CONSOLIDATED TAX RETURNS

INTRODUCTION AND STUDY OBJECTIVES

The consolidated tax return determines the tax liability of a parent corporation and its affiliated subsidiaries. The consolidated return assumes that the business of the related corporations represents a single enterprise. The aggregate income of the group rather than the separate taxable income of each corporation is taxed. The regulations that govern the rules for consolidated tax returns, and often modify the aggregate results, require special adjustments for certain exchanges such as intercompany transactions.

In studying the rules of consolidated tax returns, the student should have these objectives:

1. To learn the requirements and operating rules for filing a consolidated tax return as well as which corporations are eligible to participate in the filing.

2. To understand how to compute the consolidated tax liability of an affiliated group along with its corresponding consolidated tax liability.

3. To become familiar with the limitations and special rules imposed upon consolidated entities to ensure the clear reflection of income and prevent tax avoidance.

STUDY HIGHLIGHTS

ELIGIBILITY FOR FILING THE CONSOLIDATED RETURN

1. Section 1501 grants an affiliated group the privilege of filing a consolidated tax return if it so elects. The term affiliated group means one or more chains of includible corporations connected through stock ownership with a common parent corporation.

2. An includible corporation is any corporation other than:
   - a corporation exempt from tax
   - a corporation electing a U.S. Possession tax credit
   - certain life and mutual insurance companies
   - a foreign corporation
   - a regulated investment company
   - a domestic international sales corporation (DISC)
   - an S corporation
3. The stock ownership requirements are satisfied when the following are met:
   a. An includible parent corporation meets the 80 percent ownership test.
   b. An includible corporation is owned directly by other corporations in the group that satisfy the
      80 percent ownership test.

4. The primary difference between an affiliated group and a controlled group is that an affiliated group
   requires direct ownership, while a parent-subsidiary controlled group does not. It allows for indirect
   ownership as well.

5. All includible corporations in an affiliated group must consent to the consolidated return regulations. The
   consent is made on Form 1122. Once elected, all corporations must continue to file on a consolidated
   basis, unless the IRS, for good cause, grants a discontinuance.

6. A consolidated tax return must be filed on the basis of the common parent’s tax year. This very often
   requires a subsidiary to make a change in accounting period and to file a short period tax return.

7. The 30-day rule allows the subsidiary of an affiliated group to do either of the following:
   a. Elect to be included as a member of the group from the beginning of its tax year if it were acquired
      within the first 30 days of its taxable year.
   b. Elect out of the group for the entire consolidated tax year if it has been a member of the group for
      30 days or less.

   Note: The 30-day rules are no longer applicable for years beginning on or after January 1, 1995.

COMPUTATION OF THE CONSOLIDATED TAX LIABILITY: AN OVERVIEW

8. Computing consolidated taxable income requires the following three steps:
   a. Determine the taxable income of each member corporation as if it filed a separate tax return.
   b. Make modifications to the separate taxable incomes determined above for such items as intercompany
      transactions. The result is called separate taxable income.
   c. Combine the separate taxable incomes of each member and add to the result those items that must be
      computed on a consolidated basis (e.g., capital gains).

INTERCOMPANY TRANSACTIONS

9. An intercompany transaction is any transaction between corporations that are members of the same
    consolidated group immediately after the transaction. In July of 1995, the IRS finalized a comprehensive
    set of regulations that substantially modified the long-standing regulations that govern intercompany
    transactions.

10. The new regulations replace the deferred intercompany transaction rules of the old regulations with
    something called a “matching” rule and an “acceleration” rule. Any transactions that occur between
    members of an affiliated group are treated as if they occurred between divisions of the same company.
    This notion is called the “single entity” approach to intercompany transactions.

11. While the new regulations seem to follow a “deferral” approach similar to the old regulations, they are
    couched in transactional terms and treat one corporation as S (the seller) and the other corporation as B
    (the buyer). The regulations introduce new terms such as intercompany items, corresponding items, and
    recomputed corresponding items to calculate the amount of the deferral.
12. Because these new regulations simplify the rules for many types of intercompany transactions, the need for special intercompany inventory rules, and transactions involving stocks or obligations is eliminated for tax years beginning after July 12, 1997.

