactions was eliminated in the computation of consolidated taxable income after being eliminated from computation of separate taxable net income.

Since the basis of the subsidiary's stock could not be reduced below zero, a sale of the subsidiary in the future would result in a gain which is less than the actual gain of the investment in the subsidiary. The I.R.S. ruled that the gain accruing to the parent from cancellation of its indebtedness to the subsidiary was recognized in computing consolidated taxable income. That is, the I.R.S. revoked the normal practice of eliminating the gain or loss of any intercompany transaction.

The most significant change in the cost approach was Revenue Ruling 60-245. This Ruling, issued by the Treasury to cope with the Beck Builders' avoidance technique discussed earlier, resulted in a departure from

the historic principle of consolidated tax returns. The Commissioner stipulated that the $20 construction profit that escaped taxation as a result of its being eliminated as intercompany profit would be taxed in the year that the subsidiary was sold. That is, the parent would realize ordinary income of $20—the amount of the intercompany construction profit that had been previously eliminated. The ruling also stated that the adjusted basis of the apartment building (in the hands of the subsidiary after the date its stock was sold) was increased by the amount includible, under the ruling, in the income of the parent.

Should intercompany profit between affiliated corporations, properly and legally eliminated under the consolidated returns Regulations in a prior year, be subject to taxation in a subsequent year when stock of one of the affiliates is sold to an outsider? The most logical answer would appear to be negative since intercompany transactions during a consolidated return period are eliminated and are not taxed. Therefore, the Ruling was contrary to the Regulations existing at that time. The rationale is that all members of an affiliated group
are considered to be one economic unit or a single taxable entity. And, since the Regulations at that time did not require restoration of previously eliminated profits at the time the parent sold the stock of the subsidiary, the Treasury Ruling was inconsistent with previously established principles.

The courts rejected Revenue Ruling 60-245 in three separate cases. In the Beck case—the classical case—the parent corporation was the sole owner of a subsidiary corporation. The parent constructed and managed a housing project owned by and financed through the subsidiary and the profit paid to the parent corporation for constructing the building was eliminated in a consolidated return year as an intercompany transaction. In a later year the stock of the subsidiary was sold and the purchaser liquidated the former subsidiary.

If the apartment building had remained in the affiliated group indefinitely, there would have been no avoidance of tax, since the basis of the building for depreciation purposes did not include the amount of the

construction profit. However, when the stock of the subsidiary was sold, the outside purchaser was free to liquidate the former subsidiary so that the basis of the apartment building in the purchaser's hands was the cost to itself of the subsidiary's stock.\footnote{\textit{\textcopyright} 1964 I.R.C. Sec. 334(b)(2).} Instead of being taxed, the construction profit eliminated as an intercompany transaction appeared to permanently escape taxation.

The Commissioner argued that the intercompany profit which the parent corporation eliminated in the prior consolidated return was realized and taxable as ordinary income to the parent in the year that the subsidiary's stock was sold to the outside purchaser. But the Tax Court found no Regulations requiring the recognition of the gain and held that the parent's intercompany profit did not constitute income to the parent in the year when the subsidiary's stock was sold. In essence, the parent corporation escaped taxation on the construction profit except to the extent that depreciation deductions on the apartment building were lower than they would have
been if the construction profit had not been excluded from the tax basis of the building.

Current Regulations. After the courts had overturned the Commissioner's reasoning in Revenue Ruling 60-245 several times, the Regulations were revised. In the revision, the I.R.S. introduced a new concept for taxing intercompany profits. This concept is called the "suspense account" treatment or a "deferred accounting" approach. This chapter presents the new principles underlying the treatment of gains and losses on intercompany transactions and discusses the unconstitutionality of these principles.

Under the current Regulations, intercompany transactions include sales of goods, charges for services, rentals for property, or charges for money among corporations which are members of a group in a year for which a consolidated return is filed.\(^{27}\) The term intercompany transaction does not include financial transactions such as dividend distributions, write-off of another member's debt, or stock redemptions. These financial transactions

\(^{27}\)Reg. 1.1502-13(a)(1)(i).
have a separate treatment of their own.\textsuperscript{28} 

Not all intercompany transactions require identification and special treatment. Intercompany transactions include transactions among members which do not affect taxable income and deferred intercompany transactions. For example, profits arising from transactions among members which do not affect taxable income are not deferred or eliminated. These profits comprise payments or accruals for interest, rents, and service fees during a consolidated return period between members of an affiliated group. Thus, if a purchasing member makes an interest payment on an indebtedness to a selling member, the purchasing member must take the interest deduction into consideration in determining expenses and the selling member must also take the interest income into account.\textsuperscript{29} Thus, the payment is simultaneously a deduction to the debtor and an item of income to the creditor, and there is an immediate wash effect on consolidated taxable income.

\textsuperscript{28}Reg. 1.1502-13(a)(1)(ii).

\textsuperscript{29}Reg. 1.1502-13(b)(1).
Deferred intercompany transactions involve the sale or exchange of property, the capitalization of service fees performed by another member, and any other expenditures which are capitalized by the purchasing member in an intercompany transaction (such as rent or interest). When a deferred intercompany transaction occurs, the sale or charge by one member of a consolidated group to another does not produce immediate, complementary effects on the taxable income of the selling member and the purchasing member. Referring to the same interest example in the preceding paragraph, if the interest is capitalized as a part of the cost of property or prepaid by the debtor, the transaction is considered deferred since the income or expenses are not immediately equal.

Under this deferred accounting system the deferred intercompany transactions are not immediately included in income. Instead of being eliminated as was the case under the old Regulations, any intercompany profit or loss is deferred until a "restoration" event occurs. That is, both the amount and character of the profit or loss involved in intercompany transactions are recorded

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30Reg. 1.1502-13(a)(2).
31Reg. 1.1502-13(c)(1).
in a suspense account. Once certain specified events occur, both the amount and character of such profit or loss will be reflected in the computation of income subject to taxation. The gain or loss becomes a part of the selling member's taxable income (or consolidated taxable income if a consolidated return is filed) upon the happening of the restoration event.

The theory behind the deferred accounting system is quite simple. The profit or loss of an intercompany sale is deferred and the deferral then flows into taxable income of the seller as the increment to the sales price enters the purchaser's revenue and expense account. The character of the income (whether capital, Section 1231, or ordinary income) and the source (whether domestic or foreign) are determined at the time of the intercompany transaction. The ultimate result of these deferred profit or loss rules is to permit each affiliate to stand on its own feet. Only the timing and not the amount of each member's profits or losses are affected by the filing of consolidated returns.

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32 Reg. 1.1502-13(c)(4).
A complementary change in the Regulations involved the purchaser's basis in all property acquired in intercompany transactions. No longer will the purchaser use the seller's cost for transactions on which profit or loss is deferred. Instead, the purchaser's basis in all property acquired in intercompany transactions, deferred or otherwise, will be its cost.\textsuperscript{33}

Using the same facts as in the widget example on page 145, the mechanism for handling intercompany transactions under the present Regulations can be demonstrated. In the first year, the intercompany profit of $100 would be deferred on the sales from P to S; however, the profit on one widget would be recognized in the same year since the widget is resold to an outside customer by S. Thus, for the year 1966 P would include $50 in its gross income and S would include $20 in its gross income. In the next year, the $50 gross income deferred by P on the remaining widget would be recognized when the product is sold to an outside customer by S. The subsidiary, however, would report gross income of only $20 and the parent would include in gross income the deferred $50 profit. Thus, since part of the profit is deferred, both

\textsuperscript{33}Reg. 1.1502-31(a).
affiliates will report their respective profit at the time the goods are sold to outside customers.

**Restoration Events.** The deferred gain or loss from intercompany transactions becomes a part of the selling member's taxable income when certain restoration events occur. There are a number of major restoration events. The restoration of deferred gain or loss for property subject to depreciation, amortization, or depletion occurs in each taxable year in which a depreciation, amortization, or depletion deduction is allowed to any member of the group with respect to the property. That is, the purchasing affiliate will compute the depreciation deduction on the entire cost of the property. At the same time the selling affiliate will absorb a portion of the deferred gain or loss as determined by the following formula: 34

\[ \text{Depreciation deduction allowable for each year} = \frac{\text{Gain (or loss)}}{\text{Depreciable basis of the property}} \]

Any balance in the deferred account remaining when an asset is sold, scrapped, or abandoned is recognized at that time.

34 Reg. 1.1502-13(d)(1).
If a multiple asset account is used, the depreciation deduction allowable in the numerator of the preceding formula is determined by using the rate and method of depreciation applied to the multiple asset account. Since many taxpayers use multiple asset accounts, this procedure should greatly simplify the accounting for deferred gains.

An example will help to illustrate the mechanics of the deferred accounting system when dealing with depreciable property. Assume that corporations P, S, and T file consolidated returns on a calendar year basis, and that on January 1, 1966, S (which is in the business of manufacturing machinery) sells a machine to P for $1,000. The total direct and indirect cost of the machine is $800. P uses the machine in its trade and depreciates it by the straight-line method over an estimated useful life of ten years; salvage value of $200 is taken into account. Thus, P's annual depreciation deduction on the machine is $80 ($1,000 less $200 salvage divided by 10).

On January 1, 1969, P sells the machine to an outsider. Since the sale by S to P is a deferred intercompany transaction, S defers the $200 gain ($1,000 - $800) on the machine and the gain is characterized as ordinary income. In each of the three taxable years, of 1966, 1967, and 1968 prior to the sale of the machine to the
outsider, S would include $20 of the deferred gain in income. The portion of the gain included in income is computed as follows:

$$\frac{\text{200 deferred gain}}{\text{800 basis to P subject to depreciation}} \times \frac{\text{80 depreciation deduction}}{\text{800 basis to P subject to depreciation}}$$

Each $20 gain taken into income retains its character as ordinary income.

On January 1, 1969, S would take the remaining $140 ($200 - $60) of the deferred gain into its income since the machine is disposed of outside of the consolidated group. Again, the $140 gain retains its character as ordinary income.\(^{35}\)

Frequently, a sale by one member of a group to another member will result in more than one type of income to the seller (i.e., Section 1231 gain or Section 1245 gain). In this case, the seller's deferred account will contain two different types of gains, and there is a problem of determining how to reduce the deferred account. The Regulations stipulate that the Section 1245 gain or any other ordinary gain in the deferred account is reduced first.\(^{36}\) The rationale of this treatment stems from the

\(^{35}\) Reg. 1.1502-13(h)(4).

\(^{36}\) Reg. 1.1502-13(d)(8).
fact that the deferred gain which is taken into account by the seller (because of depreciation deductions taken by the purchaser) is treated as ordinary income in the hands of the seller, regardless of the character of the asset sold. Thus, in order to prevent a duplication of ordinary income treatment, the ordinary income in the deferred account should be reduced first.

For example, assume that P has a $200 gain on the sale of a Section 1231 asset to another member of the group—$120 of which is a Section 1245 gain. The asset is depreciated for one-half of its useful life by the purchasing member and then sold to an outside party. At the time of the sale to the third party, a $100 gain (50% x $200) remains in the deferred account. The $100 reduction in the deferred account resulting from the depreciation taken by P is applied first against the Section 1245 gain. Thus, on the disposition to the outside party, P takes $20 ($120 - $100) of the Section 1245 gain into account and $80 of the Section 1231 gain.

Transactions in Section 1231 assets and capital assets are not normally realized outside of the affiliated group in the same taxable year. Since these assets often

37Reg. 1.1502-13(c)(4)(ii).
remain in existence for years, the new deferred approach will eliminate the use of the convenient technique of transferring depreciable assets within the group at prices equal to their adjusted bases. Instead, future intercompany transactions must be priced at fair market value—a value that is often difficult to determine. Moreover, a series of intercompany sales of the same asset will result in a number of deferred accounts, and the computations in each account will have to be revised as a result of each succeeding intercompany transfer of the asset. The record keeping aspects may be burdensome.

The restoration of deferred profits or losses into income on inventory items of the seller occurs when the inventory is included in the purchaser's cost of goods sold or some other deduction account. In most cases these deferred profits or losses will be included in the seller's gross profit when the purchaser sells the inventory to an outside customer. Likewise, the deferred gain attributable to the sale of inventory to another member will be restored to income to the extent that the buyer writes down the inventory to market under the lower-of-cost-or-

\[\text{Reg. 1.1502-13(f)(1)(i).}\]
market rule. Deferred profits relating to inventory will also be recognized by the owner on the first day that a subsequent separate return is prepared by either the seller or the purchaser.40

Intercompany profits on assets that are not subject to depreciation are treated in the same manner as intercompany profits in inventory. For example, intercompany profit on the sale of land is deferred until the purchaser sells the land to an outside party.41

Deferred profits are taken into income when either the selling member or the purchasing member leaves the affiliated group (i.e., deaffiliation). Deaffiliation occurs when the percentage of ownership falls below the eighty percent level required for affiliation. When the disqualifying disposition of the stock occurs, any deferred profits on intercompany transactions are recognized immediately.42 Likewise, any deferred profits are recognized if a consolidated group dissolves. This immediate recognition is appropriate since the deaffiliation

41Reg. 1.1502-13(f)(1)(i).
of the seller or the purchaser is substantially the same as if the property under consideration has not been in the continuous possession of the affiliated group.

Deconsolidation also causes the recognition of deferred profits. Obviously, deconsolidation occurs when the members of a group remain affiliated, but decide to file separate returns. Three separate rules are provided for different circumstances. The first rule relates to deferred profits on the intercompany sale of inventory items that are includible in the purchaser's inventory at the end of a consolidated return year. The deferred profit on inventory is recognized as income to the seller for its first separate return year.43

The other two rules relate to income deferred on assets other than inventory. Under the normal rule, the remainder of the deferred profits of the affiliates will be taken into income at the time of deconsolidation in precisely the same manner as if the group had continued to file consolidated returns. This procedure will avoid burdening the affiliated group with a financial strain from unanticipated conditions. However, all deferred income will be taxed in the first separate

return year if consolidated returns have not been filed for each of the three immediately preceding taxable years.\textsuperscript{44} This exception to the normal rule should discourage the filing of consolidated returns for short periods of time merely to effect nontaxable shifts in assets.

While any deferred income is normally recognized in its entirety upon the disposition of an asset outside the affiliated group,\textsuperscript{45} there is an exception whereby the disposing member reports its gain from the disposition by the installment method. This exception permits the selling member to take the deferred gain into income on a pro rata basis as the installment payments are received.\textsuperscript{46} Although the Regulations are unclear on this point, presumably each installment payment will force into income a pro rata portion of any ordinary income and capital gain.

The above exception can result in an unexpected windfall to the taxpayer. It was previously stated that normally the ordinary income is reduced first for

\textsuperscript{44}Reg. 1.1502-13(f)(1)(vii).
\textsuperscript{45}Reg. 1.1502-13(f)(1)(i).
\textsuperscript{46}Reg. 1.1502-13(e)(2).
purposes of determining the character of the amounts left in the deferred account. Under this exception it is possible for an intercompany sale, followed by a later sale outside the group, to result in a greater capital gain than would have transpired if the sale had been to an outside member in the first place. This same windfall is also possible on the disposition of an installment obligation.

Two minor restoration events remain. Deferred profits will be recognized when an obligation of a non-member is collected or it becomes worthless. In the case of stock, deferred income will be recognized on the date the stock is redeemed or becomes worthless.

A taxpayer may apply to the I.R.S. for permission not to defer gains or losses on intercompany transactions with respect to all property or any class or classes of property. If the deferred system becomes too burdensome on certain classes of assets as a result of accounting or regulatory problems, the taxpayer may

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47 Reg. 1.1502-13(e)(3).
48 Ibid.
51 Reg. 1.1502-13(c)(3).
isolate these classes and elect not to defer the gains or losses. The I.R.S. may enter into a closing agreement mitigating the adverse effects of triggering any deferred profits when the group divests itself of control of a member. An extended period of time will be allowed, however, only if the divestiture is required pursuant to a final judgment or to a final order of a court or agency of the Federal or of a state government. This leniency is intended only for divestitures of existing subsidiaries; and subsidiaries acquired after August 31, 1966, will not qualify for the closing agreement. 52

When should the profit or loss on intercompany transactions be recognized? 53 The Regulations take the position that profits or losses deferred at the time of an intercompany transaction are nevertheless recognized at that time. The intercompany items are recognized even though the items may not be taken into income until many years later. It is questionable as to whether

52 Reg. 1.1502-13(f)(3).

53 As used in this discussion, revenue realization or revenue recognition refers to the sale of a firm's product and the receipt of assets having an objectively measurable value.
consolidated reporting under the deferred accounting system is an accounting method within the meaning of Sections 446 and 481.

It would be pure conjecture to predict the effect of this recognition concept on future Regulations. However, in a recent Tax Court case, a gain that was eliminated under the old consolidated return Regulations was not treated as a recognized gain. Thus, a contested spinoff was held to meet the requirement of Section 355(b)(2)(c). In other words, the business had not been purchased within the past five years in a transaction in which a gain or a loss was recognized in whole or in part. The spinoff would probably be disqualified if reference were made to the present Regulations.

According to consolidated return theory, the gain or loss should not be recognized until the property leaves the affiliated group. Consolidation is the recognition of the actual fact that the separate corporations, though technically distinct legal entities, are for all practical

54Baan, 45 T.C. 71 (1965)
55I.R.C. Sec. 355(b)(2)(c).
56Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements, supra, note 6.
business purposes merely branches or departments of one enterprise. A sale by the manufacturing department to the sales department in a single enterprise does not result in realized income. Neither does the profit between two branches of a single company result in realized profits.

There is always the possibility that a sale by the purchasing affiliate may create a net loss when all transactions are considered. For example, a subsidiary sells a $100 item to its parent at $130. The parent sells the item for only $95 to an outside customer. Under consolidation theory, there has been a net loss of $5. However, according to the present Regulations the subsidiary corporation has realized a gain of $30 and the parent corporation has realized a $35 loss, while in reality, there has simply been a $5 loss resulting from the sale of an item by the consolidated group to another entity.

The purchasing member's holding period for property acquired in an intercorporate transaction for purposes of determining long-term capital gain, as well as for other purposes, is computed as if separate returns were filed. The holding periods of the selling and purchasing member cannot be combined. Thus, the holding period for the purchasing member cannot include the selling member's holding
period—a situation which is contrary to the entity concept of consolidation.\textsuperscript{57}

\textbf{Inventory Adjustments.} If no special inventory adjustment was made when a group shifts from separate returns to consolidated returns, a group would obtain an one-shot deferral of gain on intercompany inventory on hand at the end of the year. For example, assume that P corporation sells widgets to its subsidiary S, and S resells the widgets to nonmembers. P sells each widget to S for $100, making a $30 profit on each sale. If S has 1,000 widgets in ending inventory when the group converts to consolidated filing, taxes would be deferred on the $30,000 intercompany profit (1,000 times $30) in the absence of some special inventory adjustment.

Prior to the recent revision of the Regulations, it was necessary to reduce the beginning inventory of S corporation for the first consolidated return period by the amount of gains or losses on all intercompany inventory transactions for the preceding year which had not been realized by sales outside the consolidated group ($30,000).\textsuperscript{58} In the case of intercompany profits, a

\textsuperscript{57}Reg. 1.1502-13(g).

\textsuperscript{58}Reg. 1.1502-39(b) (1955).
downward adjustment was required for the opening inventory of the members of the group. If the downward adjustment was not required, the shift from a separate return to a consolidated return would reduce the taxable income for the first consolidated return year $30,000 below the aggregate total of the separate taxable incomes of the members of the group. This lag in reporting of the $30,000 results from the deferral in the first consolidated return year of income which would otherwise be reported on a separate return basis.

The inventory adjustment was one significant disadvantage of consolidation, since the unrealized intercompany profit in opening inventory in the first consolidated return year was taxed twice—in the last separate return year and in the first consolidated return year. The compensating adjustments to the opening inventory under the prior Regulations were wholly inadequate since the inventory adjustments made for S's first consolidated return year could not be recovered until S ceased filing consolidated returns. In addition, the limitations on recovery of the adjustment often
prevented recovery of the full amount. \(^{59}\)

The Regulation revision attempted to mitigate this transitional problem by requiring that sellers (i.e., P corporation) of inventory held by other members of the group must set up an "initial deferred profit account" equal to the intercompany inventory profit. Subsequently, the deferred profit will be restored to the taxable income of the seller when the inventory is sold to a customer outside the affiliated group. \(^{60}\)

Hence, there is a second inclusion of the intercompany profit into taxable income. However, the income resulting from the adjustment is now assigned to the transferor of the inventory instead of to the transferee.

To compensate for the double inclusion of income the present Regulations provide for an ordinary deduction at the end of any year for the amount by which the deferred inventory profit at the end of the year is less than the initial deferral. That is, if the "unrecovered inventory amount" \(^{61}\) of a corporation is less than the

\(^{59}\) *General Electric Co. v. Commissioner*, 207 F.2d 777 (6th Cir. 1953).

\(^{60}\) Reg. 1.1502-18(b).

\(^{61}\) "Unrecovered inventory amount" is the lesser of (1) the intercompany profit amount for the year, or (2) the initial deferred profit account.
same amount in the preceding year, the decrease is treated as an ordinary loss. Likewise, if the "unrecovered inventory amount" exceeds such amount for the preceding year, the increase is treated as ordinary income. For example, in the previous widget illustration the initial deferral amount was $30,000. If the price paid by S to P for the widget drops from $100 to $95 in the second consolidated return year so that the intercompany profit in ending inventory is only $25,000, P is treated as having an ordinary loss of $5,000 in the second consolidated return year. If, however, the intercompany inventory profit at the close of the third consolidated return year is $40,000, P's income will be increased by $5,000, since the unrecovered amount is increased from $25,000 to $30,000. The amount of ordinary income is limited to the amount necessary to bring the deferred inventory profit up to its initial amount at the time consolidated returns were first filed.

When a selling corporation leaves the group, its deferred inventory profit at the end of the last year it

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\[62\text{Reg. } 1.1502-18(c)(2)(i).\]

\[63\text{Reg. } 1.1502-18(c)(2)(ii).\]
is a member will be considered to be zero. Thus, the selling member will receive an ordinary loss for any unrecovered initial deferred inventory profit.\(^{64}\) The new rules, therefore, make sure that the downward adjustment in the basis of intercompany inventory on hand at the beginning of the first consolidated return year will be eventually offset. The adjustment will be completely offset, either through reduction in the year-end inventory amounts during the consolidated return years or when the selling member eventually shifts to separate returns.

There is a situation in which a group will fail to completely receive an ordinary loss for any unrecovered initial deferred inventory profit, and that is where the inventory of the purchaser is written down to market. This inequity results from the fact that intercompany profits of the selling member are not decreased by a write down by the purchaser. Therefore, the net amount added to the income of the seller may be more than the intercompany inventory profits deferred by the seller. In this case the seller may actually report more profit

\(^{64}\)Reg. 1.1502-18(c)(3).
under consolidation than it would have if it had filed separate returns.

**Deferred Accounting System Invalid.** Very few of the individuals who have commented on the new deferred accounting system for intercorporate transactions, have regarded this change as undesirable, but most have regarded it as being progressive.65 The American Institute of Certified Public Accountants stated that the provisions dealing with intercompany transactions and deferred profits and losses are in general accord with sound accounting practice.66 However, it appears that the abandonment of the concept of eliminating all intercompany transactions is invalid under Section 1502.

An examination of the legislative history indicates that the deferred accounting rules are nonstatutory. The Senate Finance Committee in 1918 introduced a one corporation concept by referring to the fact that, where a consolidation is made, it is immaterial whether


activities are carried on as branches or as subsidiaries. The Committee viewed consolidated returns as reflecting the principle of taxing as a business unit what is in reality a business unit.\(^{67}\)

In 1928 the Senate Finance Committee clearly stipulated that the rules governing the computation of taxable income were to be based upon the principle that the affiliated group is a single corporation and that any unrealized intercompany transactions were to be eliminated.\(^{68}\) The Committee indicated that the profit or loss on intercompany transactions should be treated as intercorporate transactions and, therefore, these transactions should not be reflected in income, either in the year in which they occur or in a later year.

The Senate Finance Committee Report indicates that a consolidated return is a return of one entity in which the earnings of the entire group is to be included in one tax return. The Committee voiced the following about consolidation:

> The mere fact that by legal fiction several corporations owned by the same stockholders are


separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit.69

In another paragraph, the Committee stipulated that "it is only when the corporations are really but one corporation" that consolidated returns may be filed.70

The 1928 Revenue Act did give the Treasury the authority to deal with problems arising from consolidated returns by issuing Regulations. However, the Finance Committee made it clear that consolidated returns were based upon the concept that an affiliated group is a single corporation, and under this concept any unrealized intercompany profit or loss was to be eliminated both from the year of the transaction and for all other years. Congress provided for the continuation of the consolidated return rules that were already in existence under the 1918, 1921, 1924, and the 1926 Revenue Acts. Undoubtedly, Congress contemplated a continuation of the prior consolidated return concept and not the creation of something entirely new and different.

