Chapter C:8

Consolidated Tax Returns

Discussion Questions

C:8-1 The IRC requires that a parent corporation own stock in at least one includible corporation having at least 80% of the includible corporation's total voting power and at least 80% of the total value of the includible corporation's outstanding stock. The IRC also requires that, for each affiliated group member other than the parent corporation, the parent corporation and other group members must own stock having at least 80% of the member corporation's total voting power and at least 80% of the total value of the member corporation's outstanding stock. Certain nonvoting preferred stock is ignored for these stock ownership requirements. pp. C:8-2 and C:8-3.

C:8-2 a. Includible.

b. Generally not includible. However, Sec. 1504(d) allows inclusion of certain 100%-owned Canadian and Mexican corporations that are maintained to comply with local law regarding title and operation of property.

c. Generally not includible. However, Sec. 1504(c)(1) permits two or more Sec. 801 domestic life insurance companies to file a consolidated return, and Sec. 1504(c)(2) permits a parent corporation to elect to have all domestic life insurance companies for which the 80% stock ownership tests have been met for at least five years to be included in its consolidated tax return.

d. The limited liability company (LLC) may or may not be includible. Under the check-the-box regulations, an unincorporated business entity may choose whether to be taxed as a corporation or not. If the LLC chooses to be taxed as a corporation, it is treated as an includible corporation, provided it otherwise qualifies (e.g., it is a domestic LLC). If the LLC has not elected to be treated as a corporation, it is not an includible corporation and generally cannot be included in a consolidated tax return. However, if such an LLC is wholly owned by one of the affiliated group members, the tax law will treat the LLC as a disregarded entity, and the group member will treat the LLC's profits and losses as its own profits and losses. If the LLC has not elected to be treated as a corporation and it has two or more owners, it is treated as a partnership. The LLC's profits and losses pass through to its owners under the partnership tax rules and will be included in an affiliated group's consolidated tax return if the group elects to file a consolidated tax return and one or more affiliated group members are owners of the LLC. Unlike a single-member LLC, a multi-member LLC is not a disregarded entity, so the consolidated tax return rules (e.g., intercompany transaction rules) do not apply to it. pp. C:8-3 and C:8-4, and Chapter C:2.

C:8-3 a. P, S, and T comprise an affiliated group. P and S are part of the group because P owns at least 80% of S's stock. T is included because it is at least 80%-owned by P and S (49% + 51% = 100%). R is not part of the affiliated group because it is not at least 80%-owned by the corporations in the group; Pamela owns its stock.

b. Even though only P, S, and T comprise an affiliated group, all four corporations comprise a controlled group. P, S, and T comprise a parent-subsidiary controlled group for reasons similar to the reasons they comprise an affiliated group. P and R comprise a brother-sister controlled group because both are wholly owned by the same individual. Because P is the parent corporation of a parent-subsidiary controlled group and also is a member of a brother-sister controlled group, P, R, S, and T comprise a combined controlled group.

c. An affiliated group would not exist. S would not be included in an affiliated group because, as a foreign corporation, it is not an includible corporation. Although T is an includible corporation, it is not an affiliated group member because it is not at least 80%-owned by corporations in an affiliated group. R is not an affiliated group member because, as in Part a, it is not at least 80%-owned by corporations in an affiliated group. pp. C:8-3 and C:8-4.

C:8-4 P and S comprise both an affiliated group of corporations and a controlled group of corporations. As an affiliated group, P and S can elect to file a consolidated tax return, but they are not required to do so.

If P and S do not elect to file a consolidated tax return, each will file a separate tax return. Section 1561 allows a controlled group to benefit only once from the 15%, 25%, and 34% tax brackets. P and S allocate each bracket equally between them unless they adopt a special apportionment plan. Section 1561 and other IRC provisions also allow a controlled group to benefit only once from certain other tax provisions, such as the $40,000 alternative minimum tax exemption amount and the maximum amount of depreciable property that can be immediately expensed under Sec. 179.

If P and S elect to file a consolidated tax return, the P-S group will compute its consolidated tax liability under the consolidated tax return rules, which generally treat the group as if it were one corporation. The group will not have to allocate the 15%, 25%, and 34% tax brackets, as well as the other tax provisions that a controlled group's members must allocate among themselves, because they are filing a single tax return. However, if P and another corporation, X, comprise a brother-sister controlled group, these items must be allocated between the P-S consolidated group and X. pp. C:8-2 through C:8-4.