CONSOLIDATED ITEMS

13. Certain items must be eliminated from separate taxable income and accounted for on a consolidated basis. One such item is the consolidated net operating loss (NOL). This occurs when combining incomes and separate company operating losses exceeds separate company taxable income. Only consolidated NOLs may be carried back or over.

14. In addition to NOLs, the following must be computed on a consolidated basis:
   - capital gains and losses
   - the dividends-received deduction
   - the charitable contribution deduction
   - the tax liability
   - any resulting tax credits

LIMITATIONS AND ADJUSTMENTS DUE TO CONSOLIDATION

15. Net operating losses as well as other tax attributes (i.e., credit carryovers) that existed prior to filing a consolidated tax return can be utilized in a consolidated tax return only to the extent that the member introducing the losses contributes to consolidated taxable income. This limitation is called a separate return limitation year (SRLY). For consolidated returns filed beginning in 1997, SRLY losses are computed on a subgroup basis. In addition, the member or the subgroup, if applicable, must have contributed to consolidated taxable income on a cumulative basis.

16. The SRLY limitation does not apply on the carryover if the loss corporation is the common parent. This is known as the lonely parent rule.

17. A further limitation results in a built-in loss. This is a deduction or loss that economically accrues in a separate return year but is recognized for tax purposes in a consolidated return year. A built-in deduction can only be deducted in consolidated taxable income to the extent of the acquired (former separate company) member’s contribution to consolidated taxable income.

18. Generally, a consolidated group with losses is permitted to acquire a profitable subsidiary to help absorb some of the group’s NOL. To prevent a profitable corporation from acquiring a loss group, the Regulations state that if there is more than a 50 percent change in ownership over a two-year period, a consolidated return change in ownership (CRCO) has occurred. The CRCO rules limit the amount of the loss group’s NOL to the postchange income of those corporations. These rules apply for years before 1991.

19. Section 382 provides carryover limitations on net operating losses. This section provides for disallowance in full if certain percentages of continuity are not maintained. The limitations are applied on a consolidated basis after December 31, 1996.
20. To prevent trafficking in loss corporations (where a smaller loss corporation is merged with a larger
profitable group with the smaller corporation as parent), the Commissioner issued reverse acquisition
rules. These rules treat the acquired member as the common parent of the new group, and the tax
attributes of the old group are deemed to have risen in a SRLY. As a result, these attributes can only be
used against future income of the old group members.

21. An unused carryover or carryback of an NOL that is attributable to a member of the group may be
carried back to a separate return year of that member, provided that member belonged to the group
during the loss year.

22. Any losses attributable to a new member not in existence during a carryback year will be carried back to
the consolidated return of the affiliated group, provided that new member has belonged to the group
since its organization.

INVESTMENTS IN SUBSIDIARIES

23. At the end of each consolidated return year, a parent’s basis in the stock of the subsidiaries must be
adjusted to reflect the economic results of operations. Additions to basis are done through a series of
positive adjustments. Decreases to basis are done through a series of negative adjustments. These
positive and negative adjustments must reflect the results of lower-tiered corporations as well. As a result
of final Regulations in 1994, net positive and net negative adjustments must be made to reflect tax
considerations. (See Exhibit 8-12.)

24. When losses of a subsidiary exceed the parent’s basis, instead of denying a deduction, an extension of
the basis rules is allowed through the excess loss account. This account must be restored on the
disposition of a subsidiary.

25. A deemed dividend technique allows a group to increase the subsidiary’s basis for its accumulated
earnings and profits. A deemed dividend is an effective planning tool and is done in lieu of utilizing the
excess loss account.

26. Earnings and profits (E&P) are never calculated on a consolidated basis. Each member must reflect its
subsidiary’s E&P in its own computation of E&P. Four options are available under § 1552 for allocating
the income tax liability for purposes of computing E&P.

OPERATING RULES

27. The Regulations provide a series of detailed administrative rules and procedures necessary for filing a
consolidated return. These rules include the following:

- All groups must conform to the same accounting period.
- Estimated taxes are to be computed in the aggregate.
- Each member of the group is liable for the entire group’s tax liability.
- The parent corporation has the power to act as agent for the group.
STUDY QUESTIONS

True or False

1. Consolidated tax returns must be filed by all members of an affiliated group once they have made the appropriate election.

2. T, an individual taxpayer, owns 100% of B Corporation and 90% of S Corporation for the entire year of 2009. If B and S timely elect, they may file a consolidated tax return for 2009.