The House Ways and Means Committee followed the same line of reasoning with respect to consolidated

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70Ibid.
returns in the Revenue Act of 1934. The Committee pointed out that "the one way to secure a correct statement of income from affiliated corporations is to require a consolidated income, with all inter-company transactions eliminated."^1 Emphasis added The Committee believed that for all practical purposes the various subsidiaries, although technically distinct entities, were actually branches or departments of one enterprise. Furthermore, the Committee believed that consolidated returns would enable the Treasury to deal with a single taxpayer instead of many subsidiaries, and would eliminate "the necessity of examining the bona fides of thousands of intercompany transactions."^2

The only possible conclusion that can be drawn from the Committee Reports is that the computation of consolidated income is based upon the concept that an affiliated group is a single corporation. Under this one corporation concept, all intercompany transactions are to be eliminated. Furthermore, the elimination of those intercorporate transactions will alleviate the


^2Ibid.
necessity of examining the authenticity of thousands of intercompany transactions. Thus, Congress believed that intercorporate profit or loss had no significance in the determination of the tax of a group of corporations electing to file a consolidated return.

Consolidated return Regulations have reinforced the statutory consolidation concept for many years. These Regulations have typically required the following procedure for computing consolidated taxable income:

Subject to the provisions covering the determination of taxable net income of separate corporations; and subject further to the elimination of intercompany transactions (whether or not resulting in any profit or loss to the separate corporations), the consolidated taxable net income shall be the combined net income of the several corporations consolidated. 73

That is, prior Regulations have met the statutory provisions as established by Congress. However, the new Regulations have abandoned the consolidated return concepts prescribed for nearly fifty years; unrealized profits and losses on intercompany transactions must now be reflected in taxable income. Not only is this deferred accounting system contrary to the reasoning

73See Regs. 45, 62, and 65, promulgated under the Revenue Acts of 1918, 1921, and 1924, respectively; see also Reg. 69, Arts. 631 to 637 (1926).
of Congress, but the elimination of intercompany profit or loss is also a widely held accounting view.

Aside from being nonstatutory, the deferred accounting system does not eliminate the necessity of examining the authenticity of intercompany transactions. In fact, under this new system taxpayers will be tempted to price intercompany sales at as low a price as possible. If intercompany sales are priced at figures below the cost value, the items suspended will be losses from which benefits can be obtained in later years. Thus, in order to protect itself, the government may have to make innumerable decisions relating to the fair market value under Section 482. This Section of the Internal Revenue Code permits the I.R.S. to allocate items of income and deductions among related parties in order to equate controlled to uncontrolled parties.

The problem of examining the *bona fides* of intercompany transactions may become more significant since any examination must be made as early as possible in the audit of the following year. In many cases, audits will be required in years far in the future. The new system is in direct contradiction of the Committee Report on the 1934 Act. Congress believed that
consolidation should eliminate "the necessity of examining the bona fides of thousands of intercompany transactions."\textsuperscript{74}

As previously mentioned, the Beck Builders' tax avoidance device acted as the prime motivating factor in the revision of the Regulations. Since the Treasury does have the authority to prescribe rules which will prevent the avoidance of tax, some modification of the intercompany elimination rule was appropriate in order to prevent this tax avoidance. Although the new system is nonstatutory, it does adhere to the established rules of accounting in many respects. By treating similar transactions consistently and attributing income to the affiliate that earns it, the deferred accounting system provides for a better determination of consolidated tax liability. However, Congress should issue a Committee report or indicate that this new system is statutory under the Internal Revenue Code. Perhaps the I.R.S. will go slow in subjecting intercompany sales to readjustment under Section 482.

\textsuperscript{74}H.R. Rep. No. 704, 73rd Congress, 2nd Sess., p. 17 (1934).
CHAPTER V

CONSOLIDATED TAXABLE INCOME:
OTHER THAN INTERCORPORATE TRANSACTIONS

Since Chapter IV discussed intercorporate trans­
actions with respect to accounting and tax treatment,
Chapter V is a continuation of the discussion involving
the computation of consolidated taxable income. The
four remaining computational differences between consol­
didated returns and separate returns are as follows:
built-in deductions, transactions involving stock or
obligations, excess loss and earnings and profits
accounts, and consolidated items. Computation of the
tax liability concludes the chapter.

Built-in Deductions

As previously mentioned in the preceding chapter,
in the process of calculating the separate taxable income
of each affiliate, certain calculations must follow
special rules before they can be included in the taxable
income of the individual members. As in the case of
intercompany transactions, built-in deductions require special consideration. In general, the limitations on built-in deductions are designed to prevent a group from acquiring a subsidiary with unrealized losses for the purpose of offsetting these losses against income of other members of the group. Since realized and unused losses from separate return limitation years are limited to the income generated by the member,\(^1\) the built-in deduction rules attempt to put the unrealized losses on the same footing as realized losses. Thus, the reasoning of the built-in deductions rules is that an unrealized loss is no better than a realized one.

Built-in deductions are those deductions or losses "economically accrued" in a separate return limitation year (SRLY). That is, deductions or losses that are economically accrued by a subsidiary before its acquisition but are recognized after such acquisition are classified as built-in deductions. The term does not include, however, "operating deductions or losses incurred both economically and taxwise in a year which is not a separate return limitation year, including

\(^1\)Reg. 1.1502-1(f).
those deductions and losses incurred in rehabilitating such corporation."\(^2\)

Earlier Regulations contained a provision dealing with built-in deductions which was restricted to four items: Section 1234 property, capital assets, securities, and receivables.\(^3\) Although at least one court case\(^4\) indicated that the old rules were invalid, the new Regulations not only disregard this judicial interpretation but also enlarge the number of items classified as built-in deductions. Areas that were expanded include depreciation, depletion, or amortization deductions and inventory deductions. After 1965 these deductions may be classified as built-in deductions. There is legislation to the effect that a corporation cannot carryover its previous net operating losses where there has been a change in stock ownership and a change in the type of business performed.\(^5\) However, since there is no statutory provision that disqualifies current ordinary deductions, the present definition of

\(^{2}\text{Reg. 1.1502-15(a)(2).}\)

\(^{3}\text{Reg. 1.1502-31(b)(9)(1964).}\)

\(^{4}\text{Joseph Weidenhoff, Inc., 33 T.C. 1222 (1959).}\)

\(^{5}\text{I.R.C. Sec. 382(a), but cf. post note 121.}\)
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built-in deductions should be restricted to the four items enumerated in the prior Regulations.

Built-in deductions are not automatically disallowed; instead, they are treated as if they were in fact recognized before acquisition. Therefore they are subject to a modified separate return limitation year limit (SRLY). Any deductions that are disallowed are not necessarily irrevocably lost. Instead, the modified SRLY limit merely restricts the deductions to the income that is generated by the corporation which was acquired by the affiliated group. Thus, there is no statutory provision that stipulates that the deductions may never be used.

Since both capital deductions and ordinary deductions have different tests to meet, the first step is to identify and classify the built-in deductions as capital or ordinary deductions. Next, the two types of deductions are limited to the income generated by the member that suffered the economic impact of the loss.

In computing the limitation for ordinary deductions the following steps should be followed:

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6The Separate Return Limitation Year (SRLY) limit will be discussed later in this chapter.
1) Calculate the consolidated taxable income of all members before any net operating loss deduction.

2) Make a similar calculation of consolidated taxable income, but exclude the ordinary built-in deductions of the member being analyzed.

3) If step 1 exceeds step 2, reduce the excess by any ordinary built-in deductions of the member occurring in years prior to the SRLY being examined.

4) The remainder, if any, is the maximum ordinary built-in deduction from that member which may be utilized in the consolidated return year. Any ordinary deductions that cannot be used are treated as net operating losses arising in a SRLY, and may be carried back or forward, subject to the SRLY limitations in general.

Capital built-in deductions are handled in a similar manner. And procedures similar to the ones discussed above should be followed in determining the limitations on these deductions. Although capital built-in deductions that are not allowable are treated as capital losses arising in a SRLY, they may be carried forward to succeeding years, subject to the general SRLY limitations.

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7Reg. 1.1502-15(a)(1).

8Ibid.
Three exceptions to the built-in deductions rule make this rule applicable only in windfall situations. First, the rule is not retroactive and does not apply to corporations which became members of the group before October 1, 1965. In this case, the limitations covered in the old Regulations will continue to serve as a guideline for these members. Second, the built-in deductions rule will not apply if more than ten years have elapsed between the time the member with the built-in deductions joined the group and the first day of the consolidated return year. Third, the rule does not apply if immediately before the corporation became a member the aggregate basis of its assets (except cash, goodwill, and any marketable securities whose value was at least ninety-five percent of its basis) did not exceed their aggregate fair market value by more than fifteen percent. This determination of fair market value may prove difficult since goodwill is excluded from the computation.

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Transactions in Stock and Obligations

There is no difference between the proper accounting treatment and the tax treatment for intercorporate dividend distributions. Dividends between members of an affiliated group in a consolidated return year are eliminated in determining consolidated taxable income.\(^{11}\) Thus, an affiliated group saves 7.2 percent tax with respect to intercorporate dividends (15% x 48%).

Any capital distribution ordinarily reduces the adjusted basis of the stock in the hands of the recipient. If the non-dividend distribution exceeds the adjusted basis of the stock, any excess is treated as a gain from the sale or exchange of property (generally a capital gain).\(^{12}\) However, for consolidated purposes any non-dividend distribution will reduce the basis of the stock, but any excess over basis is not treated as a gain. Instead, the excess is added to the recipient's excess loss account applicable to the distributor's stock.\(^{13}\) Thus, the gain on non-dividend distributions is deferred until the future.

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\(^{11}\)Reg. 1.1502-14(a)(1).

\(^{12}\)I.R.C. Sec. 301(c).

\(^{13}\)Reg. 1.1502-14(a)(2).
For example, corporation P and its wholly-owned subsidiary S are members of a group filing consolidated returns. On December 31, 1966, S distributes $5,000 cash and land with an adjusted basis of $6,000 and a fair market value of $5,000 to P. The distribution does not constitute a dividend. On December 31, 1966, P had an adjusted basis of $3,000 in the stock of S. The $11,000 distribution is treated as follows: $3,000 is applied against and reduces the adjusted basis of the stock to zero, and $8,000 is treated as P's excess loss account for its stock in S. No gain is recognized by P, and P's basis in the land is $6,000.  

No gain or loss is recognized when an affiliated member receives property for the cancellation or redemption of all of or part of the stock of another member. A distribution is classified as a cancellation or redemption of stock if it is a complete liquidation or a partial liquidation of the distributing corporation and the corporation remains a member of the group immediately after the distribution. However, a gain or loss is

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14Ibid.

15Reg. 1.1502-14(b)(1).
recognized where the liquidating distribution is outside of Section 332 and cash in excess of basis is received.\textsuperscript{16}

A distributing corporation recognizes the gain or loss on a distribution just as if separate returns were filed. That is, if the stock held is a capital asset and not in a dealer's inventory, a capital gain or loss is recognized. If, however, the distribution is not a complete liquidation and the distributing corporation remains a member of the group, any recognized gain or loss is deferred. The deferred gain or loss is taken into income at the earliest of the following events:

1) when the distributee corporation ceases to be a member, or

2) when the stock of the distributing corporation is disposed of by any member of the group.\textsuperscript{17}

Gains or losses from intercompany obligations are deferred until the happening of certain events. If the obligation leaves the group, any deferred gain or loss is taken into income ratably over the remaining life of the debt. Or else, the deferral is taken into account immediately before (1) the creditor member leaves the

\textsuperscript{16}Reg. 1.1502-14(b)(2).

\textsuperscript{17}Reg. 1.1502-14(b)(3).
group, (2) the obligation is redeemed or canceled, or (3) the stock of the debtor is disposed of outside the group.\(^{18}\) The character of gains or losses from intercompany obligations is determined at the time of the initial transaction.\(^{19}\)

Thus, the tax law relating to intercompany bond holdings conforms to generally accepted accounting practice, since the reciprocal elements of the bonds are eliminated and only bonds of outsiders are shown on consolidated statements. In contrast to the previous Regulations,\(^{20}\) the present Regulations provide that a gain or loss on the sale or retirement of a bond of a member of the group is reported by the earning or sustaining member.

Tax treatment of premium or discount applicable to intercompany bonds is similar to the accounting treatment.\(^{21}\) For example, on April 9, 1968, P sells an issue of its $100 par value bonds. S purchases a bond from P for $120, and both companies file consolidated statements.

\(^{18}\)Reg. 1.1502-14(d).
\(^{19}\)Reg. 1.1502-14(e).
\(^{21}\)Reg. 1.1502-14(d)(5).
returns on a calendar year basis. S does not elect under Section 171 to amortize the $20 premium. P cannot take the $20 premium into income until it redeems the bond since S cannot properly take a deduction for the $20 premium until the bond is redeemed. Thus, when an affiliated group is viewed as one company, both the intercompany bonds and any premium or discount balances related to such bonds lose their significance and must be eliminated.

A deduction which results from a debt becoming worthless or a deduction for a reasonable addition to an allowance for an uncollectibles account is treated as a loss from the disposition of such debt.\(^{22}\) Under the old Regulations, if a deduction for a bad debt was not taken currently, a deduction may never have been allowed in the future. Now, however, a bad debt deduction may be taken currently, or, if not taken currently, the deduction will at least be allowed sometime in the future.

**Intercompany Investment Adjustments.** New consolidated return Regulations require adjustments to reflect annual changes in the investment account of a subsidiary.

\(^{22}\text{Reg. 1.1502-14(d)(i).}\)
These adjustments to the investment account must follow a tax equity approach instead of the cost approach. The premise of the tax equity method is that the basis of the subsidiary's assets should equal the basis of the parent's investment. This method can be justified as a result of the economic unity that is represented by the affiliated units as well as the control the parent can exercise over the subsidiary's activities. Thus, subsidiary profits improve the financial position of the parent and can be made available to the parent as a result of the control over the subsidiary. Conversely, losses of the subsidiary adversely affect the parent.

Generally, at the end of each consolidated return year the parent must increase the basis of its investment in a subsidiary for the profits or losses of the subsidiary reduced by dividend distributions.\textsuperscript{23} Corresponding adjustments must also be made to the parent's earnings and profits account in order to balance the parent's balance sheet.\textsuperscript{24} If the subsidiary operates at

\textsuperscript{23}Reg. 1.1502-32.

\textsuperscript{24}Reg. 1.1502-33(c). The earnings and profits account refers to the retained earnings account. Instead of adjusting the earnings and profits account for financial purposes, a new revaluation surplus (or deficit) can be created. Both methods would achieve similar results since the revaluation surplus account is closed into earnings and profits at the time the stock is sold.
a net profit for the entire year, the parent must increase both its basis in the subsidiary and its earnings and profits account. On the other hand, when the subsidiary operates at a deficit for the entire year, the parent must decrease both its basis in the subsidiary and its earnings and profits account.

In cases where a subsidiary is not included in a consolidation, a distribution is a dividend to the extent that it results from earnings and profits of the subsidiary and a return of capital in all other situations. The same rule was followed by the previous Regulations which used the cost method. Under the tax equity method required by the present Regulations, all distributions after 1965 will be treated as a return of capital which reduces the parent's stock basis. Since the parent's earnings and profits account is increased when income is earned by the subsidiary, any intercompany dividends merely require an adjustment of the investment account to reflect the subsidiary's reduced book value.

25I.R.C. Sec. 301(c).

26There was an exception in the case of distributions from preacquisition earnings. The previous Regulations disallowed losses on the sale of stock to the extent of distributions out of preacquisition earnings and profits. Reg. 1.1502-33(c)(1965).
Actually, the basis of the stock of each subsidiary and the earnings and profits account of the parent are increased or decreased for the net positive or net negative adjustments applicable to each subsidiary.\footnote{Reg. 1.1502-32(a).} "Tier" rules require that the adjustments start at the lowest level and proceed upward. Stock which is limited and preferred as to dividends is treated differently from stock that is not limited and preferred as to dividends.

There are three items that are classified as positive adjustments for stock not limited and preferred as to dividends: (1) an allocable portion of the undistributed earnings\footnote{"Undistributed earnings" refers to the earnings and profits of the taxable year, decreased by dividend distributions.} of the subsidiary for the taxable year, (2) an allocable part of the portion of any consolidated net operating loss or consolidated net capital loss, and (3) if the company owns stock in another subsidiary, an allocable portion of the net positive adjustment made by the higher tier subsidiary.\footnote{Reg. 1.1502-32(b)(1).}

Four items are classified as negative adjustments: (1) an allocable portion of any deficit in earnings of
the subsidiary for the taxable year, (2) an allocable portion of any net operating loss or net capital loss sustained in some other year which is absorbed in the consolidated return for the current year, (3) total distributions made during the current year out of earnings of the current year and preaffiliation years, and out of consolidated return years beginning after 1965, and (4) if the company owns stock in another subsidiary, an allocable portion of the net negative adjustment made by the higher tier subsidiary.  

By combining the positive adjustments and the negative adjustments, a figure can be obtained which is classified as either the net positive adjustment or the net negative adjustment.

The positive adjustment with respect to a share of stock which is limited and preferred as to dividends is an allocable portion of the undistributed earnings of the subsidiary for the taxable year. A negative adjustment is the total distribution made during the current year out of earnings of the current year and preaffiliation years, and out of consolidated return years.

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30Reg. 1.1502-32(b)(2).
beginning after 1965.\textsuperscript{31}

Allocation of undistributed earnings for the taxable year among the members of the affiliated group is complicated. Undistributed earnings for the taxable year are first allocated to all of the outstanding stock (including stock held by nonmembers) which is limited and preferred as to dividends. The amount allocated to the limited and preferred stock is equal to the excess, if any, of (1) the cumulative dividends in arrears (determined as of the last day in the subsidiary's taxable year) for all consolidated return years after 1965, over (2) the accumulated earnings of the subsidiary as of the first day of the taxable year. However, there is one limitation--the amount cannot exceed the accumulated earnings of the subsidiary as of the last day of the taxable year.\textsuperscript{32} Any balance of undistributed earnings plus any net positive adjustments made by the subsidiary with respect to lower tier subsidiaries is allocated among all of the outstanding stock of the subsidiary that is not limited and preferred as to dividends.\textsuperscript{33}

\textsuperscript{31}Reg. 1.1502-32(c).
\textsuperscript{32}Reg. 1.1502-32(d)(1).
\textsuperscript{33}Reg. 1.1502-32(d)(1)(ii).
Consolidated returns Regulations are unclear as to how the parent's basis and the earnings and profits account is to be altered when the parent owns less than one hundred percent of the subsidiary. Presumably, full adjustments are not required for undistributed earnings or deficits since the Regulations stipulate that these amounts are to be allocated to all outstanding stock "including the stock held by nonmembers."\(^{34}\) The Regulations allude to proportionate adjustment throughout Sections 1.1502-32(b) and (c) by using the phrase "an allocable part."\(^{35}\) The Proposed Regulations stipulated that the full adjustment was to be allocated to the stock of the subsidiary "even if less than 100 percent of the subsidiary's outstanding stock is owned by members,"\(^{36}\) but this stipulation was omitted from the final Regulations. Regrettably, the final Regulations do not point out what is meant by "an allocable part," and none of the illustrations provided in the Regulations involve ownership of less than one hundred percent.

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\(^{34}\)See Reg. 1.1502-32(d).

\(^{35}\)The phrase "an allocable part" did not appear in the Proposed Regulations; Prop. Reg. 1.1502-32(b), September 8, 1966.

\(^{36}\)Prop. Reg. 1.1502-32(c)(1), September 8, 1966.
If the parent is required to include all of the subsidiary's earnings, a significant windfall will accrue to the minority shareholders. Of course, the opposite would result if the subsidiary shows a deficit. To avoid this inequity, the parent's basis should be adjusted only by its proportionate share of the subsidiary's profits or losses. For example, if P owns eighty percent of S and S earns $100, P's earnings and profits account and its basis should be increased by only $80.

From a legal standpoint, periodic profits and losses of a subsidiary do not affect the parent's capital or the parent's ability to declare dividends. No income can be recognized unless the parent receives the earnings in the form of dividends. Until the recent revision the income tax laws took this same legal position. Thus, even if a company used the equity approach some modification was necessary to provide for a distinction between capital that emerges from the recognition of changes in interests in the subsidiary and capital that is legally realized and available for dividends. Such modification can be in the form of an appraisal accounting entry.
(or revaluation surplus account). Instead of crediting the subsidiary's earnings (or losses) directly to the parent's retained earnings, a credit is made to an appraisal capital account. Subsequently, when earnings are distributed by the subsidiary an entry would be made to decrease the appraisal capital account and increase the parent's retained earnings account.

Most states will allow the parent to make dividend distributions only from its own retained earnings. That is, any increase in the parent's retained earnings which results from unrealized subsidiary earnings cannot be paid out as dividends. The Ohio General Corporation Law actually prohibits the payment of dividends from undistributed retained earnings. However, the Pennsylvania Business Corporation Law permits dividend distributions out of consolidated retained earnings.


Thus, the state law assumes that the equity method is sufficiently sound and assumes that the stockholders expect their board of directors to have the power to pay dividends to the extent of consolidated retained earnings, regardless of the fact that the earnings upon which they are based are not available to the parent.\footnote{Hackeny, \textit{supra}, note 38, p. 34.}

One commentator, while discussing the Pennsylvania law, stated that it "accommodates the unanimous practice of gauging financial strength and performance of a group of affiliated corporations by reference to consolidated financial statements."\footnote{\textit{Ibid.}} However, Chairman Manuel F. Cohen of the Securities and Exchange Commission disagreed with this "unanimous practice." He states, "The effect of consolidated financial statements has been, at times, to obscure financial information which may be important to a sound analysis of the company's worth and future prospects."\footnote{Albert J. Bows, Jr., "Problems in Disclosure of Segments of Conglomerate Companies," \textit{The Journal of Accountancy}, Vol. 122 (December, 1966), 33.}

Aside from adjusting the parent's basis for undistributed earnings, there are several other miscellaneous...
operating rules that should be discussed. When an adjustment to the investment account and to the earnings and profits is made prior to the end of the taxable year of the subsidiary, all plus and minus factors, except dividend distributions, must be prorated on a daily basis.\textsuperscript{44} Furthermore, if a subsidiary joins in the filing of consolidated returns before 1967, the starting basis of the subsidiary's stock is determined by applying transitional rules from the previous Regulations (see Reg. 1.1502-34A(b)(2) and (c)\textsuperscript{45}). In addition, if all of the stock of a subsidiary is owned on each day of the subsidiary's taxable year by members of the affiliated group, an election can be made by the group to treat the subsidiary as having made a distribution in an amount equal to its accumulated earnings on the first day of the taxable year. In turn, each member who owns stock in the subsidiary is assumed to have received an allocable portion of the distribution and immediately contributed his share to the capital of the subsidiary. The election must be made before the

\textsuperscript{44} Reg. 1.1502-32(d)(4).

\textsuperscript{45} Reg. 1.1502-32(f)(1).
due date of the consolidated return (including extensions of time).\footnote{Reg. 1.1502-32(f)(2).}

In order to prevent tax avoidance or undue hardship on the taxpayers, a transitional adjustment must be made, under the equity method, on the first day that a separate return is filed by the parent or the subsidiary. Assume that $P$ organizes $S$ in 1967 by investing $500 for all of $S$'s stock. $S$ accumulates $100 of earnings during the consolidated return year of 1967. These earnings increase $P$'s basis to $600. $P$ terminates its obligation to file consolidated returns by selling forty percent of the stock of $S$ on January 1, 1968, for $300, that causes a recognition of a $60 gain ($300 - $240). However, $P$ retains economic control and can cause $S$ to distribute its accumulated earnings. A distribution in a normal nonconsolidation situation would be a dividend which increases $P$'s earnings and profits account without affecting the parent's basis. If no adjustment is required after a consolidated return period, $P$'s earnings would be increased twice for the same income. In addition, $P$'s basis is not reduced and a subsequent
sale of S's stock for $300 would produce a fictitious loss of $60 ($360 - $300).

This illustration shows that a member owning stock in a subsidiary must decrease its basis on the first day of the first separate return year of the parent or of the subsidiary. The amount of the decrease in the parent's basis is the lesser of: (1) the accumulated earnings and profits of the subsidiary, or (2) the excess of the net positive adjustments for all consolidated return years.\(^{47}\) By referring to the same facts in the preceding paragraph, one can readily see that an adjustment must be made on the first day of the parent's separate return year. The parent's basis is decreased to $300 by subtracting the $60 of accumulated earnings. Later, when the remaining sixty percent of stock is sold for $300, no loss is recognized since the parent's basis is also $300.