C:8-5 Some of the differences between an affiliated group and a controlled group are as follows:

1. Brother-sister controlled groups exist, but brother-sister affiliated groups do not exist. For example, if an individual owns all the stock of A and B Corporations, A and B comprise a brother-sister controlled group but do not comprise an affiliated group.

2. For both an affiliated group and a parent-subsidiary controlled group, the parent corporation must own at least 80% of the stock of at least one other corporation in the group, and the parent corporation and other group members must own at least 80% of the stock of each corporation in the group other than the parent. For an affiliated group, this 80% stock ownership must be met with respect to the member corporation's total voting power <u>and</u> the total value of its stock. For a parent-subsidiary controlled group, this 80% stock ownership must be met with respect to the member corporation's total voting power <u>or</u> the total value of its stock. Thus, the group must meet both 80% stock ownership tests to be an affiliated group, but meeting either of the two tests will cause the two corporations to be a parent-subsidiary controlled group.

3. For the 80% stock ownership tests, the corporations must apply stock attribution rules to determine whether a controlled group exists, but they do not apply attribution rules to determine whether an affiliated group exists.

4. The types of corporations having special status that are not includible corporations for affiliated groups differ from those that are not includible corporations for controlled groups.

5. The existence of a controlled group generally is determined only at December 31. The existence of an affiliated group is determined on each day of the year. See Chapter C:3 for further discussion of controlled group topics. pp. C:8-2 through C:8-4.

C:8-6 Only an affiliated group of corporations can file a consolidated tax return. To comprise an affiliated group, the corporations all must be includible corporations and must satisfy two 80% stock ownership requirements. Only P and S1 comprise an affiliated group. S3 is not included in the group because it is not at least 80%-owned by affiliated group members. S2 is not included in the group because, as a foreign corporation, it is not an includible corporation.

Financial accounting rules require a consolidated set of financial statements for a parent corporation and those subsidiaries it controls. Control generally is deemed to exist when the parent directly or indirectly owns more than 50% of the subsidiary's stock. The consolidated subsidiary can be domestic or foreign. Thus, P, S1, S2, and S3 generally must be included in a set of consolidated financial statements. Consolidation is required and thus is not elective under financial accounting rules, unlike the rules for federal income tax purposes. pp. C:8-2 through C:8-4.

C:8-7 Section 1502 specifically authorizes the Treasury Department to write consolidated return regulations so that a consolidated group's tax liability "may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability." Thus, Congress is delegating its rule-making authority to the Treasury Department, making the consolidated return regulations legislative regulations. In contrast, interpretive regulations merely make the IRC's statutory language easier to understand and apply, so they have less weight than do legislative regulations. Congress chose to delegate this rule-making authority to the Treasury Department because the consolidated return area is complex. Congress gave the consolidated return regulations further authority by allowing an affiliated group to file a consolidated tax return on the condition that the group consents to the consolidated return regulations in effect before the due date (without extensions) for its first consolidated tax return. pp. C:8-4 and C:8-5.

C:8-8 a. The affiliated group does not cease to exist because P continues to be affiliated with at least one other corporation, S.

b. T may or may not be required to file a consolidated tax return with Z. If Z is a member of an affiliated group that has been filing consolidated tax returns, T must join in its filing. If Z is not an affiliated group member (or is a member of an affiliated group that has not elected to file a consolidated tax return), T is not required to file a consolidated tax return with Z. However, Z and T could elect to do so.

c. Generally, no. A corporation generally has to wait 60 months before it can rejoin the same consolidated group. After the 60-month period expires, T must again file a consolidated tax return with P and S, assuming that the affiliated group continues to exist and the IRS has not granted it permission to discontinue filing on a consolidated basis. The 60-month rule does not prevent T from filing a consolidated tax return with Z while they are affiliated. The IRS may grant permission to rejoin the same consolidated group before the 60-month period expires.

d. In Part a, the affiliated group would cease to exist assuming P does not become affiliated with another corporation before the end of the current year. The answer for Part b would not change. The answer for Part c would not change except P and T would not be required to file a consolidated tax return after the 60-month period expires. Because the previous P-T affiliated group ceases to exist, a new affiliated group arises when P purchases all of T's stock from Z. This new P-T affiliated group may elect to file a consolidated tax return after the 60-month period expires, but it is not required to do so. pp. C:8-5 and C:8-6.