3. Preaffiliation net operating loss carryovers can be utilized in computing consolidated taxable income only to the extent that the new member is not the parent and contributes to the consolidated income.

4. A corporation that is exempt from tax is classified as an includible corporation.

5. A reverse acquisition is a method whereby a consolidated group purchases a loss corporation and subsequently makes the loss corporation the parent of the affiliated group.

6. Built-in deductions are economically accrued to a subsidiary in a separate return year but recognized in a consolidated return year.

7. Eighty percent of the members of an affiliated group must consent to the filing of a consolidated tax return before any member of the group is eligible to file a consolidated return.

8. Depreciation deductions will trigger gain recognition on nondeferred intercompany transactions.

9. Earnings and profits are computed on a consolidated basis.

10. The sale of land from P to its subsidiary, S, qualifies as a deferred intercompany transaction if the two corporations file a consolidated tax return.

11. A parent company’s basis in the stock of a subsidiary that joins in the filing of a consolidated return will be increased by the amount of undistributed earnings that the subsidiary has for the year.

12. The regulations governing the rules for consolidated tax returns are interpretive and can be challenged.

Multiple Choice

1. Which of the following corporations is considered to be an includible corporation in an affiliated group of corporations?

   a. Holding company.
   b. Domestic international sales corporation.
   c. Real estate investment trust.
   d. Regulated investment company.
   e. None of the above.
2. A group of corporations (A, B, C, D, and E), all having only one class of stock, have the following ownership and classification:

Corp. A — Domestic corporation that owns 85 percent of B, 20 percent of C, and 100 percent of E’s outstanding stock.

Corp. B — Domestic corporation that owns 70 percent of C and 100 percent of D’s outstanding stock.

Corp. C — Domestic corporation that owns 10 percent of A’s stock.

Corp. D — B’s DISC (domestic international sales corporation).

Corp. E — Foreign corporation that owns 10 percent of C and 5 percent of B’s stock.

Which are members of an affiliated group?

a. A and B.
b. B, C, and D.
c. A, B, and E.
d. A, B, C, D, and E.
e. A, B, and C.

3. H Corporation and its wholly owned subsidiary, D Corporation, file a consolidated return on a calendar year basis. On March 28, 2009, H sold land, used in its business for 10 years, to D for $60,000. H’s basis in the land on March 28 was $40,000. D held the land until June 2, 2010, whereupon it sold the property for $75,000 to an unrelated third party. What amount of income should H report in the consolidated return filed for 2009?

a. $0.
b. $20,000 § 1250 gain.
c. $20,000 long-term capital gain.
d. $20,000 ordinary income.
e. None of the above.

4. A Corporation and B Corporation file a consolidated return on a calendar year basis. In 2008, A sold land to B for its fair market value of $50,000. At the date of sale, A had an adjusted basis in the land of $35,000 and had held the land for several years as an investment. B held the land primarily for sale to its customers in the ordinary course of its business and sold it to a customer in early 2009 for $60,000. As a result of the sale of the land in 2009, what should the corporations report on their consolidated tax return?

a. $10,000 ordinary gain.
b. $25,000 ordinary gain.
c. $25,000 long-term capital gain.
d. $15,000 long-term capital gain and $10,000 ordinary gain.
e. None of the above.
5. X Corporation owns 75 percent of the stock of Y Corporation. X also owns 75 percent of Z Corporation. Z, in turn, owns the remaining stock of Y, and Y owns the remaining stock of Z. What is this group an example of?

   a. A brother-sister controlled group.
   b. A parent-subsidiary controlled group.
   c. An affiliated group.
   d. All of the above.
   e. Only b and c.

6. A parent corporation’s losses from a preaffiliation year may be used to offset the earnings of other members in filing a consolidated return under which of the following rules?

   a. SRLY.
   b. CRCO.
   c. Lonely parent rule.
   d. Reverse acquisition.
   e. None of the above.

7. Which of the following taxes are not included in the consolidated tax liability but are assessed on a separate company basis?

   a. Section 11, normal taxes.
   b. Section 531, accumulated earnings taxes.
   c. Section 541, personal holding company taxes.
   d. Section 58, minimum taxes.
   e. All of the above are included in the consolidated liability.