**Illustration.** The following example should serve as a guide to the adjustments to the basis of stock of subsidiaries. On January 1, 1966, corporation P organized a wholly-owned subsidiary, corporation S, and invested $1,000 in the stock of S. On the same date S

\(^{47}\)Reg. 1.1502-32(g)(2).
organized an eighty percent owned subsidiary, corporation T, and invested $600 in the stock of T. Consolidated returns are filed for the years 1966 through 1969, and there are no consolidated net losses. Earnings and deficits of S and T were as follows:

<table>
<thead>
<tr>
<th></th>
<th>S</th>
<th>T</th>
</tr>
</thead>
<tbody>
<tr>
<td>1966</td>
<td>$100</td>
<td>$(150)</td>
</tr>
<tr>
<td>1967</td>
<td>200</td>
<td>(900)</td>
</tr>
<tr>
<td>1968</td>
<td>(1000)</td>
<td>600</td>
</tr>
<tr>
<td>1969</td>
<td>500</td>
<td>(100)</td>
</tr>
</tbody>
</table>

There was one dividend distribution: $100 from S to P in 1969. On December 31, 1969, the adjusted basis of the stock of S and T would be $160 and $360, respectively, computed as follows:

<table>
<thead>
<tr>
<th>Original Basis</th>
<th>S in T</th>
<th>P in S</th>
</tr>
</thead>
<tbody>
<tr>
<td>1966:</td>
<td>$600</td>
<td>$1,000</td>
</tr>
<tr>
<td>Deficit of T</td>
<td>(120)*</td>
<td>(120)</td>
</tr>
<tr>
<td>Undistributed earnings of S</td>
<td>---</td>
<td>100</td>
</tr>
<tr>
<td>Basis</td>
<td>480</td>
<td>980</td>
</tr>
<tr>
<td>1967:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deficit of T</td>
<td>(720)*</td>
<td>(720)</td>
</tr>
<tr>
<td>Undistributed earnings of S</td>
<td>---</td>
<td>200</td>
</tr>
<tr>
<td>Basis or (excess loss account)</td>
<td>(240)</td>
<td>460</td>
</tr>
<tr>
<td>1968:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Undistributed earnings of T</td>
<td>480*</td>
<td>480</td>
</tr>
<tr>
<td>Deficit of S</td>
<td>---</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Basis or (excess loss account)</td>
<td>240</td>
<td>(60)</td>
</tr>
</tbody>
</table>
1969:

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deficit of T</td>
<td>(80)*</td>
</tr>
<tr>
<td>Undistributed earnings of S</td>
<td>--</td>
</tr>
<tr>
<td>**</td>
<td>400**</td>
</tr>
<tr>
<td>Basis</td>
<td>160</td>
</tr>
<tr>
<td></td>
<td>360</td>
</tr>
</tbody>
</table>

*Computed by multiplying 80% times the net earnings or deficit for the taxable year.

**Earnings minus dividends equals undistributed earnings
($500 - $100 = $400)

Excess Loss and Earnings and Profits Accounts

Excess Loss Account. In accounting for the investment in a subsidiary's stock, deficits or other negative adjustments may reduce the basis of the investment to zero. In fact, consistent application of the equity method may result in a negative basis in the subsidiary's stock. Prior to the revised Regulations, distributions that would reduce the stock basis below zero were treated as capital gains.\(^{48}\) Since the parent's capital gains offset the subsidiary's operating loss, the application of this technique to losses in excess of the stock basis denied a portion of the affiliated group's loss deduction. Limiting the use of a subsidiary's operating loss is inconsistent with the entity

theory of group taxation. Furthermore, even if the subsidiary has a negative book value which results from unrealized asset appreciation, no event has occurred justifying the recognition of a gain by the parent. Thus, some authorities advocate the recognition of a negative basis.

A negative basis may result if a subsidiary with low-basis assets borrows funds to the extent of market value and distributes the funds to the parent. Instead of immediately recognizing the gain, the intercompany transaction should be eliminated. Under the equity method there is a corresponding adjustment to the parent's stock basis to reflect its investment in the subsidiary. Thus the equity method merely defers recognition of gains or losses until there are transactions with outside parties. Negative basis does not,


51 This situation can be illustrated by the Beck Builders' case discussed in Chapter IV.
therefore, result in a tax-free recovery in excess of historical cost, but merely delays the recognition of any gain until the subsidiary's stock is sold.\footnote{Notes, "The Affiliated Group as a Tax Entity: A Proposed Revision of the Consolidated Returns Regulations," \textit{Harvard Law Review}, Vol. 78 (May, 1965), 1415.}

The Treasury has rejected, in the past, other negative basis proposals,\footnote{E. Randolph Dale, "Consolidated Returns: Suspense Accounts for Intercompany Transactions?" \textit{The Tax Executive}, Vol. 14 (October, 1961), 76, 84.} but the consolidated return Regulations now contain in essence, a negative basis concept. Even though the parent may make long-term advances to the subsidiary which, in fact, constitute an investment, once the subsidiary's basis is zero; these advancements are not affected by subsidiary losses.\footnote{Reg. 1.1502-32(e)(1).} Instead, any deficits or other negative adjustments are added to an excess loss account which must be maintained by the parent.\footnote{ibid. The excess losses account is also increased by Section 301 distributions not made out of earnings and profits which exceed the basis of the stock. Reg. 1.1502-14(a).}

A member must report any balance in the excess loss account as a gain when disposing of the stock of a
subsidiary. Ordinarily, the gain is taxed as a long-term capital gain, unless the subsidiary is insolvent.\footnote{Reg. 1.1502-19(a)(2)(i).} If the subsidiary's stock is worthless, any gain is taxed as ordinary income unless the group can establish that the excess loss account is attributable to capital losses of the subsidiary which reduced the long-term capital gains of the group.\footnote{Reg. 1.1502-19(a)(2)(ii).} The stock is considered worthless if the fair market value of the subsidiary's assets is less than the sum of: (1) all of the subsidiary's liabilities, (2) all of the subsidiary's liabilities which were discharged during consolidated return years to the extent that such discharge would have resulted in cancellation of indebtedness income if the subsidiary was insolvent, and (3) the amount to which all stock, limited and preferred as to dividends, of the subsidiary is entitled to in liquidation.\footnote{Reg. 1.1502-19(a)(3).} When the stock is considered to have been disposed of by a distribution in cancellation or redemption of the stock, any gain is deferred until the distributee ceases to be a member or the stock is disposed of by the distributee.\footnote{Reg. 1.1502-19(a)(2)(ii).}
A subsidiary's stock is considered disposed of on a share-by-share basis if a share is transferred to any nonmember, or the owning member receives a distribution in cancellation or redemption of such share. Conversely, all shares of a member will be considered disposed of when the following events transpire:

1) The subsidiary ceases to be a member of the group.

2) The owning member ceases to be a member of the group.

3) The subsidiary's stock becomes worthless or its debt is discharged and no income is recognized because of insolvency.

4) The subsidiary's creditors could recover no more than ten percent of the face amount of any of its obligation.

5) An obligation of the subsidiary is transferred by a member to a nonmember for twenty-five percent or less of its face value.

6) The group discontinues the filing of consolidated returns.  

\[60\text{Reg. 1.1502-19(b)(1).}\]

\[61\text{Reg. 1.1502-19(b)(2).}\]
If a disposition occurs, "tier" rules provide that the recognition of income and investment adjustments start at the lowest level and proceed upward. For example, assume that corporation P owns all of the stock of corporation S and as a result, has an adjusted basis of zero and an excess loss account of $5. Corporation S owns all of the stock of corporation T and, consequently, has an adjusted basis of zero and an excess loss account of $15. Finally, T has an adjusted basis of zero and an excess loss account of $10 as a result of owning all of the stock of corporation V. The stock of T is sold to a nonmember; both T and S are considered to have disposed of stock of a subsidiary in the same transaction. Since V is the lowest tier subsidiary, its excess loss account is liquidated first. T realizes income of $10 and S's excess loss account with respect to T's stock is reduced to $5 ($15 - $10). P's excess loss account with respect to S's stock is reduced to zero, and its basis for S's stock is increased to $5. Next, T's remaining $5 excess loss account is eliminated; S realizes income of $5, and P's basis for S's stock is increased by $5 to $10.

62Reg. 1.1502-19(c)(1).
A transfer of subsidiary stock between members of the consolidated group is not a disposition that requires the balance in the excess loss account to be forced into income. The transferee merely inherits the transferor's excess loss accounts. However, if the transferor owns or receives stock of the transferee, the transferor's excess loss account reduces the basis of the stock which the transferor owns or receives of the transferee. If the basis is reduced to zero, any excess becomes the transferor's excess loss account.

When a tax-free corporate acquisition under Section 381(a) occurs between members of an affiliated group, any member that owns stock in the subsidiary does not have to recognize as income any amount in the excess loss account. The excess loss account evaporates without tax effect. Thus, in the event of a tax-free liquidation under Section 334(b)(1) any excess loss account is eliminated and is not included within any member's income. However, if a member who owns stock in a subsidiary receives stock in another member in exchange for the stock of the subsidiary, the basis of

63 Reg. 1.1502-19(d)(1).
64 Reg. 1.1502-19(d)(2).
the stock received is reduced by any amount in the excess
loss account. In situations where the stock basis is
reduced to zero, any remaining amount is treated as an
excess loss account by the receiving corporation. There­
fore, an excess loss account reduces the basis of the
stock in a statutory merger or consolidation under
Section 368(a)(1)(A).65

**Earnings and Profits Account.** Although an affil­
iated group consolidates taxable income, the separate
earnings and profits accounts are not consolidated.66

However, if consolidated returns are filed they will
affect the separate earnings and profits accounts of
the members of the affiliated group.

The status of the earnings and profits accounts
of the various members of an affiliated group deter­
mines whether their distributions are treated as divi­
dends which are paid from earnings and profits. This
determination is essential in consolidated return years
as well as in separate return years which follow a
consolidated return period. Dividends are normally

65 Reg. 1.1502-19(e).

Ohio, 1958); Taylor-Wharton Iron & Steel Co., 5 T.C.
768 (1948).
eliminated in consolidated return years. However, distributions not resulting from earnings and profits reduce the stock basis, and any excess over basis is added to the recipient's excess loss account. When the stock is disposed of by the holder, any amount in the excess loss account is taxed as capital gains.

Profits or losses on intercompany transactions that are realized outside the affiliated group during the same taxable year in which the transactions occur affect the earnings and profits accounts of the members of the group which actually incur them. Under the deferred accounting system the profits or losses enter into the computation of the separate earnings and profits accounts of the members of the group just as if separate returns had been filed. Intercompany transactions which result in the deferral of profits or losses because they are not realized in the same year have their earnings and profits effect similarly deferred.

The courts have endorsed the principle that earnings and profits computations should follow the

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67 Reg. 1.1502-14(a)(2).
68 Reg. 1.1502-19(a).
69 Reg. 1.1502-33(a).
computation of taxable income unless they are a result of artificial prices within the group. In this case, the prices may be disregarded in determining the separate taxable incomes. Since it is advantageous for taxpayers to price intercompany sales as low as possible under the deferred accounting system, the government may be forced to make innumerable determinations of fair market value under Section 482. Consequently, the same rule may be applied in determining earnings and profits separately for the members of the group.

An exception to the general rule on the deferment of profits and losses on unrealized intercompany transactions can be found in the consolidated return Regulations. Affiliated groups filing consolidated returns can adopt, with the Commissioner's consent, a consistent practice of taking unrealized intercompany profits or losses with respect to all property or any class or classes of property into account in computing consolidated

\[70\textit{Bangor & A.R.R. v. Commissioner}, 193 F.2d 827 (1st Cir. 1951), \textit{cert. denied.} 343 U.S. 934 (1952).\]

\[71\textit{The Autocar Co. v. Commissioner}, 84 F.2d 772 (3rd Cir. 1936).\]

\[72\textit{Chap. IV, supra}, p. 180.\]
taxable income. These profits and losses must be considered in computing the earnings and profits accounts of the members of the group.

A cash distribution of earnings by a subsidiary to its parent in a consolidated return year reduces the subsidiary's earnings and profits account by the amount of the distribution and increases the parent's earnings and profits account by an amount equal to the subsidiary's reduction. If the distribution exceeds the earnings and profits account of the subsidiary, any excess reduces the basis of the subsidiary's stock in the hands of the parent. After the basis is exhausted, any excess is added to the recipient's excess loss account. Any amount in the excess loss account is treated as long-term capital gain upon the disposition of the subsidiary's stock. Dividend distributions in property likewise reduce the earnings and profits account of the distributing corporation and increase the earnings and profits account of the recipient.

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73Reg. 1.1502-13(c)(3).

74Reg. 1.1502-14(a)(2). Nondividend distributions in excess of basis in taxable years before 1968 will affect the earnings and profits account.

75Reg. 1.1502-19(a).
There are other adjustments to the earnings and profits accounts of the members of affiliated groups. Inventory adjustments giving rise to taxable income recognition as well as allowance of a deduction are reflected in the earnings and profits account.\textsuperscript{76} Likewise, recognized (nondeferred) gains and losses on members' stock and obligations immediately affect the earnings and profits account. However, deferred gains or losses on disposition of the stock or obligations of a subsidiary affect the earnings and profits account of a member in the taxable year in which the gains or losses are taken into account.\textsuperscript{77}

An affiliated group has an option as far as investment adjustments are concerned. The group may either elect to adjust its earnings and profits accounts currently, or the group must adjust its earnings and profits accounts as directed by the Regulations. The election to currently adjust earnings and profits accounts is made by submitting a statement to that effect, on or before the due date of the consolidated return for the first taxable year for which the election

\textsuperscript{76}Reg. 1.1502-33(b).

\textsuperscript{77}Reg. 1.1502-33(c)(3).
is to apply, to the district director with whom the group files its return. Once the election is made, it cannot be revoked.\textsuperscript{78}

If an election is made by a group to adjust its earnings and profits account currently, the following adjustments to the members' stock bases or excess loss accounts are also reflected in the members earnings and profits accounts:

1) The net positive and net negative adjustments under Regulations 1.1502-32(e), except the positive and negative adjustments resulting from owning a higher tier subsidiary.\textsuperscript{79}

2) The adjustment that a member makes on the first day of a separate return year to prevent tax avoidance pursuant to Regulations 1.1501-32(g).

3) If a member uses the prior Regulations\textsuperscript{80} to determine its stock basis when the group first filed consolidated returns under the new Regulations and the stock is disposed of later, the adjustments required by the old Regulations less any amount in the excess loss accounts:

\textsuperscript{78}Reg. 1.1502-33(d).

\textsuperscript{79}Reg. 1.1502-33(c)(4)((iii)(d).

\textsuperscript{80}Reg. 1.1502-32A(b)(2) and (c)(1964).
account with respect to the stock which has not been
taken into income is reflected in the earnings and
profits account. In addition, any reduction required
by Regulations 1.1502-19(a)(4) with respect to prior
year law affects the earnings and profits account.\textsuperscript{81}

4) For purposes of computing the earnings and
profits of a member resulting from the disposition of
stock or an obligation, the adjusted basis of the stock
or obligation is determined by taking the three preceding
adjustments into account.\textsuperscript{82}

Where a group does not elect to adjust the earnings
and profits accounts currently, the group must follow
rules established by the Regulations. However, rules are
only provided for taxable years ending before January 1,
1968. Rules for taxable years ending after December 31,
1967, are reserved for future promulgation.\textsuperscript{83} In
essence, the adjustments one, two, and four in the
preceding paragraph do not affect the earnings and
profits accounts for years ending before 1968. Thus,
only adjustment number three will affect the earnings

\textsuperscript{81}Reg. 1.1502-33(c)(4)(iii)(b).
\textsuperscript{82}Reg. 1.1502-33(c)(4)(iii)(c).
\textsuperscript{83}Reg. 1.1502-33(c)(4)(ii).
and profits accounts for groups which do not elect to make a current adjustment.

**Consolidated Items**

Once the separate company calculations are completed, certain current year items that were eliminated from the separate taxable incomes must be considered. The net Section 1231 gain or loss, the net capital gain or loss, the total dividends received (or paid) which qualify for special deductions, and the total charitable contributions are determined on a consolidated basis rather than separately for each member. However, before consolidated current year items are included in total consolidated taxable income, certain adjustments must be made for items from previous taxable years. These prior year items consist of net operating loss carryovers, net capital loss carryovers, and charitable contributions carryovers. The availability of these carryover deduction items, except for charitable contributions carryovers, may be subject to three limitations: (1) separate return limitation year (SRLY), (2) consolidated return change of ownership (CRCO), and (3) reverse acquisition. Net operating loss carryovers are further limited by the special limitation in Section 382(a).
Current Year Items. Two current year items that must be consolidated are capital gains or losses and Section 1231 gains or losses. All property generally falls into one of two categories: property that receives preferential tax treatment where gains or losses are involved and property that receives no special treatment. The preferential tax treatment category includes capital assets and Section 1231 Assets. Gains or losses from property other than capital assets are taxed as ordinary income or losses.

The provisions of the law on capital gains or losses for separate returns are quite involved and are beyond the scope of this presentation. However, the basic rules for separate corporations are similar to consolidated return rules, and a short, general description of the separate return rules is necessary for the understanding of the rules for consolidated returns.

All capital items are first separated into short-term and long-term items. Assets held for exactly six months or less are classified as short-term items; assets held for more than six months are long-term items. Total long-term capital losses are offset against total long-term capital gains. Likewise, total short-term capital losses are offset against total short-term capital gains.
Next, the total long-term capital gain or loss is combined with the total short-term capital gain or loss. If the final combination results in a net long-term capital gain or an excess net long-term capital gain, only fifty percent of the gain is carried to gross income. Where the final product is a long-term capital loss or excess long-term capital loss, the loss cannot be deducted but can be carried over to future years as a long-term capital loss.\footnote{There are nine possible combinations, but the remainder of the combinations are omitted. See generally Philip Bardes \textit{et al.} (eds.), \textit{Montgomery's Federal Taxes}, 39th edition (New York: The Ronald Press Company, 1964), Chp. 9.}

Although Section 1231 Assets are not technically "pure" capital assets, they are treated like capital assets.\footnote{"Pure" capital assets are negatively defined; the Code defines capital assets by stating what they are not. See I.R.C. Sec. 1221. Section 1231 Assets are comprised of a group of assets which have the advantages of capital assets without the disadvantages; see I.R.C. Sec. 1231.} Gains and losses from Section 1231 Assets are compiled separately from the "pure" capital assets. These gains and losses are treated as ordinary gains and losses if the losses exceed the gains, but if the gains exceed the losses, the Section 1231 gains as well as the losses are treated as capital items. Ordinary
gains and losses are taxed at ordinary rates or are deductible as an ordinary loss from gross income, whatever the case may be. If the Section 1231 gains exceed the losses, both the gains and losses are combined with the capital items and receive capital gains treatment. 86

The preceding discussion of separate return treatment of capital items is similar to consolidated return treatment of capital gains and losses and Section 1231 capital gains or losses. Consolidated net capital gains of an affiliated group is determined by considering: (1) the aggregate of the capital gains and losses without considering Section 1231 items and net capital loss carryovers, (2) the consolidated Section 1231 net gains, and (3) the consolidated net capital loss carryover. 87 Likewise, consolidated net capital loss is similarly determined except that the consolidated net capital loss carryover is omitted from the calculation. 88 If a consolidated net capital gain occurs, fifty percent of the gain is included in consolidated taxable income. 89

86I.R.C. Sec. 1231(a).
87Reg. 1.1502-33(a)(1).
88Reg. 1.1502-22(a)(2).
89Reg. 1.1502-11(c).
However, if a consolidated net capital loss results, no deduction can be taken but the loss can be carried forward to future years.

Consolidated reporting differs somewhat from separate return reporting of Section 1231 items. Unlike corporations filing separate returns, a single net Section 1231 gain is determined for consolidation purposes and included in the actual long-term capital gains. The consolidated return Regulations determine a net Section 1231 gain or a net Section 1231 loss and treat this figure as either an ordinary or capital gain or loss.\textsuperscript{90} Also, if a Section 1231 loss is utilized in a consolidated return year, it must first conform to the modified SRLY limit.\textsuperscript{91} For example, if corporation P has a $6,000 gain resulting from insurance proceeds for a machine (adjusted basis of zero) which was destroyed during a hurricane, and corporation S, its wholly-owned subsidiary, has a $9,000 loss in the same year resulting from a sale of a factory building used in its trade or business, the Section 1231 loss of S is offset by P's Section 1231 gain and the consolidated Section

\textsuperscript{90}\textit{Cf. I.R.C. Sec. 1231(a); Reg. 1.1502-22(a).}

\textsuperscript{91}\textit{Cf. ante, p. 185.}
1231 net loss is combined with the capital losses.

Separate corporations are allowed to deduct capital losses only to the extent of capital gains.\footnote{I.R.C. Sec. 1211(a).} Likewise, a fundamental proposition of the Code is that losses of one tax entity may not offset income of another.\footnote{New Colonial Ice Co. v. Helvering, 191 U.S. 440 (1934).} Consolidation, however, permits the group to combine capital gains and losses. This advantage of filing consolidated returns is equitable if the one unit concept is accepted.\footnote{One unit concept refers to the belief that an affiliated group is merely a single tax entity with one or more branches.}

Prior Regulations permitted the carryover of capital losses, subject to the five-year carryover rule, to the extent that the losses could be "availed of" by the member in a separate return during the consolidated return period.\footnote{Reg. 1.1502-31(a)(12) (1965). This same limitation was also applicable to net operating losses, unused investment credits, and unused foreign tax credits.} The new Regulations repealed this limitation on carryovers from all separate return years. The liberalized rules attempt to treat an affiliated group as the "same entity" for purposes of unlimited...
utilization of capital loss carryovers. In order to be treated as the "same entity" and to avoid any limit on capital loss carryover the following conditions must be fulfilled:

1) The group must have been in existence in the year the carryover was generated.

2) If the ownership of the parent corporation has changed, new members must not have been added and the members must not have changed their business.\textsuperscript{96}

3) If the carryover was generated in a separate return year, the group must not have elected multiple surtax exemptions.\textsuperscript{97}

Failure to meet the three previous conditions is not fatal; instead, the availability of the capital loss carryover is subject to three special limitations. Any amount that escapes the SRLY limit, the CRCO limit, and the reverse acquisition can be used in a consolidated return year. Since these three limitations also apply to net operating losses, foreign tax credits, and

\textsuperscript{96}\textit{Cf.} I.R.C. Sec. 382.

\textsuperscript{97}Reg. 1.1502-1. The same three conditions must be met by net operating loss carrybacks and carry-forwards, unused investment credits, and unused foreign tax credits.
investment tax credits, these limitations are discussed in the next section.\textsuperscript{98}

Several limitations on deductible items are computed as a percentage of consolidated taxable income. The charitable contributions deduction is one such item which is limited to five percent of consolidated taxable income. An aggregate of the separate charitable contributions plus any consolidated charitable contributions carryover is allowable as a deduction up to a ceiling of five percent of consolidated taxable income.\textsuperscript{99} Consolidated taxable income for purposes of determining the five percent limitation is computed before considering the consolidated contributions deduction, the consolidated dividends deduction, the net operating loss carryback, the Western Hemisphere trade corporations deduction, and the partially tax-exempt interest deduction.\textsuperscript{100} In most cases, the five percent limitation applied on a consolidated basis is more favorable to the taxpayer than application of the limitation to each corporation separately.

\textsuperscript{98}\textit{Cf. post}, pp. 234-246.
\textsuperscript{99}\textit{Reg. 1.1502-24(a)}.
\textsuperscript{100}\textit{Reg. 1.1502-24(c)}. 
Since the Revenue Act of 1964, affiliated groups have been allowed a five-year carryover of contributions when these contributions exceed the five percent limitation. Unlike the other carryovers that must be subjected to the SRLY limit, the CRCO limit, and the reverse acquisition, excess charitable contributions may be carried from separate return years and included in the consolidated charitable contributions carryover. Thus, consolidated charitable contributions carryovers consist of any excess consolidated charitable contributions of the group and any excess charitable contributions of members of the group that arise in separate return years.\textsuperscript{101}

Previous Regulations stated that, where one or more members were no longer in the group, excess consolidated charitable contributions could be carried to subsequent consolidated return years only to the extent that the excess contributions were attributable to the departed members.\textsuperscript{102} Apparently, this limitation was omitted from the present Regulations. However, if an affiliate is a member of a group when excess contributions arise

\textsuperscript{101}Reg. 1.1502-24(b).