C:8-9 If an affiliated group elects to file tax returns on a consolidated basis, it generally must continue to do so for as long as the group's common parent remains as the common parent and is affiliated with at least one subsidiary at the beginning of the year with which it was affiliated at the end of the prior year. Thus, P, S, and T could file separate tax returns if P no longer owns at least 80% (by vote and by value) of S's and T's stock. This situation would occur if P were to sell more than 20% of S's and T's stock or if S and T were to issue stock to another person such that P's ownership decreases to less than 80%. If this situation were to occur during the current year, the group still would have to file a consolidated tax return for the current year and include in it P's taxable income or loss for the entire year and S's and T's taxable income or loss for the part of the year they were group members. S and T would file separate tax returns for the post-affiliation part of the year, and all three corporations would file separate tax returns in the next year (assuming none of the corporations becomes affiliated with another consolidated group). Alternatively, the IRS could, for "good cause," permit the P-S-T group to discontinue filing a consolidated tax return. pp. C:8-5 through C:8-8.

C:8-10 a. An intercompany transaction is a transaction occurring during a consolidated return year between corporations that are members of the same consolidated group immediately after the transaction.

b. Intercompany items are the seller's (or service provider's) income, gain, deduction, and loss items arising from an intercompany transaction.

c. Corresponding items are the buyer's (or service user's) income, gain, deduction, and loss items arising from an intercompany transaction or from property acquired in an intercompany transaction.

d. Recomputed corresponding items are the buyer's (or service user's) income, gain, deduction, and loss items that would arise from an intercompany transaction or from property acquired in an intercompany transaction if the buyer and seller were two divisions of a single corporation and the transaction were between those divisions. In other words, if the buyer and seller were two divisions of a single corporation, how much income, gain, deduction, and loss would that single corporation have?

e. Under the matching rule, the seller's intercompany item is not necessarily included in consolidated taxable income at the time of the intercompany transaction. Instead, the timing of its inclusion depends on the timing of the buyer's corresponding item. The intercompany item the group includes in its consolidated taxable income in a particular tax year equals the recomputed corresponding item for that year minus the corresponding item for that year. This computation matches the seller's intercompany item with the buyer's corresponding items so that it produces the same outcome that would occur if the seller and buyer were two divisions of a single corporation.

f. The consolidated group's circumstances may change in a way that the seller's intercompany item cannot be fully matched with the buyer's corresponding items. For example, the buyer may depart the consolidated group before its corresponding items arise. Under the acceleration rule, the seller's intercompany items that have not yet been included in consolidated taxable income are so included immediately before the time it first becomes impossible to match the seller's intercompany item with the buyer's corresponding items. pp. C:8-8 through C:8-12.

C:8-11 Intercompany transactions are transactions between corporations that are in the same consolidated group immediately after the transaction. Thus, transactions Parts a and b are intercompany transactions. In Part c, the services S2 performs for S1 from January 1 through June 15 are not intercompany transactions because S2 is not yet a member of S1's consolidated group, but the services performed from June 16 through December 31 are intercompany transactions. In Part d, P's sale of inventory to the S1-S2 Partnership is not an intercompany transaction because, as an unincorporated entity, the partnership is not a member of P's consolidated group. If the S1-S2 Partnership had elected to be treated as a corporation under the "check-the-box" regulations, P's sale of inventory to the partnership would be an intercompany transaction. pp. C:8-2 through C:8-4 and C:8-8 through C:8-10.

C:8-12

Part	**Intercompany Item**	**Corresponding Item**
a.	Interest income accrued by P.	Interest expense accrued by S1.
b.	S1's profit on inventory sold to P.	None yet because P has not sold the inventory to a person outside the consolidated group. When this outside sale occurs, P's profit or loss on the sale will be a corresponding item.
c.	P's gain or loss on the land sold to S2.	None yet because S2 has not sold the land to a person outside the consolidated group. When this outside sale occurs, S2's gain or loss on the sale will be a corresponding item.
d.	Engineering services revenue accrued by S1.	S2's depreciation deductions on the building and S2's gain or loss when it sells the building to a person outside the consolidated group.

pp. C:8-10, C:8-11, and C:8-16 through C:8-18.

C:8-13 The selling group member (S) calculates its gain on the intercompany transaction in the same manner as if the transaction involved unrelated parties. The group defers the gain's inclusion in consolidated taxable income because no corresponding item or recomputed corresponding item occurs at the time of the intercompany transaction. The purchasing group member's (B's) depreciation deductions on the property will be corresponding items and will trigger inclusion of portions of S's gain in consolidated taxable income.