8. Which of the following statements is not true with respect to the filing of consolidated tax returns?

   a. All group members conform to the same accounting period.
   b. The estimated tax payments are to be determined in the aggregate.
   c. Each member of the group is liable for the entire tax liability of the group.
   d. The parent corporation has the power to act as the agent for the entire group.
   e. All of the above statements are true.

9. Each of the four following corporations have only one class of stock outstanding that is owned as follows:

   1. P Corporation—owned by twelve unrelated individuals.
   2. R Corporation—owned 80 percent by P; 20 percent by K Corporation.
   3. K Corporation—owned 40 percent by R; 45 percent by P; 15 percent by unrelated individuals.
   4. L Corporation—owned 30 percent by K; 40 percent by P; 30 percent by unrelated individuals.

Which of the following may file a consolidated tax return?

   d. Only P and R Corporations.
10. Which of the following is *not* considered an advantage of filing a consolidated tax return?
   a. Losses of an affiliate may be offset against profits of other members of the group.
   b. The election is binding and can be discontinued only with the Commissioner’s permission.
   c. Intercompany dividends between group members are eliminated from income.
   d. The basis in the stock of a subsidiary is increased by earnings and profits accumulated during consolidated return years.
   e. All of the above are advantages of filing a consolidated tax return.

11. C Corporation directly owns 25 percent of A Corporation stock and 80 percent of B Corporation stock. B Corporation directly owns 70 percent of A Corporation and 10 percent of C Corporation. Which are the subsidiary corporations and which is the parent in this triad?
   a. C is the parent, A and B are subsidiaries.
   b. C is the parent of B, B is the parent of A, and A is the subsidiary of both B and C.
   c. C is the parent, B is the subsidiary.
   d. C is the parent, A is the subsidiary.

12. The fundamental difference between an affiliated group and a parent-subsidiary controlled group is
   a. an affiliated group requires direct ownership of at least 80 percent of the other corporation’s stock.
   b. a parent-subsidiary controlled group requires direct ownership of at least 80 percent of the other corporation’s stock.
   c. an affiliated group may indirectly own 50 percent of the other corporation.
   d. a parent-subsidiary controlled group directly owns 100 percent of the other corporation.
   e. None of the above.

13. If any member of an affiliated group does not join in the filing of a consolidated return,
   a. the tax liability of each member is determined as if separate returns were filed.
   b. the group is automatically terminated by the IRS.
   c. the tax liability of each member is determined by spreading out liability among the remaining groups.
   d. the common parent is held responsible even if it was an inadvertent error.
   e. None of the above.

14. Which of the following is (are) considered to be part of the intercompany transaction rules?
   a. The built-in deduction rule.
   b. The built-in loss rule.
   c. The acceleration rule.
   d. The excess loss account rule.
   e. All of the above.
Fill In the Blanks

1. One or more chains of includible corporations eligible to file a consolidated tax return is known as an _______ _______.

2. A consent to file a consolidated tax return is made on a Form ______ attached to the first-year tax return.

3. A transaction between affiliated corporations that requires capitalization by the acquiring member is known as a _______ _______ _______.

4. Deferred intercompany transactions are deferred until such time that a _______ _______ occurs.

5. A net operating loss in a pre-affiliation year can lead to a(n) _______ or _______ _______ limitation.

6. SRLY stands for _______ _______ _______ _______ and takes place when net operating losses are brought into or taken out of a(n) _______ group.

7. SRLY limitations do not necessarily apply to common parent corporations of an affiliation group. This is known as the _______ _______ _______.
SOLUTIONS TO STUDY QUESTIONS

True or False

1. True.

2. False. B and S Corporations are brother-sister corporations and they are ineligible to file a consolidated tax return.

3. True.

4. False. It is specifically excluded.

5. True.

6. True.

7. False. Unanimous consent is required.


9. False. They are computed on a separate company basis with adjustments for lower-tiered corporations.

10. True.

11. True.

12. False. The Regulations are legislative.

Multiple Choice

1. a.

2. e.

3. a.

4. d.

5. b.

6. c.

7. e.

8. e.

9. b.
10. b.

11. c.

12. a. Direct versus indirect ownership.

13. a.

14. c. New rule became part of the Regulations in 1996.

**Fill In the Blanks**

1. Affiliated group.

2. 1122.

3. Deferred intercompany transaction.

4. Restoration event.

5. SRLY; § 382.

6. Separate return limitation year; affiliated.

7. Lonely parent rule.