\textsuperscript{102}Reg. 1.1502-31(d)(1965).
and the affiliate later files a separate return, a portion of the excess contributions attributable to the affiliate is apportioned to the separate return. The portion of the excess contributions is equal to an amount as determined by the following:

\[ \text{Consolidated excess contributions} \times \frac{\text{Charitable contributions of the affiliate}}{\text{Aggregate of all charitable contributions}} \]

Thus, corporations filing separate returns are entitled only to that amount of excess consolidated charitable contributions attributable to their own contributions.\textsuperscript{103}

Dividends received deduction is another corporate item that is limited by a percentage of taxable income applied on a consolidated basis. As in the case of separate corporations, affiliated corporations are allowed to deduct the total dividends received (or paid) if such dividends qualify for special treatment under Code Sections 243-247. This special deduction for dividends received is composed of: (1) eighty-five percent of the amount received as dividends from nonmember, domestic corporations, (2) approximately sixty percent\textsuperscript{104}

\textsuperscript{103}Reg. 1.1502-78(e).

\textsuperscript{104}i.e., \( \frac{34}{48} \times 85\% = 60.208\% \).
of the amount received as dividends on preferred stock of a public utility, and (3) eighty-five percent of the amount received as dividends from foreign corporations which are subject to federal income tax and engaged in business for a specified period of time.\textsuperscript{105} The total of the dividends received deduction may not exceed eighty-five percent of adjusted \textit{consolidated} taxable income (computed without considering the deduction for net operating loss, consolidated dividends received, and Western Hemisphere trade corporations).\textsuperscript{106}

A final special deduction is the Western Hemisphere trade corporations deduction. This deduction is normally equal to 29.17 percent (14/48) of the portion of consolidated taxable income attributable to those members of the group which are Western Hemisphere trade corporations.\textsuperscript{107} Domestic corporations—all of whose business is conducted in North, Central, or South America or the West Indies—must satisfy two requirements before being classified as Western Hemisphere trade corporations. The two requirements are as follows: (1) ninety-five

\textsuperscript{105}\textsuperscript{Reg. 1.1502-23(a).}

\textsuperscript{106}\textsuperscript{Reg. 1.1502-26(a)(2).}

\textsuperscript{107}\textsuperscript{I.R.C. Sec. 922.}
percent or more of the gross income for a three-year period immediately preceding the close of the taxable year must be derived from sources outside the United States, and (2) ninety percent or more of the same gross income for the same period must be derived from the active conduct of a trade or business. 108

For consolidation purposes, the gross income of each member is determined as if the members had filed separate returns except that several items are handled according to consolidation rules. Gains and losses on intercompany transactions, gains or losses on transactions with respect to stock, bonds, or obligations, inventory adjustments, and investment account adjustments are reflected in the manner provided by the consolidated return Regulations. The resulting adjusted gross incomes of the separate corporations are used to determine if the individual corporations satisfy the two gross income requirements. 109

Once it is determined which corporations qualify for Western Hemisphere trade corporations' treatment, the portion of the consolidated taxable income

108 I.R.C. Sec. 921.
109 Reg. 1.1502-23(b).
attributable to these corporations can be multiplied by a fraction specified by the Code. The resulting figure is the Western Hemisphere trade corporations deduction as determined by the following formula:\footnote{See Reg. 1.1502-23(c)(2) for the determination of the taxable income of each member of the affiliated group.}

\[
\text{Consolidated Taxable Income} \times \frac{\text{Sum of incomes of WHTC members}}{\text{Sum of incomes of all members}} \times \frac{14}{48}
\]

Previous Year Items. Consolidated current year items cannot be included in total consolidated taxable income until certain adjustments have been made for previous taxable years. Prior year adjustments may be necessary for net capital loss carryovers, charitable contributions carryovers, and net operating loss carryovers. Both net capital loss carryovers and charitable contributions carryovers have been discussed previously, but the three new limits on net capital loss carryovers have been deferred to this section. Thus, net operating loss carryovers and carrybacks, and the SRLY limit, the CRCO limit and the reverse acquisition are discussed in this section. Also, the special limitation of Section 382(a) on net operating loss carryover is discussed.
A corporation is normally permitted to carry back a net operating loss and reduce the taxable income of the three immediately preceding taxable years. To the extent that the net operating loss is not absorbed in preceding years, the loss can be carried forward and similarly applied in the five succeeding taxable years. Consolidated groups are also entitled to the net operating loss deduction in arriving at the amount of consolidated taxable income. But until April, 1965, the net operating loss carryover from separate return years was limited to the income generated by the corporation sustaining the loss.

A Treasury decision liberalized the old Regulations; carryovers from separate return years were not limited where the corporation which sustained the loss was a member of the group on each day of the loss year. This interim rule was incorporated in the Regulations revision with an additional requirement that the loss corporation must not have elected multiple surtax exemptions for the loss year.

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111 See I.R.C. Sec. 172(b).
114 Reg. 1.1502-1(f).
Since the filing of consolidated returns permits the possibility of combining items from all members of the group, there are a series of limitations on the net operating loss carryover and carryback. The pattern of these limitations is consistent, however, for the other carryover and carryback items, such as net capital loss carryovers, investment tax credit carryovers and carrybacks, and foreign tax credit carryovers and carrybacks. For purposes of simplicity the SRLY limit, the CRCO limit, and the reverse acquisition are discussed here only as they apply to the carryover and carryback of net operating losses.

One of these new limitations is the separate return limitation year. A SRLY is a year during which an affiliate was not a member of the group or a year during which an affiliate and the remaining members of the group elect to claim multiple surtax exemptions.115 If a net operating loss carryover or carryback arose in a separate return limitation year, it must first escape the SRLY limit before it can be utilized in a consolidated return year. In essence, losses sustained in a SRLY can be used in a consolidated return year only to

115 Ibid.
the extent that consolidated taxable income is increased as a result of the inclusion in consolidated taxable income of the income and deduction items of the member which sustained the loss.\textsuperscript{116}

The SRLY test for net operating loss carryovers or carrybacks can be outlined in four steps:

1) Make a calculation of consolidated taxable income including all members, but omit any net operating loss deduction.

2) Make a similar calculation of consolidated taxable income omitting the member being analyzed.

3) If step 1 exceeds step 2, reduce the excess by any net operating loss carryover or carryback of that member which occurs in years previous to the SRLY being examined.

4) The remainder, if any, is the maximum net operating loss carryover or carryback from that member which may be used in the consolidated return year.\textsuperscript{117}

For example, assume that in the first step a calculation of consolidated taxable income, excluding the net

\textsuperscript{116}Reg. 1.1502-21(c).

operating loss carryover, results in an amount of $210,000. In the second step, the consolidated taxable income is $120,000 after the affiliate that sustained the loss is omitted. Assuming that the net operating loss carryover is $60,000, only $30,000 of the carryover can be utilized in a consolidated return year which is calculated as follows:

Step #1
Consolidated taxable income of all members excluding net operating loss... $210,000

Step #2
Consolidated taxable income of all members except affiliate being tested........... 120,000

Step #3
Excess of Step #1 over Step #2... $ 90,000
Less net operating loss carryover... 60,000

Step #4
Maximum amount of net operating loss carryover that can be utilized... $ 30,000

The SRLY limit also applies to net capital loss carryovers, foreign tax credit carryovers and carrybacks, and investment tax credit carryovers and carrybacks. The following table illustrates the items to be taken into consideration in applying the SRLY limit to these other carryover and carryback items.\(^{118}\)

\(^{118}\)Ibid.
TABLE I

COMPUTATIONS FOR SRLY LIMIT

<table>
<thead>
<tr>
<th>Carryback or carryover item</th>
<th>To determine SRLY limit calculate this with and without the member being examined.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital loss carryover</td>
<td>Consolidated net capital gain before net capital loss carryover</td>
</tr>
<tr>
<td>Foreign tax credit carryover or carryback</td>
<td>&quot;Over-all&quot; or &quot;per-country&quot; limitation as the case may be</td>
</tr>
<tr>
<td>Investment tax credit</td>
<td>Investment credit limit based on consolidated tax</td>
</tr>
</tbody>
</table>
Careful tax planning may help affiliated groups avoid the consequences of the SRLY limitation. First, a retroactive revocation of a multiple surtax exemptions election may allow a group to fully utilize an affiliate's SRLY losses. A group is allowed a three-year period to revoke the multiple surtax exemptions election, but this revocation may result in a permanent surrender of the right to elect multiple exemptions. New consolidated return rules make it more difficult to revert to separate filing, and once multiple exemptions are revoked, there is a five-year waiting period before the election can again be made. Second, a loss affiliate may be merged with a profit affiliate through a tax-free acquisition under Section 381(a). The losses are still limited, but the earnings of the purchasing corporation can be used to absorb the losses from the SRLY. However, this technique does not offer relief in a carryback loss situation.

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119 I.R.C. Sec. 1562(e).

120 I.R.C. Sec. 1562(d).

Net operating loss carryovers (but not carrybacks) that survive the SRLY test must also undergo a consolidated return change of ownership (CRCO) test. A CRCO is defined as a fifty-percentage-point or more change of ownership in a common parent during a two-year period. This change must result from a purchase or redemption of stock. If a group is subject to a CRCO, net operating losses sustained before the change may be carried forward to consolidated return years after the change only to the extent, if any, that the old members generate income in these later years. The purpose of the CRCO test is to extend to an acquired group the rule applicable to an acquired subsidiary: a subsidiary's losses can only be carried over and applied against its own income. This limit prevents the group from carrying forward losses sustained before a CRCO and offsetting these losses against the profits of corporations who become members of the group after the CRCO.

For example, corporation P and S have a consolidated net operating loss of $600,000 during 1967. On

\[122\text{Reg. 1.1502-1(g); cf. I.R.C. Sec. 382(a) which denies net operating loss carryovers of a single corporation where there has been a major change in ownership and a change of business.}\]

\[123\text{Reg. 1.1502-21(d).}\]
January 1, 1968, an individual purchases all of the outstanding stock of P. The new stockholder subsequently contributes one million dollars to P, and P acquires the stock of corporation T. Corporations P, S, and T later file a consolidated return for 1968 which reflects consolidated taxable income of $700,000 (computed without regard to the net operating loss deduction). Since there was a CRCO, consolidated taxable income is recomputed and includes only the income and deduction items of the old members. The result is that only $450,000 of the maximum amount of $600,000 net operating loss carryover can be applied against income in 1968.\textsuperscript{124}

A taxpayer might use the following tax planning techniques to help avoid or soften the effects of the CRCO limitation:

1) Since the CRCO has no effect until a new member is included in a group, it is advisable to avoid the acquisition of the stock of a loss corporation by a purchase or redemption after a CRCO occurs.

2) Only losses arising prior to the year of change are subject to the limitation. The group's losses sustained in the year of change are not exposed

\textsuperscript{124}\textit{Reg. 1.1502-21(d)(3).}
to the CRCO limit. Thus, if an acquisition of more than fifty percent of the parent of a loss group filing on a calendar year basis is contemplated, consummate the purchase before December 31.

3) Since only the earnings of new affiliates cannot be used to offset the pre-CRCO losses, acquisition of profitable assets will circumvent the CRCO limit.

4) Do not allow a group to create a profitable new affiliate, since its earnings will not be available in computing the limitation.

5) In order to inflate the earnings of the old members, loss assets may be transferred to a new member. (But beware of Section 269.)

The CRCO limitation is similar to— but more inclusive than— the special limitation on net operating loss carryovers in Section 382(a). This Section limits the use by a single entity of its own net operating loss carryover where there has been both a fifty-percentage-point change in ownership and a failure of the corporation to carry on a trade or business (substantially the

125Salem, supra, note 121, p. 273.
same as it was conducted before the ownership change). Consolidated net operating loss carryovers are subject to this same limitation, but only a portion of any loss is eliminated under consolidation rules.

The elimination of part of the net operating loss will not occur unless at the end of a taxable year the ten largest stockholders of the common parent own at least fifty percent of the total fair market value of the outstanding stock of the parent. Moreover, during the same year and the preceding year at least one of these ten stockholders must have increased his percentage of the total fair market value of the stock owned by him by at least fifty percentage points. In addition, one of the affiliates must have substantially changed its trade or business during that period. If the requisite conditions are present, then the portion of

126 In fact, an operating loss may be limited by the Libson Shops doctrine where there is a change in business as defined in Section 382(a) even without a change of fifty percentage points in stock ownership. If there is a fifty percent shift in the beneficial ownership of the loss—a test that is more restrictive than Section 382(a)—an operating loss of a single entity may be denied. See John S. Pennell, "Does the Libson Shops Doctrine Still Apply? Recent Decisions Reflect Confusion," The Journal of Taxation, Vol. 25 (December, 1966), 341.

127 Reg. 1.382(a)(1).
any consolidated net operating loss carryover attributable to the affiliate that changed its trade or business is disallowed for that year or any subsequent years.\textsuperscript{128} Likewise, if the net operating loss carryover is from a separate return year, a portion of the carryover will be similarly disallowed.\textsuperscript{129}

There is a substantial difference between a fifty-percentage-point increase and a fifty percent increase in stock owned. For example, a shareholder who owns four percent of total fair market value of the stock and who increases his ownership to six percent has had a fifty percent change in ownership but has had only an increase of two percentage points.\textsuperscript{130}

The change-of-business condition should be applied on a consolidated group basis rather than on a company-by-company basis. If a change of trade or business is not sufficient to constitute a change of business from the point of view of the group as a whole, then Section 382(a) should not be used to disallow a portion of a net operating loss carryover. However, if the change is

\textsuperscript{128}Reg. 1.1502-21(d)(1).
\textsuperscript{129}Reg. 1.1502-21(e)(2).
\textsuperscript{130}Reg. 1.382(a)-1(d)(1).
major in relation to the overall business activities of
the group, the entire net operating loss carryover should
be denied. 131

Still another limitation, the reverse acquisition,
applies to net operating loss carryovers and carrybacks,
capital losses, unused investment credits, and unused
foreign tax credits. In essence, a reverse acquisition
occurs when a corporation acquires a new affiliate or
purchases substantially all of the assets of the affili­
ate for more than fifty percent of its own stock. 132 For
example, while in form a financially weaker affiliated
group issuing the stock is the acquiring group, in
substance a fifty percent shift in ownership connotes it
is really being acquired. Accordingly, the weaker group
is treated as having terminated and any loss carryover
is considered to be sustained in a separate return
limitation year. Of course, any losses occurring in a
SRLY are restricted by the SRLY limit previously men­
tioned. The stronger group is considered to remain in

131 Committee on Federal Taxation, "Statement Pre­
sented at Internal Revenue Service Hearings on Proposed
Regulations Regarding Consolidated Returns, December 8,
1965," (New York: American Institute of Certified Public

132 Reg. 1.1502-75(d)(3).
existence and any losses of its members are not subject
to the SRLY rules.133

This reverse acquisition concept limits the appli­cation of the CRCO rules. Certain transactions,134 which
should normally be treated as creating a CRCO, come
within the definition of a reverse acquisition. As
discussed in Chapter VII, it is hard to rationalize the
need for the reverse acquisition rule in view of the
similarity of the targets. However, the carryover items
of the old members under the CRCO rules are carried
over as a group and used against the income generated by
all the old members in the following years; whereas
the same items are completely fragmented under the
reverse acquisition rules and treated as losses occurring
in a SRLY. Thus, each such carryover item must be offset
against the income produced by the member sustaining the
loss.

The CRCO limit applies, in general, to a change in
ownership attributable to a purchase of stock or a
redemption of outstanding stock.135 On the other hand,

133 Ibid.
134 Reg. 1.1502-1(g).
135 Ibid.
a change in ownership which results from a Section 368(a)
(1)(B) reorganization is generally covered by the reverse
acquisition rule. But certain acquisitions resulting
from a combination of these prescribed changes in owner­
ship still escape both the CRCO limit and the reverse
acquisition trap. However, there are several other
limitations which apply to the carryover of net operating
losses. Both Section 269 and the business purpose
doctrine (discussed in Chapter III) may be used by the
Commissioner to deny the net operating loss carryovers
that circumvent the CRCO and reverse acquisition limita­
tions.

A final limitation prevents an affiliated group
from carrying over the portion of a consolidated net
operating loss attributable to a member whose stock was
worthless. However, the disallowance is limited to cases
where there is an amount in an excess loss account
applicable to the subsidiary. 137

Computation of Consolidated Tax Liability

Consolidated taxable income is computed by com­
bining the separate taxable income of each member of the

136 Reg. 1.1502-1(f)(3).
affiliated group with the consolidated items. If the affiliated group has a consolidated net operating loss for the entire year, the group is permitted to carry the loss back and reduce the taxable income of the three immediately preceding taxable years. To the extent that the loss is not absorbed in the preceding years, it can be carried forward and similarly applied in the five succeeding taxable years. However, if the group has consolidated taxable income, the normal tax rate of twenty-two percent is applied against the first $25,000 and both the normal tax and the surtax rate of twenty-six percent is applied against any excess. This consolidated tax is added to any of the other taxes applicable to the particular affiliated group—personal holding company tax, accumulated earnings tax, alternative tax for mutual savings banks conducting life insurance business, consolidated life insurance company tax of Section 802 and 831, alternative capital gains tax, and war loss recoveries tax.\textsuperscript{138}

Next, two tax credits are offset against the total tax computed in the preceding paragraph: the investment tax credit and the foreign tax credit. These

\textsuperscript{138}Reg. 1.1502-2.
credits may be composed of both credits earned in the current year and those credits of prior years carried over or of later years carried back into the current year. Furthermore, the carryover or carryback items may be from separate or consolidated return years. Thus, both of these credits are limited by the SRLY, CRCO, and reverse acquisition rules. After the two tax credits are deducted from the total tax, the amount of consolidated tax is obtained.

**Investment Tax Credit.** A group filing consolidated returns computes its investment credits earned and calculates its limitation on a consolidated basis. The investment credit, which is generally seven percent of qualified property, is a direct reduction in consolidated tax liability in the year the property is acquired. However, the credit is limited to the consolidated tax liability up to $25,000 plus twenty-five percent of the liability for tax in excess of $25,000.\(^{139}\) If the entire credit cannot be claimed in the first year because it exceeds the limitation, the excess may be carried back to each of the three preceding years. To the extent the

\(^{139}\text{Reg. 1.1502-3(a)(3). This limitation is liberalized after December 31, 1967. The investment credit will be limited to $25,000 plus }\frac{1}{2}\text{ of the tax liability in excess of }$25,000.
excess is not absorbed in the preceding years, it may be carried forward and similarly applied in the five succeeding taxable years.\textsuperscript{140}

There is no investment credit for business machinery and equipment in excess of $20,000 ordered or acquired during a suspension period from October 10, 1966 through December 31, 1967. Thus, during the suspension period the consolidated group is limited to a tax credit of only $1,400 (7% of $20,000). Beware, the $20,000 exception is not an annual amount but covers the entire suspension period.\textsuperscript{141}

Qualified property is generally depreciable, tangible, personal property and depreciable real property (except buildings and structural components of buildings). However, for purposes of computing a member's qualified investment, any gain or loss deferred or realized on a purchase from another member does not affect the basis

\textsuperscript{140}I.R.C. Sec. 46(b). The carryover is also liberalized after December 31, 1967; taxpayers will be permitted to carryforward unused credits for seven years instead of the present five years.

\textsuperscript{141}See Gerald J. Holtz and Harold R. Jenkins, "How to Deal with the Investment Credit and Accelerated Depreciation Suspension," The Journal of Taxation, Vol. 25 (December, 1966), 322-325.
of the property for purposes of the investment credit.\textsuperscript{142} Thus, if \( S \) purchases qualified property for $100 from \( P \), its common parent, which costs \( P \) $80, \( S \) will get the investment tax credit on $80. The $80 basis will be used even though \( P \) elects to recognize the $20 profit immediately and not defer it.

The carryover and the carryback of the investment tax credit may be from separate return years or from consolidated return years. Where a credit is carried over or carried back from a separate return year, it is limited by the SRLY limit. The SRLY test for investment credit carryovers and carrybacks is outlined in the following steps:

1) Make a calculation of the investment credit limit based on the consolidated tax.

2) Make a similar calculation of the investment credit limit on the consolidated tax but \textit{omit} the member being analyzed.

3) If step 1 exceeds 2, reduce the excess by any investment credit earned by \textit{that member in the current year}.

\textsuperscript{142}Reg. 1.1502-3(a)(2).
4) The remainder, if any, is the maximum investment tax credit carryover or carryback from that member which may be used in the consolidated return year.¹⁴³

For example, assume that in the first step, the investment credit limit based on consolidated tax of all affiliates is $50,000. In the second step, the investment credit limit is $30,000 after the affiliate being tested is omitted. Assuming that the affiliate being tested has a carryover of $16,000 from a SRLY and also a current year credit of $8,000, only $12,000 of the investment credit carryover can be utilized in the consolidated return years. Therefore, $4,000 ($16,000 - $12,000) of the investment credit carryover will have to be used in another year. The calculations are as follows:

Step #1
Investment credit limit based upon consolidated tax of all members . . . . $50,000

Step #2
Investment credit limit based upon consolidated tax of all members except affiliate being tested . . . . 30,000

Step #3
Excess of Step #1 over Step #2 . . . . $20,000
Less current year investment credit earned by affiliate being tested . . . . 8,000

¹⁴³Reg. 1.1502-3(c)(2).
Step #4
 Maximum amount of investment tax credit carryover that can be utilized . . $12,000

Foreign Tax Credit. As in the case of the investment credits and limitations, the foreign tax credits and limitations are calculated on a consolidated basis. The purpose of the foreign tax credit is to minimize the double taxation of income derived from sources outside the United States. The parent corporation determines whether taxes paid or accrued to any foreign country or to any possession of the United States are deductible from gross income or credited against the income tax due to the United States.\textsuperscript{144} If the foreign taxes are credited against the United States taxes, the common parent determines whether a per-country limitation, or an overall limitation is applicable to the consolidated foreign taxes paid by the group.\textsuperscript{145}

One alternative, the per-country limitation, is applied separately with regard to each foreign country or to any possessions of the United States. The limitation is calculated by multiplying the United States tax against which credit is claimed (before any credit

\textsuperscript{144}Reg. 1.1502-4(a).

\textsuperscript{145}Reg. 1.1502-4(b)(1).
for taxes) by a fraction, the numerator of which is consolidated taxable income from sources within the foreign country and the denominator of which is total consolidated taxable income from all sources, both foreign and domestic:

\[
\text{Maximum credit using the per-country limitation} = \frac{\text{United States income tax}}{\text{Total consolidated taxable income}} \times \text{Consolidated taxable income from foreign country}
\]

The amount of the consolidated credit which may be taken by the group is the lesser of: (1) the taxes paid or accrued to the foreign country or (2) the amount of the per-country limitation for that country.\textsuperscript{146}

Another alternative, the overall limitation, is the amount of the United States tax on the aggregate foreign income. It is computed by multiplying the United States tax against which credit is claimed (before credit for any tax) by a fraction, the numerator of which is consolidated taxable income from sources outside the United States and the denominator of which is total consolidated taxable income from all sources, both foreign and domestic:

\textsuperscript{146}Reg. 1.1502-4(c); I.R.C. Sec. 904(a)(1).
Maximum credit using overall limitation = \frac{\text{United States income tax}}{\text{Total consolidated taxable income}} \times \frac{\text{United States}}{\text{outside}}

The amount of the consolidated credit which may be taken by the group is the lesser of (1) the aggregate amount of taxes paid or accrued to all foreign countries; or (2) the amount of the overall limitation.\(^{147}\)

Use of the per-country limitation is more advantageous than use of the overall limitation if the group suffers losses in one or more foreign countries and derives taxable income from another foreign country or countries. Conversely, the overall limitation is more advantageous than the per-country limitation in any year in which the group pays taxes to one or more foreign countries at an effective rate higher than the United States rate.\(^{148}\)

Any consolidated foreign tax credit in excess of the per-country limitation or the overall limitation may

\(^{147}\)Reg. 1.1502-4(c); I.R.C. Sec. 903(a)(2).

be carried back two years and carried forward five years.\footnote{Reg. 1.1502-4(e); I.R.C. Sec. 904(d).} However, both foreign tax carryovers and carrybacks from separate return limitations years are limited by the SRLY rule. That is, the member's credit is usable only to the extent the affiliate generates income. The actual computation of the SRLY limit for foreign tax credits is identical to the calculation of the SRLY limit for the investment tax credit.\footnote{Reg. 1.1502-4(f); cf. ante, pp. 237, 251-252.}

Unused foreign tax credits carryovers (but not carrybacks) are further limited by the CRCO test and the reverse acquisition rule as previously explained.\footnote{Reg. 1.1502-4(g); cf. ante, pp. 239-246.}
CHAPTER VI

CONSOLIDATED RETURNS REWARDS: A COMPARISON

The preceding chapters discuss the numerous and drastic changes that have occurred in the area of consolidated returns. As a result of these changes, the consolidated return election offers overall tax savings in many situations, but along with the election come numerous possible dangers and disadvantages that must not be overlooked. An election is not a step to be taken haphazardly, and the affiliated group that contemplates the election must realize that the return to separate filing is difficult and often costly. However, the election is too useful a tool to disregard because of the complications that may arise, for the dangers may be reduced by a proper understanding of the consolidation area.