B's basis for the property equals its purchase cost. B continues to depreciate the portion of the basis equal to S's adjusted basis (known as the carryover basis) using the MACRS elections and recovery period used by S. B depreciates the stepped-up portion of its basis in the property (B's purchase cost minus S's adjusted basis) as a new property using a seven-year

MACRS recovery period. The totals of these two depreciation numbers (B's total depreciation deductions) are its corresponding items. The recomputed corresponding items are the depreciation deductions that would have resulted if S and B were a single corporation (i.e., what S's depreciation deductions would have been had it not sold the property to B). As a result of these corresponding and recomputed corresponding items, S's intercompany item (i.e., deferred gain) is included in consolidated taxable income over several years subsequent to the intercompany transaction. pp. C:8-10, C:8-11, and C:8-14 through C:8-16.

C:8-14 The lending group member's (S's) interest income is matched with the borrowing group member's (B's) interest expense for consolidated tax return purposes under the matching rule. The intercompany items are S's interest income accruals. The corresponding items are B's interest expense accruals. The recomputed corresponding items are zero because there would be no interest income or expense if S and B were a single entity; the intercompany loan would be merely an internal loan. S's interest income accrues at the same time as B's interest expense accrues because they both use the accrual method of accounting, so the group will immediately include S's interest income in consolidated taxable income under the matching rule. S's interest income and B's interest expense generally will offset one another in arriving at consolidated taxable income. The group will not defer the interest income's inclusion because no lapse in time occurs between S's accrual of its interest income and B's accrual of its interest expense.

For consolidated financial statement purposes, S's interest income and B's interest expense are usually eliminated. This elimination generally has the same zero net effect on consolidated net income as it has on consolidated taxable income. Eliminating the interest income and interest expense, rather than allowing them to merely offset one another, is important because it may affect ratios that a financial statement user computes. pp. C:8-10, C:8-11, C:8-16, and C:8-17..

C:8-15 The problem does not provide enough information to tell whether the corporations would obtain a greater charitable contribution deduction for the current year by filing a consolidated tax return or separate tax returns. Recall that the corporate charitable contributions deduction is limited to 10% of taxable income computed without regard to the charitable contribution deduction, NOL carrybacks, capital loss carrybacks, the dividends-received deduction, and the U.S. production activities deduction.

Brooklyn and Bronx might obtain the same charitable contribution deduction whether they file a consolidated tax return or separate tax returns. This result might occur if each corporation's charitable contributions are less than its separate 10% limitation and their total charitable contributions are less than the consolidated 10% limitation.

A second possibility is that Brooklyn and Bronx would obtain a larger charitable contribution deduction by filing a consolidated tax return than by filing separate tax returns. This result might occur if Brooklyn makes charitable contributions greater than its separate 10% limitation and Bronx makes no contributions. By filing a consolidated tax return, the group may increase its deductions because Bronx's 10% limitation in excess of its zero contributions may allow the group to deduct more of Brooklyn's contributions than Brooklyn could deduct separately. In short, Bronx's excess limitation can offset Brooklyn's excess contributions.

A third possibility is that Brooklyn and Bronx would obtain a smaller charitable contribution deduction by filing a consolidated tax return than by filing separate tax returns. This might occur if Brooklyn makes charitable contributions greater than its separate 10%

limitation and Bronx makes no contributions and has a net operating loss for the current year. By filing a consolidated tax return, the amount of deductions may decrease because Bronx's net operating loss makes the consolidated 10% limitation less than Brooklyn's separate 10% limitation, so the group could deduct fewer charitable contributions on a consolidated basis than it could on a separate basis. pp. C:8-20 and C:8-21.

C:8-16 Many reasons may explain why the group's consolidated capital gain net income or net capital loss is not merely the sum of the members' separate capital gain net incomes and net capital losses if they were to file separate tax returns. Three important reasons are the following:

1. Net Sec. 1231 gains are treated as long-term capital gains (if they are not treated as ordinary income due to nonrecaptured net Sec. 1231 losses), but net Sec. 1231 losses are treated as ordinary losses. For example, suppose that one group member has a $10,000 net Sec. 1231 gain and another group member has an $8,000 net Sec. 1231 loss. If the group's members file separate tax returns, the $10,000 gain is treated as a long-term capital gain, and the $8,000 loss is treated as an ordinary loss. If the group files a consolidated tax return, it nets the $10,000 gain and $8,000 loss and reports a $2,000 consolidated net Sec. 1231 gain, which is treated as a long-term capital gain.