There is no general formula or rule that can be used to decide when a consolidated return election should be utilized. Each affiliated group must be given individual attention and the election should be made only
after giving judicious consideration to the advantages and disadvantages, viewed in perspective to the circumstances surrounding the particular group and the other alternatives available to the group.

Alternatives of an Affiliated Group

An affiliated group has five alternatives from which to choose. First, the group may merge its separate entities into a single entity and operate the separate businesses as branches or divisions. Second, the members of the group may file separate returns and apportion a single surtax exemption among the members. Third, separate returns may be filed by the members of the group and multiple surtax exemptions may be elected at the cost of an additional six percent tax. Fourth, the group may file separate returns, apportion one surtax exemption, and eliminate one hundred percent of its intercorporate dividends. Fifth, the affiliated group may elect to file consolidated returns.

An explanation of some of these alternatives is necessary before they can be compared with the consolidated return election. Likewise, advantages of operating a business through several corporations rather than a single corporate entity is presented in order to clarify
certain points and to provide a more complete explana-

tion.

Multiple Corporations. A firm may operate as a
single corporate entity, but there are many tax and non-
tax incentives that encourage operating a multicorporate
form.1 One such non-tax motive is limited liability.
Separate corporations protect assets from torts, con-
tracts, or mortgage liability. Use of separate corpor-
ations also enables a group to segregate the diversified
activities of an enterprise along functional lines,
according to geographic locations, or by type of cus-
tomers served in each location. Lower local advertising
rates and exclusive franchises for branded lines of
merchandise are reasons to operate in multicorporate
form. In addition, closer identification with the local
community, avoidance of double taxation under state laws,
and ability to bargain with the local labor establish-
ment encourage the formation of multiple entities.

1See generally Peter K. Maier, "Use of Multiple
Corporations Under the 1964 Revenue Act," Taxes - The Tax
Magazine, Vol. 42 (September, 1964), 565-581; K. Martin
Worthy, "Multiple Corporations," Proceedings of the
Tulane Fourteenth Annual Tax Institute (1965), 136-170;
Peter Elder, "Operating Problems of Multiple Corporations,"
Proceedings of the Twenty-fourth Annual New York Univers-
ity Tax Institute, Vol. 24 (1966), 1145-1149.
The major tax motivation for small affiliated corporations is the possibility of obtaining additional surtax exemptions. If multiple surtax exemptions are able to withstand the attacks of the Commissioner\(^2\) a maximum tax savings of $5,000\(^3\) for each member will accrue to the group. Corporations are allowed to accumulate $100,000 of undistributed earnings without incurring a tax on accumulated earnings.\(^4\) Thus, multiple entities will afford a group a $100,000 credit for each corporation. As in the case of the accumulated earnings credit, corporations with estimated tax in excess of $100,000 are required to file declarations of estimated tax\(^5\) and prepay part of the tax during the current year.\(^6\) Division of earnings among a number of companies can eliminate this prepayment and retain cash for working capital purposes.

Each member of a group may make a number of inconsistent elections in order to obtain maximum tax

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\(^2\)Most notable, I.R.C. Secs. 61, 269, 482, and 1551.

\(^3\)i.e., \((26\% - 6\%) \times 25,000 = 5,000\).

\(^4\)I.R.C. Sec. 531.

\(^5\)I.R.C. Sec. 6016.

\(^6\)Ibid.
advantage. For example, treatment of foreign taxes,\(^7\) choice of an accounting period,\(^8\) or of accounting methods,\(^9\) and write-off elections\(^10\) are situations where each corporation may make a decision independently of the other members of the group. Likewise, certain types of income can be concentrated in different entities to obtain Western Hemisphere trade corporations deductions. There are other tax as well as non-tax reasons for splitting into separate corporations, but the aforementioned reasons are sufficient to indicate the desirability of a group of companies as opposed to one large corporation.

There are some disadvantages, however, to multiple corporations. Operating costs are relevant if they would be incurred by multiple corporations but would not be incurred by a single company. Several relevant costs are incurred by multiple corporations that would not be incurred by a single corporate organization. For example, audit fees will increase since separate and

\(^7\)I.R.C. Sec. 904.
\(^8\)I.R.C. Sec. 441.
\(^9\)I.R.C. Sec. 446.
\(^10\)I.R.C. Secs. 168(b), 169(c), 179(c), 248, and 263(c).
consolidated statements must be prepared. Additional franchise and operating privilege taxes of state and local taxation authorities will be incurred. In addition, operating costs of maintaining separate books and records for numerous corporations can be expensive. Furthermore, dealing with more than one I.R.S. agent in more than one location can be burdensome. Finally, intercompany loans among affiliates could cause the Commissioner to maintain that there have been dividends to the shareholders.

**Multiple Surtax Exemptions.** Component members of a controlled group of corporations are entitled to only a single $25,000 surtax exemption.\(^{11}\) This single exemption may be divided equally among the members of the group\(^{12}\) or, if the members consent to an apportionment plan, the single exemption can be allocated under the terms of the plan.\(^{13}\) Any apportionment plan is effective for succeeding taxable years unless the plan is amended or terminated.

The members of a group of corporations may elect to have each member claim a separate surtax exemption in

\(^{11}\)I.R.C. Sec. 1561.
\(^{12}\)I.R.C. Sec. 1561(a)(1).
\(^{13}\)I.R.C. Sec. 1561(a)(2).
lieu of dividing a single exemption among the members.\textsuperscript{14} However, if the group elects multiple surtax exemptions, the income of each member is increased by six percent on the first $25,000 of taxable income.\textsuperscript{15} Election of multiple surtax exemptions is normally made when the tax return is filed for the taxable year, but the election may be made at any time within three years after the original due date of the corporate return.\textsuperscript{16} Consents must be filed by all corporations which are component members of the group during the three year period following the original due date of the tax return.\textsuperscript{17}

Once an election to use multiple surtax exemptions is made, it is effective for all following years until the election is terminated. Termination may occur by the consent of the members, refusal of a new member to consent, filing a consolidated return, or demise of the controlled group.\textsuperscript{18} If an election is terminated for any of these reasons, the group or any other successor group is not eligible to make a new election for a period

\begin{enumerate}
\item[I.R.C. Sec. 1562(a).]
\item[I.R.C. Sec. 1562(b).]
\item[I.R.C. Sec. 1562(e).]
\item[I.R.C. Sec. 1562(a)(1).]
\item[I.R.C. Sec. 1562(c).]
\end{enumerate}
of five years.\textsuperscript{19}

A general rule can be established to determine at what level of taxable earnings it is more advantageous to elect multiple surtax exemptions.\textsuperscript{20} Generally, a multiple surtax exemptions election derives more tax savings than a single surtax exemption whenever the total taxable income of the group exceeds $32,500.\textsuperscript{21} This critical level of taxable income can be calculated by dividing the gross tax savings resulting from a multiple surtax exemptions election by the net tax rate savings from the same election. Therefore, the numerator is $25,000 multiplied by the twenty-six percent surtax rate, or $6,500. The denominator, the net tax rate savings, is calculated by subtracting the normal

\begin{itemize}
\item \textsuperscript{19}I.R.C. Sec. 1562(d).
\item \textsuperscript{21}This calculation assumes that each corporation's surtax exemption can withstand an attack by the Commissioner under tax avoidance provisions (i.e., I.R.C. Secs. 61, 269, 482, and 1551).
\end{itemize}
tax rate of twenty-two percent and the six percent penalty tax from the total corporate tax rate of forty-eight percent. The calculation of the point of indifference is as follows:

\[
\frac{25,000 \times 0.26}{0.48 - (0.22 + 0.06)} = \frac{6,500}{0.20} = 32,500
\]

Table II proves the reliability of the critical point formula. If a corporation earns exactly $32,500, its total tax liability using both the single surtax exemption and multiple surtax exemptions is $9,100. Below taxable income of $32,500 the single surtax exemption is more economical; whereas, above $32,500 the multiple surtax exemptions election provides greater tax savings.

One Hundred Percent Intercorporate Dividends Received Deduction. Another alternative available to an affiliated group is to elect the one hundred percent intercorporate dividends received deduction under Section 243. Corporations are normally allowed to exclude only eighty-five percent of the dividends received from other domestic corporations, but an entire affiliated group may join in an election to

\[22\] I.R.C. Sec. 243(a)(1).
<table>
<thead>
<tr>
<th></th>
<th>Single Surtax Exemption</th>
<th>Multiple Surtax Exemptions</th>
</tr>
</thead>
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<tr>
<td><strong>Taxable Income</strong></td>
<td>$25,000</td>
<td>$25,000</td>
</tr>
<tr>
<td></td>
<td>$7,500</td>
<td>$7,500</td>
</tr>
<tr>
<td></td>
<td>$32,500</td>
<td>$32,500</td>
</tr>
<tr>
<td><strong>Surtax Exemption</strong></td>
<td>$-25,000</td>
<td>$-25,000</td>
</tr>
<tr>
<td></td>
<td>$-00</td>
<td>$-7,500</td>
</tr>
<tr>
<td></td>
<td>$-25,000</td>
<td>$-32,500</td>
</tr>
<tr>
<td><strong>Subject to Surtax</strong></td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>$7,500</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>$7,500</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Normal Tax</strong></td>
<td>$5,500</td>
<td>$5,500</td>
</tr>
<tr>
<td></td>
<td>$1,650</td>
<td>$1,650</td>
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<tr>
<td></td>
<td>$7,150</td>
<td>$7,150</td>
</tr>
<tr>
<td><strong>Surtax</strong></td>
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<td>$0</td>
</tr>
<tr>
<td></td>
<td>$1,950</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>$1,950</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Penalty Tax</strong></td>
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</tr>
<tr>
<td></td>
<td>$0</td>
<td>$450</td>
</tr>
<tr>
<td></td>
<td>$0</td>
<td>$1,950</td>
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<tr>
<td><strong>Total Tax</strong></td>
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</tr>
<tr>
<td></td>
<td>$3,600</td>
<td>$2,100</td>
</tr>
<tr>
<td></td>
<td>$9,100</td>
<td>$9,100</td>
</tr>
</tbody>
</table>

*This table assumes the following tax rates:
- Normal tax . . . . . 22%
- Surtax . . . . . . 26%
- Penalty tax . . . . 6%
exclude one hundred percent of the intercorporate dividends for a taxable year. However, the election applies only to dividends paid out of earnings and profits accumulated during taxable years in which the distributing corporation was a member of the group for a full year. In addition, this election applies only to taxable years ending after December 31, 1963.

The election under Section 243 is made by the common parent, but the component members of the group must each consent to the election. Once the election is made it is effective until terminated by consent of the members or failure of a new member to consent to the election. If the election is terminated, a taxpayer is not barred from making a new election at any time. But the election may be costly in terms of the benefits that the group must forego.

One of the benefits that an affiliated group must forego if it elects the one hundred percent dividends received deduction is the right to use multiple surtax

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\(^{23}\) I.R.C. Sec. 243(a)(3).

\(^{24}\) I.R.C. Sec. 243(b)(1).

\(^{25}\) I.R.C. Sec. 243(b)(2).

\(^{26}\) I.R.C. Sec. 243(b)(4).
exemptions. 27 A corporation has to decide which election is more advantageous tax-wise: multiple surtax exemptions or one hundred percent dividends received deduction. One way to make a decision between the two elections is to determine how much intercorporate dividends must be generated by the group in order to make the one hundred percent dividends received alternative as attractive as the multiple surtax exemptions election.

The critical level of intercorporate dividend flow can be determined by dividing the net tax savings resulting from a multiple surtax exemptions election by the effective tax rate on intercorporate dividends. 28 Thus, to obtain the numerator of the fraction, one must multiply one less than the number of Above corporations (companies having taxable income of at least $25,000) in the group by $5,000 and then subtract $1,500. However, the numerator has to be adjusted by adding twenty percent times the summation of the taxable incomes of


corporations having income less than $25,000 (Below companies).\(^{29}\) The denominator (the effective tax rate) can be computed by multiplying the percentage of dividends excluded from taxes, 15% (100% - 85%), by the corporate tax rate.\(^{30}\) For example, assume that there are eleven members in an affiliated group and ten members have at least $25,000 of taxable income, but the eleventh member has only $15,000 of taxable income. Thus, the critical point of $645,833 represents an average level of intercorporate dividend distributions which must be maintained over a period of time before it will be profitable to use the tax-free intercorporate dividends received election. The calculation of the break-even point is as follows:

\[
\frac{\overline{(n_a - 1)} \times \$5,000 - \$1,500 + .20 \left( \sum E_b \right)}{.15 \times .48} = \\
\frac{\overline{(10 - 1)} \times \$5,000 - \$1,500 + .20($15,000)}{.15 \times .48}
\]

\(^{29}\)This calculation assumes that the surtax exemptions can survive an attack by the I.R.C. under the tax avoidance provisions (i.e., I.R.C. Secs. 61, 269, 482, and 1551). Terms used in these formulae are as follows: \(n_a\) = number of affiliates with taxable income greater than $25,000, and \(E_b\) = income of companies with less than $25,000 of taxable income.

\(^{30}\)Computation assumes that each corporation receiving the dividends has taxable income of at least $25,000.
\[
\frac{46,500}{0.072} = 645,833.33
\]

Of course, the above formula does not take into consideration the other disadvantages or restrictions of this tax-free dividend election. Other restrictions besides the single surtax exemption are as follows:

1) The group, in the aggregate, must elect either to claim deductions or credits for foreign taxes. If they claim foreign tax credits, each affiliate must use the per-country limitation or the overall limitation in computing the size of the limitation.

2) Members are limited, in the aggregate, to one $100,000 accumulated earnings credit.

3) Only one $100,000 exploration expenditure deduction with respect to mineral deposits is allowed the entire group during a taxable year, and only a maximum of $400,000 is allowed for any number of years.

4) The group is allowed only one $25,000 limitation on small business deduction of life insurance companies.

5) The group is allowed only one $100,000 exemption for estimating taxes to determine if accelerated tax payments are due.\(^{31}\)

\(^{31}\)I.R.C. Sec. 243(b)(3).
In all but special cases, the only disadvantages of the tax-free dividend election are the interest that is lost due to the necessity of accelerated payments of estimating taxes on only one $100,000 exemption and the loss of multiple surtax exemptions. Thus, for all but special cases, the preceding formula can be converted into another formula to determine when the tax-free dividend election is appropriate.

Assume the same facts as in the preceding example except ten of the corporations have tax liabilities of at least $100,000 and the eleventh corporation has taxable income of $15,000 with a tax liability of $3,750. Also, the group has total intercorporate dividends of $600,000. Thus, a formula can be established which shows the tax savings of multiple surtax exemptions on one side and the tax savings of the tax-free intercorporate dividends received deduction on the other side. A new factor is added, however, to take into consideration the accelerated tax payments under the 100% dividends received election. The loss of interest which results from accelerated tax payments in 1967 can be calculated by using the formula developed
in Appendix C. The cost of working capital is assumed to be six percent. By combining the loss of interest formula with the factors in the previous formula, the following new formula is obtained:

\[
\overline{(n_a - 1)} \times \frac{5,000}{100,000} - 1,500 + 0.20(\Sigma E_b) + 0.06/100,000(10) + 3,750 - 100,000 \cdot 0.420838 \neq 7.2(600,000) - 0.26(25,000) \cdot 15.
\]

Therefore,

\[
\overline{(10 - 1)} \times \frac{5,000}{100,000} - 1,500 + 0.20(15,000) \neq 0.06/100,000(10) + 3,750 - 100,000 \cdot 0.420838 \neq 7.2(600,000) - 0.26(25,000) \cdot 15.
\]

Thus,

\[
46,500 + 22,819 > 43,200 - 97.50.
\]

Thus, with intercorporate dividends of $600,000 the multiple surtax exemptions election is more economical than the one hundred percent dividends received deduction. In fact, this same answer can be obtained by referring to Table III on page 272. Look on the line for eleven corporations. The break-even level of dividends flow (considering only the loss of multiple surtax exemptions) is $673,611. Since the actual dividends flow of $600,000 is less than the critical level, multiple surtax exemptions should be elected.

\[32\] The proof of the loss of interest on accelerated tax payments is found in Appendix C.
TABLE III
DIVIDEND FLOW REQUIRED TO OFFSET LOSS OF MULTIPLE SURTAX EXEMPTIONS

<table>
<thead>
<tr>
<th>Number of Corporations</th>
<th>Cost of Not Using Multiple Surtax Exemptions</th>
<th>Break-even Dividends Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$ 3,500</td>
<td>$ 48,611</td>
</tr>
<tr>
<td>3</td>
<td>8,500</td>
<td>118,056</td>
</tr>
<tr>
<td>4</td>
<td>13,500</td>
<td>187,500</td>
</tr>
<tr>
<td>5</td>
<td>18,500</td>
<td>256,944</td>
</tr>
<tr>
<td>6</td>
<td>23,500</td>
<td>326,389</td>
</tr>
<tr>
<td>7</td>
<td>28,500</td>
<td>395,833</td>
</tr>
<tr>
<td>8</td>
<td>33,500</td>
<td>465,278</td>
</tr>
<tr>
<td>9</td>
<td>38,500</td>
<td>534,722</td>
</tr>
<tr>
<td>10</td>
<td>43,500</td>
<td>604,167</td>
</tr>
<tr>
<td>11</td>
<td>48,500</td>
<td>673,611</td>
</tr>
<tr>
<td>13</td>
<td>58,500</td>
<td>812,500</td>
</tr>
<tr>
<td>15</td>
<td>68,500</td>
<td>951,889</td>
</tr>
<tr>
<td>17</td>
<td>78,500</td>
<td>1,090,278</td>
</tr>
<tr>
<td>20</td>
<td>93,500</td>
<td>1,298,611</td>
</tr>
</tbody>
</table>
Since the one hundred percent dividends received deduction is only one advantage offered by the consolidated return election, a corporation willing to forego the multiple surtax exemptions should probably elect consolidated returns. But there may be special cases where the tax-free dividends deduction may be chosen instead of consolidated returns. These special situations are as follows:

1) The definition of affiliation for purposes of the one hundred percent dividends received deduction is more inclusive than for consolidation.\textsuperscript{33} Groups qualified for the tax-free dividends received election but not qualified for consolidation may want to eliminate all of the intercorporate dividends.

2) A group that has an insurance company with non-insurance companies cannot elect consolidated returns.\textsuperscript{34}

3) Returning to separate return filing from consolidated returns is difficult; whereas the tax-free dividends received deduction election can be terminated easily.\textsuperscript{35}

\textsuperscript{33} cf. I.R.C. Sec. 243(b)(5); I.R.C. Sec. 1504(a).
\textsuperscript{34} I.R.C. Sec. 1504(b)(2).
\textsuperscript{35} cf. Reg. 1.1502-75(c); I.R.C. Sec. 243(b)(4).
Advantages of Consolidation

A mere listing of the advantages and disadvantages of consolidation as compared to separate filing is no longer appropriate. Where multiple corporate entities exist, consolidated filing must be compared with separate returns utilizing multiple surtax exemptions and separate returns utilizing the one hundred percent intercorporate dividends election. Also, serious consideration must be given to the possibility of merging the corporations and operating through a single entity.

Utilization of Losses. Corporations normally may utilize the carryover and carryback provisions of the Code in order to salvage losses. Congress incorporated this privilege in the statutes in order to recognize the fact that any fiscal year is an arbitrary designation of time used to measure the continuing earnings or losses of an accounting or taxpaying entity. However, there are two situations in which an affiliated group

36 The investigator assumes that the use of the fifth alternative—separate filing with a single surtax exemption—is economical only when total taxable income is consistently below $32,500. Since such a small amount of earnings is limited to a few affiliated groups, for simplicity this alternative is omitted from the comparison.

can realize a net gain by filing consolidated returns. First, a net gain may be realized if the affiliate with the loss does not have earnings in any years to which it could carry a loss and thus obtain a refund or reduction in taxes. Second, even if the loss affiliate has income in a subsequent year to which the loss could otherwise be carried, filing consolidated returns may be more beneficial because of the present value of money.

In the first situation, there is no gain or loss to the individual affiliate, but there is a net gain to the group as a whole. A loss which otherwise is not usable to absorb operating income of the individual affiliate because it had no earnings during the specified period, is usable to offset earnings of other members if consolidated returns are filed.

In the second situation, the tax savings is the value of the compounded interest of the income tax which is postponed. When losses are applied to earlier years in the consolidated tax return, the group has prolonged use of the funds which otherwise would have been used to pay a greater tax liability. The value of this postponement or the tax savings is equal to the product of the postponed tax times the sum of one plus the effective cost of working capital, raised to the power representing
the number of years the tax is postponed. \( A = P(1 + r)^n \)

The loss offset privilege is probably the principal benefit of filing consolidated returns. Current ordinary losses generated by members can be offset against the current income of profitable members of the group. Likewise, current capital losses can be absorbed by current capital gains of other affiliates.\(^{38}\)

If a new subsidiary generates losses in excess of all other affiliates, they may be carried back against consolidated income in prior years even though the subsidiary was not in existence.\(^{39}\) In addition these same losses can be carried back to the income of the parent in a prior separate return year.\(^ {40}\) In both cases, however, the new subsidiary must have been a member of the organization since the affiliate's birth.

\(^{38}\)Reg. 1.1502-11, 12 and 22(a).

\(^{39}\)Reg. 1.1502-79(a)(2). This was the rule under the old Regulations (Rev. Rul. 64-93, 1964-1 C.B. 325), but not before the Commissioner had won a victory in the Tax Court and then lost in the Eighth Circuit Court. See Midland Management Company, 38 T.C. 211 (1962), rem'd., 316 F.2d 190 (8th Cir. 1963). See also Randolph E. Dale, "New Decision Seen as a Dangerous Precedent to Disregard of Consolidated Returns Regulations," The Journal of Taxation, Vol. 17 (September, 1962), 130-135.

\(^{40}\)Reg. 1.1502-79(a)(2). No carryback was possible under the old Regulations; Trinco Industries, Inc., 22 T.C. 959 (1954).
Under the new SRLY rules, losses from separate return years of a subsidiary which was a member of the group for each day of the loss year can be carried back or forward to be absorbed by consolidated income (provided multiple surtax exemptions were not elected during the loss year). Likewise, losses from unaffiliated or separate return years of a parent company can be carried back or over against consolidated income, provided multiple surtax exemptions were not used during the loss year. The present Regulations correct the inequality in the prior Regulations which favored a loss group over a single loss corporation. The old Regulations stipulated that a consolidated net operating loss carryover of an affiliated group could offset profits of a newly acquired subsidiary. But an unaffiliated corporation with a carryover loss could not offset its loss against the earnings of a subsidiary it acquired by merely filing consolidated returns. However, an unaffiliated loss corporation can now acquire profitable subsidiaries and offset its own loss carryover against the

41 Reg. 1.1502-21(c).

current income of the new subsidiaries.\textsuperscript{43}

The consolidated offset privilege has been diluted by the new Regulations. Under the old Regulations the separate return limitation year could be avoided rather easily.\textsuperscript{44} Since the direct acquisition of a loss group would result in the loss years of each member being treated as a SRLY, the profit group would acquire the stock of the loss group but keep the parent of the loss group as the common parent of the combined group. Hence, consolidated losses of the loss group could be carried over and offset against the income of all members, including the new profit members. However, the new CRCO and reverse acquisition rules have closed this loophole.\textsuperscript{45}

The advantage derived from the consolidated offset privilege is diminished to some degree by the fact that a current use of the loss may produce a basis adjustment or an excess loss account even though the loss could have

\textsuperscript{43}Ibid. Net capital losses can only be carried forward to offset net capital gains. Reg. 1.1502-22.

\textsuperscript{44}This old rule was Reg. 1.1502-31(b)(3). Losses arising during a separate return year could be used to offset consolidated income only to the extent of the income generated by the loss member.

\textsuperscript{45}Reg. 1.1502-21(d), 22(d) and 1(g); Reg. 1.1502-75(d)(3) and 1(f)(3).
been carried back to previous separate return years with no adverse effect. A member disposing of stock of a subsidiary must report as income (usually capital gains) its excess loss account with respect to the stock. This restoration is not so bad but the loss disappears under consolidation although it may have been ultimately utilized under the separate return basis. Also, in applying the rules of Section 382(a) to consolidated groups, a more stringent test may limit the utilization of the loss carryover of a newly purchased loss group.