2. Corporations can use capital losses to offset capital gains but cannot use them to offset ordinary income. For example, suppose that one group member has a $7,000 capital gain net income and another group member has a $6,000 net capital loss. If the group files a consolidated tax return, the $6,000 loss offsets part of the $7,000 gain. If the group's members file separate tax returns, the $6,000 loss cannot offset any of the $7,000 gain but must be used to offset that member's capital gain net incomes in the three preceding and five succeeding tax years.

3. The consolidated group applies the matching and accelerated rules to report Sec. 1231 gains and losses and capital gains and losses arising from intercompany transactions. As a result, the consolidated group may report such gains and losses at a different time than the constituent corporations would report them if they were to file separate returns. pp. C:8-21 and C:8-22.

C:8-17 a. The group member includes the dividend in its gross income but may claim a 70% dividends-received deduction for it, assuming the 10%-owned corporation is not a member of the affiliated group (i.e., other group members do not own 70% or more of its stock).

b. Because the 100%-owned corporation is a consolidated group member, the distributee group member excludes the intercompany dividend from its gross income and cannot claim a dividends-received deduction for it. The distributee group member also makes a corresponding negative adjustment to its basis in the distributing corporation's stock.

c. The group member includes the dividend in its gross income but may not claim a dividends-received deduction for it. The distributing corporation is not a member of the affiliated group because, as a foreign corporation, it is not an includible corporation. The group may not claim a dividends-received deduction because the distributing corporation is not a domestic corporation and has no U.S.-source income (see Chapter C:3). However, a deemed paid foreign tax credit is available to the consolidated group under Sec. 902 if the foreign corporation paid income taxes to a foreign government (see Chapter C:16).

d. If the life insurance company is not included in the group's consolidated tax return, the distributee group member must include the dividend in its gross income but may claim a 100% dividends-received deduction for it. If the life insurance company is included in the group's consolidated tax return, the distributee group member excludes the intercompany dividend from its gross income, cannot claim a dividends-received deduction for it, and makes a corresponding negative adjustment to its basis in the distributing corporation's stock.

e. Because the dividend-paying corporation is a consolidated group member, the distributee group members exclude the intercompany dividend from their gross incomes, claim no dividends-received deductions for it, and make a corresponding negative adjustment to their bases in the distributing corporation's stock. pp. C:8-2, C:8-3, C:8-22, C:8-23, and C:8-34 through C:8-36.

C:8-18 Assuming an extended carryback period does not apply, the P-S-T group carries back two years and forward 20 years the current year consolidated NOL. Assuming the three corporations file consolidated tax returns during the two-year carryback and 20-year carryover periods, the group uses the NOL first to offset its consolidated taxable income in the second-preceding year. The group then uses any remaining NOL to offset, in chronological order, its consolidated taxable income in the preceding year, in the year succeeding the current year, in the second succeeding year, etc. Alternatively, the group's parent could elect to forego the NOL carryback period. If it so elects, the group uses the NOL to offset, in chronological order, its consolidated taxable income in the year succeeding the current year, then the second succeeding year, etc. This treatment of a consolidated NOL treatment is similar to the treatment of an unaffiliated corporation's NOL (see Chapter C:3).

If S did not file a consolidated tax return with the other group members for the year to which the NOL carries back or carries over, the group must apportion a fraction of the unused consolidated NOL to S so that S can use it on S's separate tax return for that year. The fraction equals S's separate NOL for the year the consolidated NOL arose divided by the sum of S's and T's separate NOLs for the year the consolidated NOL arose. The offspring rule provides an exception to this treatment. If the consolidated NOL carries back to a year in which S did not exist and S has been a member of the affiliated group continually since it was organized, P can use on its separate tax return the fraction of the consolidated NOL apportioned to S.

In a similar fashion, the group must apportion a fraction of its unused NOL to T if T did not file a consolidated tax return with the other group members for the year to which the NOL carries back or carries over. The offspring rule may apply to T's fraction of the consolidated NOL. pp. C:8-27 through C:8-30.

C:8-19 Like this decision for an unaffiliated corporation, one important factor is the marginal tax rate in the carryback period versus the carryover period. The tax savings obtained from the NOL deduction will be higher when the marginal tax rate is higher. A second factor is the time value of money. The group obtains immediate tax savings by carrying back the NOL but delayed tax savings by carrying it forward. A third factor is the benefit the group obtains from a tax credit carryover that is subject to a limitation based on its tax liability. If the group carries back the NOL, its reduced tax liability for the preceding year(s) may prevent the tax credit carryover from being fully used before it expires. By forgoing the carryback, the group may be able to use both the credit carryover and the NOL.

Another factor pertains to an NOL arising in a consolidated return year and carried back to a separate return year. If the group member to which a fraction of the consolidated NOL is apportioned filed a consolidated tax return with another affiliated group in the carryback year, the tax refund from the NOL will be paid to the parent of that other affiliated group. By foregoing the carryback period, the member's current consolidated group will benefit from the NOL's tax savings. (The member's current and former consolidated groups may have an agreement regarding the tax benefits of the member's NOLs.) A similar issue arises when a fraction of the consolidated NOL apportioned to a member carries forward to a separate return year of that member. pp. C:8-27 through C:8-30.

C:8-20 A SRLY is a separate return limitation year. It is any separate return year except for (1) a separate return year of the consolidated group's parent corporation or (2) a separate return year of any corporation that was a member of the affiliated group for every day of the loss year.

The SRLY rules limit the amount of an NOL incurred in a SRLY that may be used in a consolidated return year to the lesser of (1) the aggregate of the consolidated taxable income amounts for all consolidated return years of the group determined by taking into account only the loss member's items of income, gain, deduction, and loss; (2) consolidated taxable income; or (3) the remaining NOL carryover. The rules restrict the use of a SRLY NOL to a group member's cumulative contribution to consolidated taxable income for all consolidated return years. Special rules apply to SRLY losses incurred by a subgroup, to SRLY losses incurred by a corporation in a transaction that is also subject to the Sec. 382 loss limitation, and to reverse acquisitions. pp. C:8-30 through C:8-34.

C:8-21 The overlap rule waives the application of the SRLY rules in many circumstances where the Sec. 382 limitation also applies. The SRLY limitation applies to NOLs that carry from a separate return limitation year to a consolidated return year. The Sec. 382 limitation applies when a Sec. 382 stock ownership change occurs, which generally is the case when the percentage of stock of the new loss corporation owned by one or more 5% shareholders has increased by more than 50 percentage points over the lowest percentage of stock in the old loss corporation owned by such shareholders at any time during the preceding three-year (or shorter) testing period (See Chapter C:7). Many corporate acquisitions would be subject to both the SRLY and Sec. 382 limitations if the overlap rule did not exist. For example, if S Corporation has unused NOLs and P Corporation purchases 100% of S's stock, the SRLY limitation would apply because S's NOLs arose in a separate return limitation year, and the Sec. 382 limitation would apply because P's ownership of S increases by more than 50 percentage points. The overlap rule reduces the P-S consolidated group's tax compliance burden by eliminating the SRLY limitation and applying only the Sec. 382 limitation. pp. C:8-33 and C:8-34.

C:8-22 a. S's taxable income is taxed on the consolidated tax return. If S did not pay any dividends to P, the earnings S retains likely would increase the value of S's stock. Thus, if P did not increase the basis in its S stock by S's taxable income, P would realize a larger gain (or smaller loss) if it were to sell S's stock. However, this increased gain (or reduced loss) is attributable to earnings that previously were taxed to the consolidated group. To prevent such double taxation, the tax law allows P to increase the basis of its S stock by S's taxable income. Similarly, when S pays a dividend to P, the value of the S stock that P owns likely will decrease. If P did not decrease its basis by the dividend received from S, it would realize a smaller gain (or larger loss) if it were to sell S's stock. However, this reduced gain (or increased loss) is attributable to the intercompany dividend, which P excludes from its gross income. To prevent a second tax benefit from the intercompany dividend, the tax law requires P to reduce the basis of its S stock by the dividend received from S. P also must increase the basis for its S stock by S's tax-exempt income and decrease it for S's nondeductible, noncapital expenditures.

b. As in Part a, P must increase the basis in its S stock by S's taxable income and tax-exempt income and decrease the basis by S's nondeductible, noncapital expenditures and the dividends S pays to P. Similarly, S must increase the basis for its T stock by T's taxable income and tax-exempt income and decrease it by T's nondeductible, noncapital expenditures and the dividends T pays to S. The adjustments that S makes to the basis for its T stock tier up so that P also adjusts the basis in its S stock for these amounts, in addition to the adjustments P makes because of S's income and expense items. pp. C:8-34 through C:8-36.