The change-of-business concept is applied on a company-by-company basis, and if there is a fifty percentage point change in ownership of the parent and any affiliate changes its trade or business, Section 382(a) will deny the loss carryover arising with respect to the affiliate. Furthermore, the parent is assumed to own one hundred percent of the stock of each subsidiary regardless of any minority interest.

Availability of a three-year carryback and five-year carryover of net operating losses and a five-year carryover of net operating losses and a five-year carryover of net operating losses and a five-year carryover of net operating losses and a five-year carryover of net operating losses and a five-year carryover of net operating losses and a five-year carryover of net operating losses and a five-year carryover of net operating losses and a five-year carryover of net operating losses and a five-year carryover of net operating losses and a five-year

\[\text{\footnotesize 46 Reg. 1.1502-32.}\]
\[\text{\footnotesize 47 Reg. 1.1502-19.}\]
\[\text{\footnotesize 48 Reg. 1.1502-21(e)(1).}\]
carryover of net capital losses to unconsolidated loss members of a group reduces the importance of the consolidated offset privilege. In fact, if the loss member had no earnings in the three preceding years and prospects for earnings in the next five years are doubtful, the losses of an affiliate filing separate returns can be salvaged by merging the loss member with the parent or another member with enough earnings to absorb the losses. However, use of the loss on a consolidated basis may be more advantageous in terms of present value than its use as a carryover on a separate return since the group has the immediate use of funds which would otherwise be paid as taxes by the other members of the group. If the use of investment credits and foreign tax credits were also deferred by filing separate returns and then merging the subsidiary, the cost of postponing the tax benefits might be prohibitive.

Another adverse consequence of consolidation occurs in a situation where a foreign government seizes a subsidiary and creates a foreign expropriation loss. The fifty percent threshold requirement for the special ten-year expropriation loss carryover must be met by the entire group's losses, instead of the single
subsidary's losses. Conceivably, one subsidiary's expropriation loss may be large enough to raise another member's expropriation loss above fifty percent on an aggregate basis. Still another way to lose the benefits of a carryover under consolidation occurs when the loss carryover period expires sooner than with separate filing. Since a member's year terminates when it enters or leaves an affiliated group and the resulting short period is treated as a taxable year, the five-year loss carryover period may be less than the normal sixty months.

Consolidating a group may convert capital gains into ordinary income. For example, one member may have a Section 1231 capital gain of $100 and another member may have a Section 1231 capital loss of $100. If separate returns were filed, the $100 gain would be taxed at the twenty-five percent preferential tax rate and the $100 loss could be deducted from income as an ordinary loss. However, if consolidated returns are filed, the Section 1231 gains and losses would have to be offset.

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49 Reg. 1.1502-21(b)(2)(iii).
50 Reg. 1.1502-78(d).
51 Reg. 1.1502-11, 12, and 23.
effect, $100 would be taxed at higher ordinary income rates instead of the twenty-five percent capital gains rates.

Where a business is organized on a single entity basis or where all members are merged into a single corporate structure the utilization of losses may be more beneficial than under both the separate return basis and the consolidated return basis. The current branch losses may be absorbed by current earnings of other branches, and the combined losses of the single company may be carried back and carried forward without the numerous limitations imposed by the consolidated return Regulations. However, the merger of subsidiaries may create short taxable years and cause loss carryovers to expire sooner. Likewise, capital gains may be converted into ordinary income as a result of the improper income mix discussed in the example in the previous paragraph.

**Intercorporate Dividends.** A group filing consolidated returns eliminates intercorporate dividends, and thereby saves an effective tax of 7.2 percent on the

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52 i.e., SRLY limit, CRCO limit, reverse acquisition, and built-in losses.
dividends. However, Table III shows the amount of intercorporate dividends per year that is necessary to overcome the loss of multiple surtax exemptions. For the tax-free dividends advantage to be of value there must be large distributions of dividends. If only one surtax exemption worth $5,000 is lost, the intercompany dividends must be about $69,445 in order to break-even.

If the dividend distribution is made out of pre-affiliation earnings and profits, any gain on the distribution is deferred but the stock basis must be reduced. Once the stock basis reaches zero, remaining distributions increase the excess loss account. The adjustment to the stock basis has the effect of increasing a gain or reducing a loss upon the disposition of the subsidiary's stock. Likewise any balance in the excess loss account is treated as capital gains. Thus, although the original distribution avoided a 7.2 percent tax, the theoretical benefit was obtained at an additional cost of twenty-five percent capital gains tax.

53 Reg. 1.1502-14(a)(1). This 7.2% figure ignores the surtax exemption. A correction for this assumption would be to subtract $97.50 from the figure computed. i.e., 7.2% (intercorporate dividends) - 7.2% (25,000)26%.

54 Reg. 1.1502-14(a)(2).

55 Reg. 1.1502-19.
If an affiliated group files separate returns, intercorporate dividends from pre-affiliation or post-affiliation earnings and profits cause no basis adjustment. Therefore, the capital gains tax could be avoided. Also, an affiliated group can elect tax-free distribution of post-affiliated, post-1963 dividend, provided separate returns are filed and only one surtax exemption is utilized.\(^56\)

A single entity operation may prove even more advantageous. Property can be transferred within the corporate structure without being limited by the earnings and profits of the subsidiaries. However, there would be only one surtax exemption which may be too high a price to pay for tax-free distribution of cash within a business.

**Tax Credits.** In a similar fashion to unused losses, a consolidated return may permit current use of an investment credit where the credit would otherwise be limited to fifty percent of the tax on the return of the corporation that made the eligible investment.\(^57\) Since

\(^{56}\)I.R.C. Sec. 243(b).

\(^{57}\)This discussion assumes that the investment tax credit will be fully restored to the tax system.
the investment credit and limitation are computed on a consolidated basis when consolidated returns are filed, this can be advantageous where a loss member has a substantial unused credit. However, if the member with the credit is profitable and the group as a whole has less earnings, the tax credit would be less than on a separate return basis.

The carryover and carryback of investment tax credits may be from separate return years or from consolidated return years. Unused credits from separate return years can be utilized on a consolidated basis unless multiple surtax exemptions were elected for the carryback or carryover year or the subsidiary with the unused credit was not a member of the group for each day of the year.\(^{58}\) Aside from the liberal utilization of carryovers and carrybacks, members of an affiliated group are able to transfer property among the members without causing the investment credit recapture rules to apply.\(^ {59}\)

The branch method of operations not only affords the same opportunities for investment credit utilization

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\(^{58}\)Reg. 1.1502-3(c) and 1(f).

\(^{59}\)Reg. 1.1502-3(f)(2).
as consolidation, but credits from separate return years can also be used without regard to the limitations of multiple surtax exemptions or the prior affiliation of an affiliate. However, the ability of the single entity approach and the consolidated approach to offset unused credits of a member against the income tax of another member may be accomplished by a group filing separate returns. A member with a small amount of earnings can take advantage of a large investment credit by having a financial institution buy the property and lease the property to the affiliate. The financial institution uses the investment credit and passes the tax benefit to the affiliate by reducing the rental payments.

There are situations where separate filing is more advantageous than consolidated or branch filing. Since an affiliate's year ends when it enters or leaves a group, the resulting investment credit carryover period may be shorter than the normal sixty-month period. Furthermore, investment credits may be wasted under

60 I.R.C. Sec. 381(c)(23).

consolidation or branch filing. For example, assume that P and S are organized in 1965 and file separate returns. Corporation P has no income tax or investment credit, but S has a $10 tax but no credit has been earned. In 1966, P and S each have a $10 credit earned while P has a $20 income tax and S breaks even. Under consolidation, the 1966 credit absorbs the entire tax. Likewise, under separate filing the effect is the same since S will have a carryback. However, in consolidation, S can use its investment carrybacks from the years 1967 and 1968 through 1965. By filing separate returns P can utilize its investment credit carrybacks from 1967, 1968 and 1969 through 1966. Further, if P has a loss carryback to 1966 absorbing its income tax, the 1966 credit earned would become a carryover and possibly be wasted if consolidated returns were filed. By filing separate returns a $10 credit can be salvaged as a carryback to 1965.62

Another credit, the foreign tax credit, is computed on a consolidated basis in a consolidated return year.63 This consolidated basis provides a tax advantage that

62 Ibid.
63 Reg. 1.1502-4.
does not exist under separate filing. This consequence arises from the difference between the application of consolidated limitations and the application of separately computed limitations on the credit. However, when a loss is incurred by a member of the affiliated group, the filing of consolidated returns may be less advantageous than filing separate returns.

Unused foreign tax credits of a newly organized affiliate can be carried back from a consolidated return year to a previous separate return year of the parent.  

In addition, if multiple surtax exemptions were not elected and the affiliate was a member of the group, any unused credits from a separate return year can be carried back or forward and offset against consolidated taxes. If the two previous circumstances are not met, the carryover or carryback will be limited by the SRLY, CRCO, and reverse acquisition rules.

Since an affiliated group must jointly elect either the per-country limitation or the overall limitation on the foreign tax credit, a subsidiary may shift from the overall limitation to the per-country limitation without

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64 Reg. 1.1502-79(d).

65 Reg. 1.1502-4(f) and 1(f).
obtaining a consent of the Commissioner. This is accomplished by filing a consolidated return with a parent that is using the desired foreign tax credit limitation. Likewise, the affiliate may make a second election with respect to the overall limitation after having once shifted back to the per-country limitation without obtaining a consent. However, since the parent determines the method of limitation, the filing of a consolidated return may require a change by the subsidiary if it is using a different limitation. Thus a foreign tax credit carryover could be lost since an unused credit from a year under one limitation cannot be utilized in a year in which the other method is in effect.

As far as loss of carryovers are concerned, separate filing is more beneficial than consolidating or merging into one corporate structure. Likewise, under the new deferred accounting system, separate returns may be more advantageous. The deferred profit does not become foreign source income until recognized as taxable income

66 Reg. 1.1502-4(b).
67 Ibid.
68 I.R.C. Sec. 904(e).
under the new Regulations.69 Once recognized, the limitations may deny the use of a foreign tax credit that could have been utilized if the foreign source income was recognized as realized.70

Intercompany Transactions. Gains are deferred on intercorporate sales and transactions within an affiliated group if the gains are not realized outside the group during the taxable year.71 The gains are not taxed but deferred until recognized to the transferor upon the occurrence of certain events. The gains are recognized: (1) when the property is disposed of outside the group, (2) as depreciation is claimed, (3) when either party leaves the group, (4) in the case of inventory when separate returns are filed, and (5) other miscellaneous circumstances.72 If there are substantial intercompany transactions among the members of the group, consolidation permits the group to defer the tax incidence. When the group's intercompany sales are increasing steadily, there is a permanent deferral. This

69Reg. 1.1502-4(d)(1).
70Mirsky, supra, note 61, p. 846.
71Reg. 1.1502-13(c).
deferral is even more advantageous since the gross profit can be deferred and the administrative and selling expenses are immediately deductible against other income.\textsuperscript{73} Installment obligations may also be transferred among the members without resulting in the recognition of the remainder of the installment gain.\textsuperscript{74}

Again, however, a single entity operating through branches can obtain the same deferral advantages and avoid several adverse consequences of consolidation. Since a consolidated group is required to make an opening inventory adjustment to avoid a large dip in income,\textsuperscript{75} the group is only permitted to defer the reporting of future increases in intercompany sales. That is, gains on pre-consolidated intercompany sales cannot be deferred under the consolidated return basis. However, by liquidating the subsidiaries or merging the affiliates into a single corporation, all intercompany sales may be deferred; this results in a large decrease in income (which the inventory adjustment attempts to overcome). Furthermore, deferrals on depreciable property may almost be permanent since the gains are not

\textsuperscript{73}Reg. 1.1502-13(c)(2).
\textsuperscript{74}Reg. 1.1502-13(c)(1) and (e).
\textsuperscript{75}Reg. 1.1502-18(b).
recognized until disposition outside the company.\textsuperscript{76}

Finally, the Commissioner will probably no longer allow intercompany sales at basis.\textsuperscript{77} Branch operations will avoid the complexities involved in determining fair market value and will avoid the close scrutiny of intercorporate sales by Revenue Agents.

The filing of consolidated returns may convert capital gains into ordinary income. This would not occur if separate returns were filed or if a single entity concept were followed. For example, if separate returns are filed, depreciable property can be sold to another member and any gain is taxed as capital gains to the extent Section 1245 and 1250 do not apply. However, if a capital or Section 1231 Asset is transferred within a consolidated group, the deferred gain is recognized as ordinary income.\textsuperscript{78} Thus, as far as intercompany transactions are concerned, it may be more beneficial to file separate returns. The record keeping complexities of the deferred accounting system is avoided, and capital and Section 1231 gains are taxed

\textsuperscript{76}Cf. Reg. 1.1502-13(d).

\textsuperscript{77}Cf. Reg. 1.1502-80; I.R.C. Sec. 482.

\textsuperscript{78}Reg. 1.1502-13(c)(3).
at only twenty-five percent. Furthermore, the seller under separate filing is able to defer any gain on intercompany transactions by electing the installment treatment. A gain may be deferred longer by filing consolidated returns, but the gain is eventually taken into income and taxed at the higher ordinary income tax rate.

The filing of consolidated returns may also deny an investment credit on intercompany profits. This adverse consequence results from the fact that there can be no investment credit with respect to profit on intercompany transfers, even if the group elects to recognize the gain immediately. By filing separate returns and reporting the intercompany sale on the installment basis, any gain is recognized piecemeal, and is, in effect, offset by the depreciation deductions taken on a stepped-up basis. Thus, the investment credit is obtained at no tax cost to the group.

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79Reg. 1.1502-3(a)(2).
80Reg. 1.1502-13(c)(3).
Deferral of intercompany profits may be detrimental since the filing of separate returns or a new parent may cause some or all of the gain to be taken into income. On the other hand, if the group filed separate returns and elected the installment method, the deferred gain would not be taken into income prematurely.

Deductions. There are a number of deductions that may be more advantageously used by a group filing consolidated returns. A clear advantage of multiple corporations over a branch operation is in the area of the Western Hemisphere trade corporations. By creating subsidiaries a group can obtain the benefits of a special deduction of 29.17 percent (14/48) of the consolidated income attributable to Western Hemisphere trade corporations. Groups filing consolidated returns can also obtain this benefit since the Western Hemisphere income requirements are tested on a separate corporation basis. The special income is determined by multiplying the consolidated taxable income by a fraction, the denominator being the total income of all members of the group having income and the numerator being the total

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82 Reg. 1.1502-13(f)(1)(iii), (iv), and (vii).

83 Reg. 1.1502-25(b).
income of all the Western Hemisphere trade corporations having income. Thus, if any of the members of the group operate at a loss for the taxable year, a larger Western Hemisphere trade corporations deduction can be obtained by filing separate returns since the full deduction is not decreased by losses of other separate corporations.

However, this special deduction may be increased by filing consolidated returns. For example, assume that a Western Hemisphere corporation has a $100 loss which offsets income of a non-Western Hemisphere corporation during a consolidated return year. In the next year the Western Hemisphere corporation operates at a profit and is entitled to a full deduction since there is no carryover loss. If, however, the group were filing separate returns, the prior year's loss would absorb income of the current year and eliminate the benefits of the special deduction.

A number of limitations on deductions are applied on a consolidated basis. Consolidation may have the effect of lifting limitations which would otherwise be

84 Reg. 1.1502-25(c).

85 Salem, supra, note 81, p. 147.
applicable to some members of the group if they were applied separately. The charitable contributions deduction is limited to five percent of consolidated taxable income.\(^{86}\) This consolidated limitation may make it possible for charitable contributions by a loss member to be deductible although the member may have been denied the deduction if separate returns were filed. Conversely, if the aggregate taxable income of the profitable members is larger than consolidated income, the consolidated deduction may be less than the aggregate of the separate return deductions. Since branch filing results in the same advantages and disadvantages as consolidation, the income mix of each group determines whether separate filing or consolidated filing is more advantageous. However, contributions carryovers from separate or consolidated return years are treated as consolidated carryovers,\(^{87}\) and this result is a clear advantage of consolidation over separate return filing.

As in the case of charitable contributions, the income mix of the group determines whether consolidation or separate filing is more beneficial with respect to the

\(^{86}\) Reg. 1.1502-24(a).

\(^{87}\) Reg. 1.1502-24(b).
dividends received deduction. The eighty-five percent dividends received deduction applicable to dividends received from corporations not members of the group is limited to eighty-five percent of consolidated income. 88 When the deduction cannot be utilized on a separate return basis because a member does not have enough income, consolidated returns may allow the group to deduct the full amount if there is sufficient consolidated income. On the other hand, if consolidated taxable income is less than aggregate taxable income of the members, the aggregate of the separate return deductions may be larger than the consolidated dividends received deduction. However, where consolidation produces a net operating loss for the taxable year, the limitation of eighty-five percent of taxable income is removed since the limitation does not apply when there is a net operating loss. 89

Miscellaneous Benefits. There are a number of benefits of filing consolidated returns that offset the disadvantages of the election. For example, depreciable

88Reg. 1.1502-26(a).

89I.R.C. Sec. 246(b)(2); See also Fred W. Peel, Jr., Consolidated Tax Returns (Chicago: Callaghan and Company, 1959), p. 14.
property transferred among the members of a group continues to qualify for accelerated methods of depreciation—a privilege not available to companies filing separate returns.\(^{90}\) Likewise, property can be transferred among members without causing the recapture of the investment tax credit.\(^{91}\) Also, property subject to Sections 1245 and 1250 can be sold to other members without causing the depreciation recapture rules to take effect.\(^{92}\) However, the same adverse result is accomplished since, regardless of the nature of the deferred gain, the gain is later treated as ordinary income.\(^{93}\)

Although the consolidated return Regulations with respect to personal holding company tax have not been promulgated, there is an advantage to filing consolidated returns. In 1964 Congress failed to reduce the eighty percent test of personal holding company income to the more inclusive sixty percent test. Thus, if a corporation meets the eighty percent test before 1964 but fails to meet the sixty percent test, the corporation can purchase a subsidiary with enough nonpassive

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\(^{90}\)Reg. 1.1502-12(g).

\(^{91}\)Reg. 1.1503-3(f)(2)(iii).

\(^{92}\)Reg. 1.1502-3(f)(2).

\(^{93}\)Reg. 1.1502-13(d)(3).
income to bring the consolidated personal holding company income below the sixty percent requirement. Of course, the corporation could merge with the subsidiary and obtain the same results, but the corporation would be subject to the risks and liabilities of the subsidiary.\textsuperscript{94}

Another advantage of consolidation involves tax-free liquidation under Section 332. One of the requirements of a liquidation is that the distributee corporation must own at least eighty percent of the stock of the liquidating subsidiary before there is any nonrecognition of gain or loss.\textsuperscript{95} In meeting the eighty percent test during a consolidated return year, all of the stock of the liquidating subsidiary which is owned by members of the group is considered as owned by the distributee.\textsuperscript{96} However, the tax-free liquidation may be less desirable than a stepped-up basis that can be obtained by filing separate returns.

The preceding aggregate stock ownership rule also applies in determining whether worthless securities

\textsuperscript{94}Salem, \textit{supra}, note 81, p. 149.

\textsuperscript{95}I.R.C. Sec. 332(b)(1).

\textsuperscript{96}Reg. 1.1502-34; this special aggregate stock ownership rule also applies to Sections 165(g)(3)(A), 333(b), 351(a), and 904(f).
produce ordinary losses or capital losses. If at least ninety-five percent of each class of stock is owned by the taxpayer, any loss on worthless securities is treated as an ordinary loss. Therefore, in determining whether the ninety-five percent test has been met, the stock owned by each member in a consolidated return year will be considered as owned by the other members.

Dealing with the I.R.S. is more convenient and practical when consolidated returns are filed. The parent corporation is agent for the entire group, and it is more efficient for all parties if all communication is channeled through the parent. Since the parent is the sole agent of the affiliated group in all matters relating to the tax for consolidated return years, it may be advantageous for multiple corporations to file consolidated returns and avoid the cost of maintaining separate books and records. Also, filing of consolidated returns may prevent the Commissioner from asserting

97 I.R.C. Sec. 165(g)(3)(A).
98 Reg. 1.1502-34.
99 Reg. 1.1502-77.
100 Peel, supra, note 89, p. 10.
that the members of the affiliated group represent an association which is taxable as a corporation.\textsuperscript{101}

Canadian or Mexican corporations may be treated as domestic corporations in a consolidated return year if they were organized to comply with foreign laws.\textsuperscript{102} Thus, these corporations qualify as Western Hemisphere trade corporations and can obtain the special 26.17 percent deduction. In addition, the affiliated group will not have to obtain a special ruling from the Commissioner with respect to the recognition of gains in any of the exchanges described in Section 367.

In addition, where the parent and an affiliate are not on the same tax year, the due date of the tax liability of the affiliate in the first year of consolidation can be postponed to the parent's closing date without paying interest.\textsuperscript{103}

\textbf{Disadvantages of Consolidation}

Elimination of several disadvantages of filing consolidated returns has made the election more attractive. The two percent penalty tax, a permanent increase

\textsuperscript{101}\textit{Ibid.}, 1964 cumulative supplement, p. 2.
\textsuperscript{102}\textit{I.R.C. Sec. 1504(d)}.
\textsuperscript{103}\textit{Reg. 1.1502-76(c)}.
in income due to the opening inventory adjustment, and a strict similar method of accounting have been eliminated by the new Regulations revision. However, there are still numerous disadvantages of filing consolidated returns that cannot be overlooked.

**Exemptions.** Probably the most significant disadvantage of consolidation is the loss of multiple surtax exemptions. Although the Commissioner is actively attempting to disallow multiple surtax exemptions, affiliated groups may elect multiple exemptions worth $5,000 for each subsidiary earning more than $25,000 of taxable income. In spite of the additional six percent tax, each exemption creates a $5,000 (\$6,500 - \$1,500) tax savings which can add up to a large figure if there are many members in the group.

For example, Table IV shows the cost of losing the benefits of multiple surtax exemptions. If an affiliated group has only six members, the loss in tax savings is $23,500 for one year. Once a multiple surtax election is terminated, however, it may not be reinstated for a period of five years.\textsuperscript{104} At $23,500 per year the surtax exemptions loss could amount to a total of $141,000. In

\textsuperscript{104}I.R.C. Sec. 1562(c)(3).
TABLE IV
FORBEARANCE OF MULTIPLE SURTAX EXEMPTIONS AND MULTIPLE $100,000 EXEMPTIONS
FOR DECLARATION OF ESTIMATED TAX IN ORDER TO ELECT
CONSOLIDATED RETURNS FOR SIX YEARS

<table>
<thead>
<tr>
<th>Number of Corporations</th>
<th>Cost of Loss of Surtax Exemptions for One Year&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Cost of Loss of Surtax Exemptions for Six-Year Period&lt;sup&gt;b&lt;/sup&gt;</th>
<th>Interest on Accelerated Payments of Income Tax for One Year&lt;sup&gt;c&lt;/sup&gt;</th>
<th>Interest on Accelerated Payments of Income Tax for Four Years&lt;sup&gt;d&lt;/sup&gt;</th>
<th>Total Cost for Six Years&lt;sup&gt;e&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$ 3,500</td>
<td>$ 21,000</td>
<td>$ 2,525</td>
<td>$ 10,100</td>
<td>$ 31,100</td>
</tr>
<tr>
<td>3</td>
<td>8,500</td>
<td>51,000</td>
<td>5,050</td>
<td>20,200</td>
<td>71,200</td>
</tr>
<tr>
<td>4</td>
<td>13,500</td>
<td>81,000</td>
<td>7,575</td>
<td>30,300</td>
<td>111,300</td>
</tr>
<tr>
<td>5</td>
<td>18,500</td>
<td>111,000</td>
<td>10,100</td>
<td>40,400</td>
<td>151,400</td>
</tr>
<tr>
<td>6</td>
<td>23,500</td>
<td>141,000</td>
<td>12,625</td>
<td>50,500</td>
<td>191,500</td>
</tr>
<tr>
<td>7</td>
<td>28,500</td>
<td>171,000</td>
<td>15,150</td>
<td>60,600</td>
<td>231,600</td>
</tr>
<tr>
<td>8</td>
<td>33,500</td>
<td>201,000</td>
<td>17,675</td>
<td>70,700</td>
<td>271,700</td>
</tr>
<tr>
<td>9</td>
<td>38,500</td>
<td>231,000</td>
<td>20,200</td>
<td>80,800</td>
<td>311,800</td>
</tr>
<tr>
<td>10</td>
<td>43,500</td>
<td>261,000</td>
<td>22,725</td>
<td>90,900</td>
<td>351,900</td>
</tr>
<tr>
<td>11</td>
<td>48,500</td>
<td>291,000</td>
<td>25,250</td>
<td>101,000</td>
<td>392,000</td>
</tr>
<tr>
<td>12</td>
<td>53,500</td>
<td>321,000</td>
<td>27,785</td>
<td>111,100</td>
<td>432,100</td>
</tr>
<tr>
<td>13</td>
<td>58,500</td>
<td>351,000</td>
<td>30,300</td>
<td>121,200</td>
<td>472,200</td>
</tr>
<tr>
<td>14</td>
<td>63,500</td>
<td>381,000</td>
<td>32,925</td>
<td>131,300</td>
<td>512,300</td>
</tr>
<tr>
<td>15</td>
<td>68,500</td>
<td>411,000</td>
<td>35,500</td>
<td>141,400</td>
<td>552,400</td>
</tr>
<tr>
<td>16</td>
<td>73,500</td>
<td>441,000</td>
<td>38,060</td>
<td>151,500</td>
<td>592,500</td>
</tr>
<tr>
<td>17</td>
<td>78,500</td>
<td>471,000</td>
<td>40,600</td>
<td>161,600</td>
<td>632,600</td>
</tr>
<tr>
<td>18</td>
<td>83,500</td>
<td>501,000</td>
<td>43,140</td>
<td>171,700</td>
<td>672,700</td>
</tr>
<tr>
<td>19</td>
<td>88,500</td>
<td>531,000</td>
<td>45,680</td>
<td>181,800</td>
<td>712,800</td>
</tr>
<tr>
<td>20</td>
<td>93,500</td>
<td>561,000</td>
<td>48,220</td>
<td>191,904</td>
<td>752,904</td>
</tr>
</tbody>
</table>

<sup>a</sup>(No. of corporations - 1) $5,000 - $1,500.
<sup>b</sup>Six times first column.
<sup>c</sup>(No. of corporations - 1) $100,000/ x (.06 x .4208838). See page 271.
<sup>d</sup>Column 3 times 4.
<sup*e</sup>Column 2 plus Column 4.
addition, the surtax exemptions would not be available to any new subsidiaries acquired during the six-year period. Table III indicates that a group would have to have intercorporate dividends of $326,389 per year over a six-year period in order to offset this loss of surtax exemptions. In other words, if only one surtax exemption worth $5,000 is lost, the dividends would have to be about $69,445 in order to break-even. Thus, forbearance of the multiple surtax exemptions in order to file consolidated returns or to merge into a single entity may be impractical.

Aside from the surtax exemption, the loss of all but a single $100,000 exemption for the consolidated declaration of estimated tax may also be costly. An affiliated group electing to file consolidated returns is required to file a consolidated estimated tax return starting with the third consolidated return year. Thus, for the first two consolidated return years each affiliate has to make current payments on its tax liability in excess of $100,000. However, for the third year and any subsequent years that the group files consolidated returns the group must make current payments on its combined tax liability in excess of
This current estimated tax payable is due in four installments on April 15, June 15, September 15, and December 15. If the estimate is not paid, the group is subject to a six percent penalty on the under payment.

Thus, a group filing consolidated returns for at least two years must file a consolidated declaration of estimated tax thereafter which limits the group to a single $100,000 exemption. This single exemption may be beneficial to the group if an individual affiliate's estimated tax exceeds $100,000, but the consolidated estimated tax is less than $100,000. However, the single exemption will normally cause accelerated payments of the tax liabilities of the members and have an adverse affect on the cash position. Table IV, column four shows the approximate cost of making accelerated payments in a consolidated return year (assuming a six percent cost of working capital). For example, an affiliated group with ten members would lose approximately $22,725 of interest on accelerated


106Reg. 1.1502-5(b).
payments of income tax if they were filing consolidated returns in 1967.

As in the case of estimated tax payments, the filing of consolidated returns may limit a group to a single $100,000 accumulated earnings tax credit. Although proposed Regulations relating to the credit have not been published, the old Regulations limit an affiliated group to a single $100,000 credit\(^\text{107}\) and the new Regulations will probably continue this restriction.

The law generally frowns upon the retention of earnings which are unrelated to the business needs of a company. Thus, a penalty tax is placed upon earnings which are retained by the corporate organization for the purpose of avoiding the dividend tax that would have been imposed if they had been distributed to the shareholders.\(^\text{108}\) Every corporation has a $100,000 credit, even though a company is accumulating earnings for no worthwhile business purpose. Moreover, a corporation can retain more than $100,000 accumulated earnings if the company can show that the excess is necessary to meet the

\(^{107}\text{Reg. 1.1502-31A(a)(19)(1955).}\)

\(^{108}\text{The tax rate is } 27\frac{1}{2}\% \text{ on the first } $100,000 \text{ of unreasonable accumulated earnings and } 38\frac{3}{4}\% \text{ on all earnings beyond this first } $100,000.\)
"reasonable needs of the business." By carefully building a record of the reasonable business needs of a corporation, a business can accumulate up to $300,000 of retained earnings.

If the new Regulations do contain a single $100,000 exemption with respect to the accumulated earnings tax, careful long-range planning will be necessary to avoid the possible imposition of the penalty tax. For example, if there are ten members in the affiliated group and the more liberal $300,000 exemption is used, each member will only be able to accumulate about $30,000 in retained earnings. However, if management will make judicious use of two other techniques—reduction of equity capital in favor of debt and conversion of earnings into compensation— the disadvantage of the single accumulated earnings tax credit can be overcome. Affiliated corporations filing separate returns may not necessarily be protected from this same obstacle. One court has held that resources of related companies may be considered in judging whether earnings have been accumulated beyond the reasonable needs of the business, even though

109 I.R.C. Sec. 537.
separate returns are filed.\textsuperscript{110}

The single $100,000 exploration expenditure deduction under consolidation is similar to the disadvantage of a single accumulated earnings credit. Each member of a nonconsolidated group may deduct mine exploration expenditures in an amount up to $100,000 in any taxable year instead of capitalizing the expenditures. However, there is a maximum of $400,000 for any number of years.\textsuperscript{111} A group filing consolidated returns is only allowed a single $100,000 deduction and a single maximum of $400,000 even though more than one member of the group makes such expenditures.\textsuperscript{112} A single corporate structure operating through branches would also be limited by these single deduction limitations.

\textbf{Losses.} The deferment of unrealized intercompany losses by the new deferred accounting system may delay the tax benefits which can be derived immediately on a separate return basis or on a branch operation basis.\textsuperscript{113}

\textsuperscript{111}\textit{I.R.C. Sec.} 615.
\textsuperscript{112}\textit{Reg.} 1.1502-16(a).
\textsuperscript{113}\textit{Reg.} 1.1502-13(c).
Likewise, a Section 1231 ordinary loss of one affiliate, which normally reduces its income taxable at the full forty-eight percent rate, may be wasted if it is offset against another member's Section 1231 gain which is normally taxable at the capital gains rate of only twenty-five percent. Of course, this same problem would occur under the single entity system.

Similarly, under certain circumstances an ordinary forty-eight percent operating loss can be completely wasted where there are large capital gains. For example, assume that the parent of an affiliated group has a $10,000 ordinary loss and a subsidiary has a $30,000 capital gain. If separate returns are filed, the parent would be able to use the operating loss as a carryback or carryover and the subsidiary would pay a twenty-five percent tax ($7,500) under the alternate tax computation. By consolidating, however, the same $7,500 tax under the alternate method would be payable (since it is less than the ordinary tax on $200,000 of income), but the operating loss is treated as having been absorbed.

\[114^{\text{Reg. 1.1502-23.}}\]

\[115^{\text{Salem, supra, note 81, p. 151.}}\]
The new Regulations do not provide for the addition of holding periods when property is transferred between members of an affiliated group.\textsuperscript{116} Thus, adverse effects may occur when determining whether the six-month holding period under Section 1223 has been met or when applying Section 1250 (which gets better and better as the property ages).

If a subsidiary has a different tax year from that of its parent, a change to consolidated returns may cause a loss carryover to expire sooner than with separate filing. The subsidiary will have a short year which counts as a tax year for purposes of exhausting the years available for carryback or carryover of net operating losses. Of course, the same short tax year may occur when a member leaves the group.\textsuperscript{117}

**Consolidated Imprisonment.** The members of a group filing consolidated returns are not allowed to use different accounting periods but must adopt the accounting period of the parent.\textsuperscript{118} There are two exceptions:

\textsuperscript{116}Reg. 1.1502-13(g).

\textsuperscript{117}Reg. 1.1502-76(d). The aggregate carryover period of a subsidiary may be reduced as much as eleven months.

\textsuperscript{118}Reg. 1.1502-76(a)(1).
a member who is on a 52-53 week year may continue the
different period and a parent may change to a calendar
year basis if one of the subsidiaries is an insurance
company. 119

If an affiliated group terminates a multiple sur-
tax exemptions election in order to file consolidated
returns, the surtax election cannot be reinstated for a
period of five years. 120 Furthermore, an election to
file consolidated returns in one year may bind the
group to file consolidated returns in following years.
The new Regulations make drastic changes in the rules
under which an affiliated group may shift from consoli-
dated to separate returns. Shifts from consolidation
now require the permission of the Commissioner in all
cases. 121

Another aspect of the confinement effect caused by
consolidation is that the excess loss account, all
deferred inventory profits, and certain other inter-
company transactions have to be taken into income in the

119 Reg. 1.1502-76(a)(1). Conversely, the members are not required to adopt consistent methods of account-
ing; Reg. 1.1502-17.

120 I.R.C. Sec. 1562(c)(3).

121 Cf. Reg. 1.1502-75(c); Reg. 1.1502-11A(a)(1955).
first separate return year. This requirement is especially harsh since the group may cease to exist but all the members may be included in some other group which does file a consolidated return.\footnote{122}{Reg. 1.1502-19(b)(2)(vi).}

**Miscellaneous.** The following disadvantages are briefly listed in order to make this chapter complete. Reference should be made to the advantages and to the other chapters for a complete explanation of these disadvantages.

1. Intercompany transactions among members of an affiliated group must be priced at fair market value, which may be difficult to accomplish.\footnote{123}{Reg. 1.1502-13(c)(2).} The Commissioner will scrutinize the pricing of intercompany sales of depreciable and depletable assets and may use Section 482 to question the price established by the members of the group.

2. Deferred gain or loss accounts on sale of Section 1231 Assets and capital assets may remain in existence for years. A series of intercompany sales of the same asset will result in a number of deferred accounts which must be revised as a result of each succeeding
transfer of the asset. The record keeping problems may be a burden.

3. A group filing consolidated returns will lose the investment tax credit on the profit element of an intercompany sale. The credit will be allowed only on the seller's basis and not the fair market value (or selling price).

4. Filing consolidated returns for federal tax purposes may cause adverse effects for state income or franchise tax purposes.

5. A consolidated group is required to make an opening inventory adjustment to avoid a sudden decrease in the sales. Under the single entity basis no adjustment is required and all sales may be deferred, and thereby result in a large decrease in sales.

6. The parent corporation determines the group's choice of crediting or deducting foreign income taxes and the choice between the per-country limitation and the overall limitation on foreign tax credit. Thus,

124 Reg. 1.1502-13(c)(5).
125 Reg. 1.1502-3(c)(5).
126 Peel, supra, note 89, p. 26.
127 Reg. 1.1502-18(b).
128 Reg. 1.1502-4(b).
if a subsidiary is required to change its method of determining the foreign tax credit limitation, an unused foreign tax credit may be lost.\textsuperscript{129}

7. When a corporation joins or leaves a consolidated group a short tax year may occur. This short tax year may reduce the overall period for the utilization of net operating loss carryovers, unused foreign tax credits and investment tax credits, and charitable contributions carryovers.

\textbf{Minority Stockholders' Problems.} Another disadvantage of consolidation is the unique minority shareholders' problems encountered by an affiliated group. Since the term "stock" does not include nonvoting stock which is limited and preferred as to dividends in the determination of control,\textsuperscript{130} it is possible that all of a company's preferred stock may be owned by minority shareholders. In addition, if the chain is lengthened to include more distant corporations connected to the common parent by intermediate corporations, the possible minority stock interest, although not exceeding twenty percent for any one corporation, can become quite

\textsuperscript{129}\textit{I.R.C. Sec. 904(e)}.

\textsuperscript{130}\textit{I.R.C. Sec. 1504(a)}.
substantial. 131

Although there has been comparatively little litigation on the question of who should get the tax benefits from consolidation, one authority has suggested that minority stockholders have been either ignorant or complacent in enforcing their rights, or else they have been lying in ambush. 132 Carryback and carryover privileges, loss of surtax exemptions, intercorporate dividends, intercompany transfers of assets, and charitable contributions are only some of the situations where consolidation will change the tax liability which, in turn, may affect the minority shareholders' equity in the affiliated group. Basically, two principal theories have been advanced on behalf of minority shareholders.

The first theory is based upon the general fiduciary duty owed by directors and officers to their corporation, and upon the more specific standards that the courts have developed for transactions between companies having common


directors or officers. At first contracts between companies with interlocking directors and officers were held to be void. Today, however, these contracts can be voided only if they fail to measure up to some standard such as fairness or actual or constructive fraud.

A second theory is supported by the fiduciary obligations that the dominant or majority stockholders owe to the minority. The courts took an early position that the majority stockholders had no fiduciary duty to the minority. Later, the courts took the position that relief should be granted in aggravated situations where there is actual or constructive fraud. Today, the majority of the courts are holding the dominant or majority


135 Johnson, supra, note 131, p. 335.


138 Allied Chemical and Dye Corp. v. Steel and Tube Co., 14 Del. Ch. 1, 120 A 486 (1923).
shareholders to a fiduciary duty of "fairness" and "good faith." \(^{139}\)

From an accounting point of view, a third theory can be developed to indicate that minority stockholders should receive some of the tax benefits of consolidation. One generally accepted accounting concept is that revenues and expenses should be matched in order to accurately present the results of operations. \(^{140}\) If the premise that income tax is an expense is accepted, \(^{141}\) the income tax expense of the consolidated group should be matched with the revenue it produces.

However, the complex structure of the tax laws makes the concept of matching difficult to accomplish. For example, multiple surtax exemptions, capital gains and losses, Section 1231 Assets, and limits on deductible expenses cause a changing average tax rate. A consolidated tax cannot be allocated to various affiliates which


have the same effective tax rate since each affiliate is liable on a separate return basis at a different average tax rate.\textsuperscript{142} Since it is too difficult or almost impossible to relate the consolidated tax to the income on which the tax is being levied, a compromise is to relate the total tax to the total income of the affiliate. This matching of the consolidated tax to the income of the affiliate should not adversely affect the minority stockholders' equity in the affiliated company.

Although three separate theories indicate that minority shareholders should be paid for loss of benefits, the courts have been reluctant to require the majority stockholders to compensate the minority for loss of such benefits.\textsuperscript{143} In a recent case, however, the New York Court of Appeals upheld an allocation agreement in which the parent corporation was compensated for the use of its tax benefit. Ironically, the Court stressed the duty of the majority stockholders to be equitable to the


\textsuperscript{143}Western Pacific R.R. Corp. v. Western Pacific R. Co., 197 F.2d 994 (9th Cir. 1951), rev'd of other grounds, 345 U.S. 247 (1953); Alliegro v. Pan-American Bank of Miami, 130 S.2d 656 (Fla. App. 1962).
minority stockholders, and then upheld as "fair" an agreement which allocated to the parent substantially all of the benefits. However, with the current stress of the Supreme Court in other areas of minority rights, consolidation may present a problem in the near future as far as minority shareholders are concerned.

CHAPTER VII

FUTURE IMPLICATIONS AND CONCLUSION

Major revision of the consolidated returns Regulations is now a matter of history. In most cases the new provisions dealing with intercompany transactions, deferred gains or losses, and deferred earnings and profits are in general agreement with generally accepted accounting practice. However, a number of changes would improve the soundness of the new provisions, eliminate hardships imposed by some of the new rules, and simplify the administration of the new Regulations. Many of the recommendations in this chapter are made in order that the Regulations will adhere more closely to the entity concept of consolidation.

Suggested Recommendations

The presentation on suggested consolidated return improvements is divided into two parts: First, what may

be called positive recommendations, and second, status quo suggestions.

Positive Suggestions. A separate return year should not be made a separate return limitation year (SRLY) merely because the taxpayer elected multiple surtax exemptions. The surtax exemptions election has its own statutory penalties as defined by Congress and there is no reason to administer another penalty through the consolidated return Regulations.

Under the previous Regulations, carryover items were limited by what was called the (b)(3) limitation. The old (b)(3) rule limited the carryover or carryback of losses from separate return years to the amount of income generated by the corporation sustaining the loss. The purpose of this limitation was to preserve the integrity of the two percent penalty tax by preventing groups from switching in and out of consolidated filing.

For example, if carryovers and carrybacks were not limited to the amount of income of the sustaining corporation, the same loss carryover advantage of consolidation

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2 Reg. 1.1502-1(f).

3 i.e., The 6% penalty tax; also, once terminated, no multiple surtax election can be made for five consecutive years.

could be obtained for all years by occasionally filing consolidated returns. Without the (b)(3) limitation separate returns could be filed for four years and the accumulated losses of any of the members could be absorbed in the fifth year by filing consolidated returns. Thus, skillful planning would result in substantial tax avoidance before the repeal of the two percent penalty tax. The (b)(3) rule prevented a group from taking advantage of multiple surtax exemptions and other benefits of separate filing; and, then, when the unused losses were substantial, permitted their utilization merely by switching to consolidated returns.

Under the present Regulations, the (b)(3) limitation has been replaced by the separate return limitation year (SRLY) rule. Losses of subsidiaries generated during SRLY's may be carried, without limitation, to consolidated return years if the loss corporation was a member of the group during each day of its separate return year and multiple surtax exemptions were not elected. Thus, if an affiliated group has not elected multiple surtax exemptions, consolidated returns may be filed each fifth

\[5\text{Reg. 1.1502-1(f).}\]
year and the accumulated losses of the various members can be absorbed.

Since groups may obtain the advantages of consolidated filing even though separate returns are filed, the purpose of the old multiple surtax exemptions limitation has disappeared. If the purpose of the limitation has disappeared, the limitation should disappear also. Besides, there does not appear to be any connection between the two events (multiple surtax exemptions and change of ownership) and the limitation. If the change of ownership is significant, the two Code provisions (Sections 382 and 269) involving change of ownership should determine whether the carryovers are disallowed.6

Aside from the argument that multiple surtax exemptions are administratively penalized through the consolidated return Regulations, there is ample policy justification for allowing, in full, carryovers from separate return years. A fundamental proposition of the loss carryover area is that the taxpayer who suffers the loss should realize its benefits.7 When an affiliated group


files separate returns, the group is the "economic unit" which suffers the loss and is, therefore, entitled to the benefits of the loss. Thus, the multiple surtax exemptions election should not determine the extent to which losses that occurred in separate return years may be used to offset consolidated income.

Two other improvements of the Regulations would eliminate hardship imposed by the rules with respect to discontinuing consolidated returns. First, a new provision should be added to the Regulations which permits affiliated groups to discontinue the filing of consolidated returns after they have been filed for a minimum period of five years. The new Regulations tightened the rules for returning to separate return filing, and the acquisition of a new member will no longer automatically give the group the opportunity to return to separate filing. A shift to separate returns requires the permission of the Commissioner either by the taxpayer's petition or by a blanket permission to all groups.

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9 Reg. 1.1502-75(c)(1).
10 Reg. 1.1502-75(c)(2).
This confinement of consolidated groups is too harsh, and steps should be taken to remove this disadvantage of filing consolidated returns. Where there are substantial disadvantages in continued consolidated returns, the group should be able to elect separate returns filing. However, by making the confinement period at least five years, the groups would not be able to switch from one method of filing to another method simply by a comparison each year of consolidated returns with separate returns. Thus, consolidated returns could not be used as a tax gimmick for the sake of obtaining a one-shot tax advantage.

Second, a provision should be added to the Regulations which allows taxpayers sixty days in which to file separate returns after permission to switch from consolidated filing has been granted.¹¹ The present Regulations encourage tardiness in filing consolidated tax returns and may penalize a group which files its tax return early. For example, if the Commissioner were to grant permission on March 14, to all calendar-year taxpayers to file separate returns, those taxpayers who filed consolidated returns without requesting an extension of time and

¹¹This sixty-day extension was included in the proposed Regulations but was omitted from the final Regulations. Cf. Pro. Reg. 1.1502-75(c)(3) and Reg. 1.1502-75 (c)(3).
who did not learn of the special grant, would be barred from filing separate returns for that year. However, the taxpayers who requested extensions of time for filing their consolidated returns would have time to discover and evaluate their right to file separate returns. Under the present Regulations groups that file consolidated returns should request, each year, extensions of time for filing their consolidated returns in order to circumvent this inequity in the Regulations.

Another improvement would be to eliminate the reverse acquisition concept from the Regulations. The reverse acquisition provision creates a separate return limitation year where a common parent of a group (whether filing a separate return or consolidated return) is acquired by another company which becomes the new common parent. Thus, the losses of the former group (that is treated as going out of existence) are fragmented, and further use of the losses is limited to the particular loss member's future profit.\textsuperscript{12} Instead of applying the reverse acquisition rule, the consolidated return change of ownership (CRCO) rule should be the only limit on carryover items.

\textsuperscript{12}Reg. 1.1502-75(d)(3).
Both the reverse acquisition and consolidated return change of ownership (CRCO) rules refer to the underlying ownership of the parent of the group and both concepts are activated when there has been a more than fifty percent change in ownership of the group. Likewise, both conclude that a more than fifty percent change in ownership activates the application of the SRLY test to loss carryovers. Furthermore, both concepts attempt to put the acquisition of loss groups on a parity with the purchase of a loss corporation.\(^{13}\)

Since there is so much similarity between the two concepts, the CRCO rules should be the only limit on carryover items from the former affiliated group. The CRCO rule provides sufficient protection against abuse in this area,\(^{14}\) and the reverse acquisition rule produces harsher results than those which would prevail if the group had not been acquired by the creation of a new parent.\(^{15}\)


\(^{14}\) The effect of the CRCO rule is that the losses sustained by a group before a CRCO cannot be carried forward and used against the profits of corporations who become members after the ownership change.

In addition, the CRCO rule follows more closely the entity concept or "unit concept" than the reverse acquisition concept.

As in the case of the preceding suggestion, the application of the change-of-business concept of Section 382(a) on a consolidated group basis would follow more closely the entity concept than the more restrictive company-by-company basis which is presently incorporated in the Regulations.\(^{16}\) If a change of trade or business is not sufficient to constitute a change of business from the point of view of the group as a whole, then Section 382(a) should not be used to disallow a portion of a net operating loss carryover. However, if the change is major in relation to the overall business activities of the group, the entire net operating loss carryover should be denied.\(^{17}\) Also, the parent should not be assumed to own one hundred percent of each subsidiary in the group since there may be as much as twenty percent minority interest.

Another recommendation is to restrict the built-in deductions provision to include only the four items

\(^{16}\)Reg. 1.1502-21(e)(1).

\(^{17}\)Committee on Federal Taxation, supra, note 1, p. 4.
specified in earlier Regulations. Although at least one court case has indicated that this old provision is invalid, the current Regulations have been expanded to include built-in depreciation, depletion, and amortization deductions as well as built-in inventory deductions. There is a statutory provision to the effect that a corporation cannot carry forward its prior net operating losses where there has been a change in stock ownership and a change in the type of business performed. However, since there is no legislation that disqualifies current ordinary deductions, the present definition of built-in deductions should be restricted to the four items enumerated in the previous Regulations.

The Spreckels doctrine or lack of a sound business purpose has been used by the courts to deny consolidated returns where the taxpayer attempted to take advantage of built-in deductions. An assessment of the legislative intent, however, shows that the only prerequisite for

20 Reg. 1.1502-15(a)(2).
21 I.R.C. Sec. 382(a).
22 J.D. and A.B. Spreckels Co., 41 B.T.A. 375 (1940).
affiliation, and the resulting qualification for consolidated returns, is the requirement of stock ownership. At no time has Congress given the Commissioner the power to prescribe Regulations making a business purpose a prerequisite of consolidation.\(^{23}\)

Since stock ownership is the only statutory test of affiliation, the Spreckels doctrine should not continue to be used as a test of affiliation.\(^{24}\) The Commissioner has the power to " prescribe such regulations as he may deem necessary."\(^{25}\) Therefore, he can use the "principal purpose" test of Section 269 to deny the acquiring corporation (or its affiliated group) the opportunity to offset income with preacquisition losses of a subsidiary which was acquired merely for tax purposes. It does not seem equitable to allow the Commissioner to make a twofold attack on affiliation by giving him the power to deny affiliation on the ground that no business purpose was served and to determine if the principal purpose of purchasing a subsidiary was avoidance under Section 269.


\(^{24}\)The Ninth Circuit, in Hawaiian Trust Co., Ltd. v. U.S., 291 F.2d 761 (9th Cir. 1961), implied that the business purpose test is no longer applicable.