C:8-23 One likely advantage of filing a consolidated tax return is that the P-S1-S2 group can use S2's current year losses to offset P's and S1's current year profits. The group's ability to use S2's losses from its first two years of operations to offset its current year profits may be limited. If S2's loss carryovers are separate return limitation year (SRLY) losses, the group's use of them is subject to the SRLY limitation, but an exception to the SRLY rules applies if S2 was a member of the affiliated group on each day of the loss year. The Sec. 382 loss limitation also may apply to S2's losses if P acquired S2 after S2 incurred its losses. Neither the SRLY nor the Sec. 382 limitations apply if P has owned at least 80% of S2 since S2's inception. Another likely advantage of filing a consolidated tax return is that the group can defer taxation of S2's profits on its intercompany sale of cosmetics to S1 until S1 sells them to retailers.

The group's consolidation of S2's losses with P's and S1's profits may affect some of its deduction and credit limitations. The effect could be to increase or decrease the limitations, so this factor cannot be classified as an advantage or disadvantage without knowing more about the group's circumstances. The deferral of S1's intercompany profits may also affect the group's deduction and credit limitations. pp. C:8-36 and C:8-37.

C:8-24 Assuming your client and its largest supplier would comprise a new affiliated group after the acquisition, the two companies could continue to file separate tax returns or elect to file a consolidated tax return. If the acquisition occurs before the end of the supplier's tax year, the supplier must file a separate tax return (or join in the consolidated tax return of its former consolidated group) for the portion of its tax year before the acquisition.

The primary advantage of filing a consolidated tax return in this situation is likely to be the ability to defer taxation of the supplier's profits on its sales to the manufacturing company. Another possible advantage is a reduced alternative minimum tax (AMT) liability. If one company owes AMT on a separate return basis and the other one does not, they may have a reduced AMT on a consolidated basis.

The ability to offset one company's losses against the other company's profits in a consolidated tax return does not appear to be an advantage of filing a consolidated tax return because both companies are currently profitable. This ability to offset, however, may become an advantage if one company becomes unprofitable while the other remains profitable, but filing separate returns initially does not preclude later making an election to file on a consolidated basis. Moreover, if the losses occur after the companies become affiliated, the group will not be subject to the SRLY or Sec. 382 limitations. Dividends received by the parent corporation from its subsidiary are effectively tax-exempt whether they file a consolidated tax return or not. The parent excludes the intercompany dividend if it files a consolidated tax return. If the corporations file separate returns, the parent's 100% dividends-received deduction fully offsets its intercompany dividend income.

A final factor is the companies' ability to use tax deductions and credits because of limitations on them (for example, the general business credit). The limitations may be increased or decreased on a consolidated basis, so this feature may be advantageous or disadvantageous.

To give the president a more-informed answer, you need additional information. What is your client's legal form of organization? Is it a corporation or an unincorporated entity? If it is an unincorporated entity, has it elected to be treated as a corporation under the check-the-box regulations? What is the supplier company's legal form of organization, and how is it treated for federal income tax purposes? Will your client be acquiring at least 80% of the supplier's stock by vote and by value? What amount of intercompany profits are the two companies likely to have? What are the companies' AMT statuses, and what would it be if they file on a consolidated basis? pp. C:8-36 and C:8-37.

C:8-25 The affiliated group can elect to file on a consolidated basis at any time until the consolidated tax return's due date (including any extensions). The group makes the election by filing a consolidated federal income tax return for all members of the affiliated group.

The parent's sale of its sole subsidiary's stock could terminate an affiliated group, and this termination could occur on any day of the tax year. An affiliated group also can request IRS permission to discontinue filing a consolidated tax return, and this change in status could be effective for any date of the tax year. The IRS may or may not approve the group's "good cause" request. Most good cause requests are the result of changes in the Internal Revenue Code or the consolidated return Treasury Regulations. pp. C:8-4 through C:8-6 and C:8-37.

C:8-26 Each subsidiary corporation files the initial consent for the consolidated return election on Form 1122 (Part a). Assuming the group's members elect to file a consolidated tax return, the parent corporation acts as the group's agent for the other three actions (Parts b, c, and d).
p. C:8-38.