\(^{25}\)I.R.C. Sec. 1502.
The final positive recommendation is that deconsolidation should not result in the immediate restoration of deferred gains or losses into income where inventory gains or losses are involved or where consolidated returns are filed for less than three consecutive years. Instead of being taxable upon deconsolidation, the deferrals should be taken into income in precisely the same manner as that which would have occurred if the group had continued to file consolidated returns. This suggested procedure is the normal procedure provided for other deferred items, and there does not appear to be a valid reason to depart from the normal rule where inventories are involved or where consolidated returns are filed for less than three consecutive years.

Apparently, the Commissioner believed that the two exceptions were necessary in order to prevent the movement to and from consolidated returns merely to effect non-taxable shifts of assets. However, since the Commissioner

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26 "Deconsolidation" refers to a situation where the members of a group remain affiliated but choose to file separate returns.

27 Reg. 1.1502-13(f)(1)(iv) and (vii).

28 Reg. 1.1502-13(f)(1)(i),(ii) and (iii).

must approve a shift to separate return filing, this
confinement requirement should be a sufficient safeguard
against shifting to and from consolidation. If this
suggestion is incorporated into the Regulations, it would
allow all groups to deconsolidate and avoid penalty whenever
the Commissioner grants blanket permissions to return
to separate filing.30

Status Quo Suggestions. Some commentators have
suggested that consolidation should be compulsory as in
the original provisions of the United States income tax31
and as in the United Kingdom excess profits levy and tax.32
Mr. Jerome R. Hellerstein summarized this argument with
the following statement:

There is no good reason for allowing taxpayers to elect consolidations only in circumstances in which tax liabilities will be
increased.... The considerations which warrant the utilization of consolidated returns at all
suggest the desirability of making such returns mandatory.33

30 See Committee on Federal Taxation, supra, note 1, p. 5.
31 Revenue Act of 1918, Sec. 240(a).
32 Finance Act, 1937, 1 Edw. 8 and 1 Geo., c. 54, sec. 22.
But he admitted that mandatory consolidated returns would impose "the complexities inherent in the procedure for such returns"\(^{34}\) upon many taxpayers.

Most students of consolidation believe that the consolidation procedure is too complex to be forced upon a taxpayer.\(^{35}\) The affiliation test would probably have to be broadened in order to prevent tax avoidance which would increase the administrative burden.\(^{36}\) Likewise, there would be an increased incidence of suits by minority stockholders unless a satisfactory solution is found to the numerous problems of allocating the tax benefits of consolidation among the members of the group.\(^{37}\) The present policy of consolidated returns, which are initially optional with the taxpayer, should be continued.\(^{38}\)

Another procedure that should be continued is the new deferred accounting system. Although the new

\(^{34}\)Ibid., p. 457.


\(^{36}\)Hellerstein, supra, note 33, p. 456; Ibid.

\(^{37}\)Horwich, supra, note 35, p. 565.

procedure is proven to be nonstatutory in Chapter IV, the deferred system does adhere to the established rules of accounting in many respects. By treating similar transactions consistently and attributing income to the affiliate that earns it, the deferred accounting system provides a better determination of the consolidated tax liability. Congress should issue a Committee report or indicate that this new system is statutory under the Internal Revenue Code.

Congress should also resist the temptation to impose any form of additional penalty tax on the consolidated return election when there is a need for increased Federal revenues. Although the election is a privilege in a legal sense, the use of consolidated returns results in a more realistic measure of earnings for affiliated groups than do separate returns. Consolidation is a recognized accounting practice and necessary to determine the true net income of a group of affiliated companies.\footnote{S. Rep. No. 665, 72nd Congress, 1st Sess., p. 9 (1932); Randolph Paul, Hearings Before Committee on Ways and Means, Revenue Revision of 1942, 77th Congress, 2nd Sess., p. 88 (1942).} Thus, it is difficult to see how one can defend a Regulation which levies an additional penalty tax for the privilege
of using a procedure that results in a more accurate measurement of earnings.

Another status quo recommendation involves the investment tax credit. Any step-up in basis of assets transferred within an affiliated group in deferred intercompany transactions is disregarded in computing the investment tax credit.\(^{40}\) The Committee on Federal Taxation of the American Institute of Certified Public Accountants has suggested that the credit should be based on the selling price of the property regardless of whether or not intercompany gain or loss is deferred.\(^{41}\) However, the present treatment of the credit follows more closely the concept that the affiliated group is a single entity. Not only is the credit disallowed on the deferred gain, but the investment credit cannot be recaptured if intercompany transfers occur. The transferee becomes responsible for any subsequent transfers.\(^{42}\) To be entirely consistent with the entity concept, however, any investment credit attributable to any deferred gain should be deferred until the gain is restored.

\(^{40}\)Reg. 1.1502-3(a)(2).  
\(^{41}\)Committee on Federal Taxation, supra, note 1, Technical Memorandum, Part I, p. 2.  
\(^{42}\)Reg. 1.1502-3(f)(2).
The Committee on Federal Taxation also commented on the new account—the excess loss account—required by the new Regulations. Excess loss accounts are now established for each subsidiary in which an affiliate owns stock to record (1) non-dividend distributions with respect to stock that exceeds its basis, and (2) negative investment adjustments after the basis of the stock has been reduced to zero. Any amount in the account is applied against subsequent net positive investment adjustments with respect to the affiliate's stock in the subsidiary or offset against the basis of subsequent investments in the stock of the subsidiary. If, however, the parent disposes of the subsidiary or the group ceases to file consolidated returns, any balance in the account is included in the income (usually as a long-term capital gain) of the affiliate which owns the stock.

The fundamental reason for the excess loss account is to prevent a subsidiary's operating loss deducted on a consolidated return from also being reflected in an investment loss. In Charles Ilfeld v. Hernandez, 292 U.S. 62 (1934), the Supreme Court refused to allow a loss

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43 Reg. 1.1502-19.
44 Reg. 1.1502-32(e)(2) and (3).
on the liquidation of a subsidiary which duplicated operating losses that had already been utilized by the parent on a consolidated return. Previous Regulations required the parent to adjust the stock basis downward for losses of the subsidiary utilized on a consolidated return which the subsidiary could not have used on a separate return. However, the prior Regulations were silent as to the correct procedure for losses that exceeded the aggregate investment of the group in the subsidiary. Thus, the negative basis approach was incorporated into the Regulations to express the concept inherent in the Ilfeld opinion.

Instead of using this negative basis approach to recapture benefits received from owning a subsidiary, the A.I.C.P.A. Committee wanted the tax benefits "awarded to that affiliate through reasonable earnings and profits allocation rules which permit proper tax sharing among members."\(^\text{45}\) The Committee was critical of the theory that the tax benefits from losses of affiliates is necessarily appropriated by the parent or other affiliates owning stock in the loss affiliate. "As a business matter this is frequently not true, especially where there may be

\(^{45}\text{Committee on Federal Taxation, supra, note 1, p. 6.}\)
The Committee gave the following example of "appropriate financial adjustments" among the members of the group:

If the profit members of a group actually pay over to a loss member the tax benefit of consolidated utilization of its losses, no basis adjustment should be necessary.47

Although the Committee believed that "reasonable and equitable rules" could be promulgated under Section 1552 (relating to the allocation of consolidated tax liability), the report did not include any suggested "reasonable and equitable rules." There are basically, however, four ways the tax savings from consolidation could be allocated:

1) The tax savings can be allocated to some group other than the affiliated companies.

2) A trust fund can be established for the benefit of any or all of the corporations involved.

3) The tax savings could be allocated directly to the affiliates.

4) The parent could receive the entire tax benefit

46 Ibid., Technical Memorandum, Pt. 1, p. 8.
47 Ibid.
of filing consolidated returns. 48

Allocation of the tax benefit to some outside party is a ludicrous approach, and the trust fund approach merely postpones the problem of allocation. As for the third approach, three separate theories were outlined in Chapter VI which indicated that subsidiary corporations should receive some of the tax benefits of consolidation (especially where minority stockholders are involved). There are three statutory methods of allocating the consolidated tax liability among the affiliates. 49

However, all of these methods shift taxes and include some characteristics that are biased. 50 Although it is beyond the scope of this dissertation to prove this tax shift and bias characteristics of the three methods in the Internal Revenue Code, 51 these two arguments discredit


49 I.R.C. Sec. 1552.

50 Taylor, supra, note 48, pp. 186 and 193. "Bias" is defined as the tendency of any classification of a company in an affiliated group to be better off or worse off as a result of changes in the consolidated tax liability; Taylor, supra, note 48, p. 65.

51 Mr. Taylor summarizes in a table the tax shift under the three methods as a result of certain factors such as loss of surtax exemptions, operating losses, operating loss carryovers, and so forth. Taylor, supra, note 48, p. 187.
the three methods of allocating the tax savings directly to the affiliates.

In addition to tax shift and bias, a forceful financial argument can be developed to indicate that the entire tax benefit should be allocated to the parent corporation. This financial argument is based upon the premise that companies are generally consolidated to obtain greater control over the operations. Thus, the officers of the company proposing the acquisition of another company are attempting to improve the position of their company's stockholders and these shareholders should receive any tax benefits accruing from the consolidation. One such potential improvement is the numerous financial advantages of acquiring a subsidiary.

First, the financial strength of the affiliated group becomes the average strength of the members of the group. Thus, the extra strength of one affiliate can be transferred to a weaker affiliate. The total group will gain if the financially stronger affiliate has "extra strength." The total group does not suffer from the shift of the superfluous strength, and the weaker affiliate clearly gains. The flexibility of acquiring a subsidiary is to enlarge the total financial strength of the group over the
sum of the individual "strengths" of the members. 52

Second, the acquisition of a subsidiary can be considered an investment. Interest, dividends, and capital gains are rewards from an astute investment. Since the parent company manipulates the financial resources, any benefits from such manipulation should accrue to the parent. Thus, the parent company should get all of the benefits or losses of the consolidated burden since through its control the parent determines when consolidated returns are filed. 53

If the two foregoing arguments are sound, then the parties responsible for the decision are also the ones who should benefit from the consequences. Thus, the shareholders of the parent should be compensated for the astute judgment of their board of directors and officers. 54

52 Taylor, supra, note 48, p. 191.
53 Ibid. The argument against this all-to-the-parent approach can be summarized in the words of Mr. Justice Jackson: "Each of the parties had but one key, and how can it be said that the holder of the other key had nothing worth bargaining for?" Western Pac. R.R. Corp. v. Western Pac. R. Co., 197 F.2d 994 (9th Cir. 1951), rev'd on other grounds, 345 U.S. 277 (1953).
54 Several courts have said that such payments for "tax benefits" are illegal since such a procedure is not a part of the federal consolidated tax returns procedure. See Western Pac. R.R. Corp. v. Western Pac. R. Co., supra, note 53; Beneficial Corp. v. Commissioner, 18 T.C. 396 (1952); Allegro v. Pan American Bank of Miami, 136 So.2d 656 (Fla. App. 1962).
The minority shareholders of the subsidiary are no worse off than they would have been if they had filed separate returns. Of course, they may be in a less favorable position than they would have been if some other allocation plan was used. However, contrary to the reasoning of the A.I.C.P.A. Committee, the appropriation by the parent of any tax benefits may be most fair from the point of view of the minority stockholders and will leave them unaffected by the consolidation.^55

From the foregoing discussion there does not appear to be any financial reason for not allowing the negative basis approach which assumes that the parent corporation appropriates the tax benefits from losses of affiliates. Furthermore, the use of the excess loss account is similar to the generally accepted practice of deferring income under the accrual method. The tax benefits of owning a subsidiary is deferred in the excess loss account and is taken into income at the happening of certain events. Law commentators have generally agreed that the negative basis—in the form of excess loss accounts—follows more

^55 Although the New York Court of Appeals, in Case v. New York Central R.R. Co., 243 N.Y.S.2d 620 (1963), stressed the duty of the majority stockholders to be fair to the minority equity holders, an agreement which allocated substantially all of the tax benefits to the parent was upheld.
closely the entity concept of consolidation,\textsuperscript{56} and there does not appear to be any legitimate reasons why the accounting profession should not welcome this new procedure.

\textbf{Conclusion}

Congress has eliminated the two percent penalty tax on consolidated returns and has provided a specific six percent additional levy on multiple surtax exemptions. Moreover, the Treasury is consistently attempting to limit multiple corporations to one surtax exemption.\textsuperscript{57} Consolidation should be encouraged by these developments and most commentators have predicted an increase in the use of consolidated returns. In fact, in 1964 there was an upsurge in the number of consolidated return elections as well as the number of subsidiaries included within


\textsuperscript{57}The Treasury is attempting to deny multiple surtax exemptions by applying the tax avoidance provisions of Sections 61, 269, 482, and 1551.
these returns.\textsuperscript{58} However, an election is not a panacea for the problems of multiple corporations and the election should not be made unless there are immediate distinct tax advantages.

The one hundred percent intercorporate dividends exclusion and the loss offset privilege are the two major advantages of consolidation. Since multiple surtax exemptions are lost during consolidation, the most desirable procedure is to elect multiple surtax exemptions for a number of years so as to gain the benefits of the multiple exemptions and accumulate the dividends in the individual affiliates. In a future year the group can file a consolidated return so as to draw down the accumulated earnings and thereby avoid the effective 7.2 percent tax on intercorporate dividends. Since multiple surtax exemptions cannot be availed of for a five-year period after its termination, the earnings can be passed through

\textsuperscript{58}The 7300 consolidated returns filed in 1964 were 1500 more than 1963, but 2,000 short of the highest year, 1928. However, one out of every eight corporate returns filed in 1964 was filed by a member of a controlled group. Of the 182,000 returns filed by controlled groups, 104,000 (about 57%) elected multiple surtax tax exemptions and the other 78,000 used the single group exemption. Out of the remaining 43% using a single surtax exemption, 45,300 of the corporations were included within a consolidated group. The 38,000 subsidiaries included in these consolidated returns reflect 42% increase over 1963.
the tier of affiliates as business considerations permit. Permission to revert to separate filing is rarely granted, but substantial changes in the tax laws usually result in blanket permission by the Commissioner to return to separate filing. Since blanket permission occurs approximately every three or four years, a group will not be confined indefinitely to consolidation.

As for the loss offset privilege, any losses that occur during the years in which a multiple surtax exemptions election is in effect will be limited by the SRLY limit. Thus, a group should not elect consolidation when there are large amounts of carryforwards available but should make the election before any affiliates begin having large amounts of losses. Even here, however, the group has to consider the liberal loss carryover rules with respect to Section 332 liquidations or other Section 381(a) transactions. For example, the losses of an affiliate can be salvaged if another member of the group generates enough taxable income and if it is possible to merge the two members. By merging the two members, both the loss

59 Both the 1962 and 1964 acts carried with them the right to discontinue consolidation. Likewise, the same permission was granted for the first year to which the revised Regulations applied, 1967; T.I.R. 769 (10/1/65).
offset privilege and the benefits of multiple surtax exemptions are obtained.

There are two ways, however, in which the loss offset privilege is beneficial to a consolidated group: (1) if the loss affiliate does not have earnings in any years to which it can carry the loss; and (2) if the loss affiliate has income in a subsequent year to which the loss could otherwise be carried. The merger plan will work in both instances, but, if the merger is consummated in the fourth or fifth year of the carryover period, the group has overpaid its taxes. When losses are applied to earlier years in the consolidated tax return, the group has prolonged use of the funds which otherwise would have been used to pay the greater tax liability.\textsuperscript{60} If the use of foreign tax credits and investment credits are also postponed as the result of filing separate returns and then merging the members, the cost of postponing the tax may be greater than the loss of surtax exemptions. However, the group also has to consider both the loss of all but one $100,000 accumulated earnings credit and one

\textsuperscript{\footnote{The value of this postponement is equal to the product of the postponed tax times the sum of one plus the effective cost of working capital, raised to the power representing the number of years the tax is thus postponed. \textit{i.e.,} A = P(1 + r)^n/}}
$100,000 estimated tax payments exemption when consolidated returns are filed.
# APPENDIX A

SIMPLIFIED FORM 1120 FOR HYPOTHETICAL, NORMAL UNITED STATES CORPORATION

## Gross Income

- Net Sales less Cost of Goods Sold
- Receipts from Services
- All Dividend Income
- Interest
- Rents and Royalties
- Gains or losses on Sale or Exchange

## Less Ordinary Deductions from Gross Income

- Salaries and Wages
- Compensation of Officers
- Bad Debts
- Taxes
- Interest
- Contributions (limited to 5% of adjusted taxable income)
- Advertising
- Depreciation and Depletion
- Casualty Losses
- Repairs
- Rents
- Net Operating Loss Deduction
- Amortization
- Pensions and Profit-Sharing Plans

## Minus Certain Special Deductions

- 85% Dividend Received Deduction
- Western Hemisphere Trade Corporation Deduction (14/48 or 21.17% of taxable income)
- Organization Expense Amortization
Special Deduction by Public Utilities on Preferred Stock (21.17% of dividends paid)
Approximately 60% Dividends Deduction from Preferred Stock of Public Utilities

Equals Taxable Income

On which 22% Normal Tax Rate is applied against the first $25,000. However, if multiple surtax exemptions are claimed, the Normal Tax is 28% on income below $25,000. Surtax Tax Rate of 26% and Normal Tax Rate of 22% is applied against income above $25,000.

Less Credits

Investment Tax Credit (7%)
Foreign Tax Credit

Equals Income Tax Liability

Payable to the Internal Revenue Service on March 15 or by the 15th day in the third month following the close of the taxable year.
APPENDIX B

TAX COST OF THE LOSS OF MULTIPLE SURTAX EXEMPTIONS

Probably the most significant disadvantage of consolidation is the loss of multiple surtax exemptions. Although the Treasury is attempting to disallow multiple surtax exemptions, affiliated groups may elect multiple exemptions worth $5,000 for each subsidiary earning more than $25,000. In spite of the additional six percent penalty tax, each exemption creates approximately $5,000 ($6,500 - $1,500) tax savings which can amount to a large figure if there are many affiliates in the group.

This appendix determines the tax cost of the loss of multiple surtax exemptions. In this proof two types of corporations are encountered. Below companies (b) are those corporations that have taxable incomes less than or equal to $25,000. Above companies (a) are those corporations with taxable income greater than $25,000. Any negative figures are construed as zero. Symbols used in this proof are defined as follows:
\( e \) = ordinary income  
\( n \) = number of affiliates  
\( r \) = tax rate  
\( D \) = total tax burden of consolidation  
\( T_1 \) = total Below and Above tax  
\( e_b \) = ordinary income of a Below company  
\( e_a \) = ordinary income of an Above company. 

Formulae for Below companies' taxes (first the individual company and then for all such corporations) are as follows:

1) \( .22e_b = t_b \) and \( .28e_b = T_b \)  
The tax increases to .28 for "all such corporations" because of the additional six percent penalty tax.  

Formulae for Above companies' taxes (first the individual company and then for all such corporations) are as follows:

2) \( .48e_a - 5000 = t_a \) and \( .48\sum e_a - 5000n = T_a \)  

Formula for consolidation is as follows:

3) \( T_1 = .48(\sum e_a + \sum e_b) - 6500 \)  

Formula three (3) is not valid where \( (\sum e_b = 0) \) and \( (\sum e_a) \) is less than $25,000. The minus $6500 represents the maximum surtax exemption which applies only if total taxable income is at least $25,000.
For the total tax payable on an individual basis the formula is as follows:

4) \( T = T_a + T_b \)

The total tax burden of consolidating the income can be expressed as follows:

5) \( D = T^1 - T \)

Thus, by substituting into formula 5, the following formula is obtained:

6) \( D_s = 0.48(\xi e_a + \xi e_b) - 6500 - (T_a + T_b) \)

By cancelling and combining the preceding formula, the tax cost of the loss of multiple surtax exemptions for Above companies and Below companies is obtained:

7) \( D_s = 5000(n_a - 1) + 0.20 \xi e_b - 1500 \)

When no Below corporations are included, the formula becomes:

8) \( D_s = 5000(n - 1) - 1500 \)
Corporations with estimated tax liabilities greater than $100,000 must pay accelerated tax payments on April 15, June 15, September 15, and December 15. These corporations normally have to file their tax return on March 15 of the following year. Until 1970, however, companies that have estimated tax liabilities greater than $100,000 (Upper companies) are required to pay only a portion of their total tax liabilities. Thus, for 1967 and 1968 the following percentages of the tax liability will be paid by the Upper corporation the stipulated months ahead of the normal payment date:

<table>
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<th>Year</th>
<th>Percentage</th>
<th>Amount</th>
<th>Year</th>
<th>Percentage</th>
<th>Amount</th>
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<td>1967</td>
<td>14% x 11/12</td>
<td>.128338</td>
<td>1968</td>
<td>19% x 11/12</td>
<td>.174173</td>
</tr>
<tr>
<td></td>
<td>14% x 9/12</td>
<td>.105000</td>
<td></td>
<td>19% x 9/12</td>
<td>.142500</td>
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<td></td>
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<td></td>
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</tr>
<tr>
<td></td>
<td></td>
<td>.420838</td>
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<td></td>
<td>.504173</td>
</tr>
</tbody>
</table>

Similarly, in the third consolidated return year, the entire group is allowed only one $100,000 estimated tax credit. If the consolidated estimated tax liability is
greater than $100,000, the group has to make accelerated tax payments. The question is how much interest is lost due to the accelerated payments of the tax liability that would not have to be paid if separate returns had been filed.

In the proof of the loss of interest, two types of corporations are encountered. Upper companies (u) are those companies that have estimated tax liabilities greater than $100,000; whereas, Lower companies (l) are those companies with estimated tax liabilities less than or equal to $100,000. Symbols used in this proof are defined as follows:

- \( i \) = interest burden.
- \( n \) = number of affiliates.
- \( i_l \) = interest burden of a Lower company.
- \( i_u \) = interest burden of an Upper company.
- \( n_l \) = number of Lower companies.
- \( t_l \) = tax liability of a Lower company.

For illustration purposes, the cost of working capital is assumed to be six percent and 1967 is chosen as the tax year in question.

The basic formula is the simple interest formula:

1) \( I = P \times R \times T \)
Since the Upper companies normally have to pay estimated tax on amounts greater than $100,000, the interest burden of consolidation is the interest on the accelerated payments of the first $100,000. Formula for Upper companies' interest is as follows:

2) \[ i_u = 0.06(100,000N) \times 0.420838 \]

The figure 0.420838 takes into consideration that part of the total principal (tax liability) is not payable ahead of schedule.

The interest burden of consolidation for Lower companies is the summation of the tax liabilities of the individual companies:

3) \[ i_L = 0.06(\sum t_1) \times 0.420838 \]

Formula for consolidation is:

4) \[ I = 0.06(100,000N_U + \sum t_1 - 100,000) \times 0.420838 \]

Formula four (4) is not valid where \( \sum t_1 \) is less than zero. The minus $100,000 represents the maximum estimated tax credit which applies only when total estimated tax liability is at least $100,000.
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VITA

Donald Larry Crumbley, the son of Carl Donald Crumbley and Velvia Luetta Kelly, was born in Kannapolis, North Carolina, on January 18, 1941.

He received his elementary and secondary education in the Cabarrus County public school system in Kannapolis, North Carolina and was graduated as an honor student from A. L. Brown High School in May, 1959. The following September he entered Pfeiffer College, Misenheimer, North Carolina. He served as president of the student body and held an assistantship in Accounting. Graduating cum laude with the class of 1963, he was awarded a Bachelor of Science degree in Accounting.

Before coming to Louisiana, he married the former Donna Darlene Loflin of Winston-Salem. Upon being awarded a graduate assistantship in Accounting at Louisiana State University, he enrolled in the Graduate School of that institution in September, 1963. He received the degree of Master of Science in Accounting in May, 1965.
In June, 1965, he re-enrolled in the Graduate School of Louisiana State University. From January, 1965 to June, 1966, he served as a Graduate Teaching Assistant. He was the recipient of a Ford Foundation Grant and Humble Oil Company Fellowship during the 1966-67 academic year. He passed the written examination for the Certified Public Accountants' certificate for North Carolina in November, 1966, and he is now satisfying the experience requirements for the certificate. He has joined the staff of Pennsylvania State University as an Assistant Professor of Accounting and is currently a candidate for the Degree of Doctor of Philosophy of Accounting.
Candidate: Donald Larry Crumbley

Major Field: Accounting

Title of Thesis: Analysis of the Current Status of the Consolidated Return Election under Federal Income Tax

Approved:

Major Professor and Chairman

Dean of the Graduate School

EXAMINING COMMITTEE:

Clarence L. Dunn

Raymond L. Sera

Donald E. Vaughan

Date of Examination:

July 18, 1967