Issue Identification Questions

C:8-27
- What types of corporate groups can file a consolidated tax return?
  - What are the stock ownership and includible corporation requirements for an affiliated group?
  - Do Red and Green, as brother-sister corporations, satisfy these requirements?
- If Red and Green currently do not comprise an affiliated group, what changes to the corporate structure could be made so they do comprise an affiliated group?
- What tax advantages would Red and Green likely obtain if they were to become an affiliated group and elect to file a consolidated tax return?
  - Would taxation of Red's profits on its intercompany inventory sales to Green be deferred?
  - Could Green's $30,000 current year losses offset Red's current year profits? Are there any restrictions or limitations on deducting Green's current year losses?
  - Could Green's pre-affiliation losses offset post-affiliation consolidated taxable income? Could they offset Red's pre-affiliation separate taxable income? Are there any restrictions or limitations on deducting the pre-affiliation losses?

- What might be the disadvantages if Red and Green were to become an affiliated group and elect to file a consolidated tax return?
  - Would it be more favorable or less favorable to apply limitations for deductions and credits on a consolidated basis or a separate return basis?
  - How much additional recordkeeping is involved in filing a consolidated return instead of two separate tax returns?

Red and Green currently have a brother-sister relationship, so they do not comprise an affiliated group and cannot file a consolidated tax return. If Red owned at least 80% of Green's stock by vote and by value (or vice versa), they would have a parent-subsidiary relationship, would comprise an affiliated group, and could elect to file a consolidated tax return. Mark could accomplish this restructuring by making a capital contribution of at least 80% of Green's stock to Red (or at least 80% of Red's stock to Green).

By filing a consolidated tax return, Red and Green could defer the taxation of Red's profits on its intercompany inventory sales to Green. These intercompany sales have increased during the last five years. Depending on the inventory method employed (e.g., LIFO or FIFO), the tax deferral could either be short-term or long-term. The companies could compare the results under each alternative.

Without obtaining additional information, it cannot be determined whether applying limitations on deductions and credits on a consolidated basis or separate return basis would be more favorable or less favorable. Red and Green would have additional recordkeeping if they elect to file a consolidated tax return, but this disadvantage might be outweighed by the advantages of consolidated filing.

If they were to file a consolidated tax return, Green's post-change NOLs could offset Red's profits. If Red and Green become an affiliated group because Mark contributes Green's stock to Red, Green's pre-change NOLs generally would be SRLY losses and could be used by the Red-Green consolidated group only to the extent that Green subsequently earns a net profit. Red and Green might try to increase Green's post-affiliation profits, thereby increasing the SRLY limitation, by reducing the price that Red charges Green on its intercompany inventory sales, but this strategy may indicate a tax avoidance motive and might cause the IRS to apply the Sec. 482 transfer pricing rules to the intragroup transfers. If Mark were to contribute Red's stock to Green, Green's pre-change NOLs generally would not be SRLY losses because Green would be the parent corporation, but the SRLY limitation would apply to the NOLs if Green's acquisition of Red were a reverse acquisition. pp. C:8-36 and C:8-37.

C:8-28
- Is Charter Corporation included in the existing Alpha-Baker affiliated group and consolidated tax return filing?
- What tax year(s) can Charter elect?
- What overall accounting method(s) can Charter elect?
- What inventory method can Charter elect?
- Can Charter elect to amortize its organizational expenditures and/or its start-up expenditures?

Charter will be a new member of the existing affiliated group because at least 80% of its stock will be owned by Baker, so Charter must file a consolidated tax return with Alpha and Baker. Charter must use the same tax year as Alpha and Baker. Charter need not use the same accounting method as Alpha and Baker, so it generally can elect to use the cash, accrual, or hybrid methods of accounting. However, it is producing parts for the automobile industry, so inventories likely will be a material income-producing factor. If so, it must use the accrual method of accounting for its sales-related activities. Charter may be able to use the hybrid accounting method and, if so, Charter would not have to use the accrual method of accounting for its other income and expense items. The consolidated group can make a Sec. 248 election to deduct and amortize Charter's organizational expenditures. If it makes this election, the group can deduct $5,000 of the organizational expenditures in the current year and amortize the remaining $7,000 ($12,000 - $5,000) over the 180-month period beginning in the month Charter begins business. Similarly, the consolidated group can make a Sec. 195 election to deduct and amortize its start-up costs. If it makes this election, the group must amortize over 180 months all $60,000 of the start-up costs because they exceed $55,000. The group can make the Sec. 248 and Sec. 195 elections without regard to whether it made these elections for Alpha and Baker. Under Temp. Reg. Sec. 1.195-1T and 1.248-1T, Charter is deemed to make these elections unless it elects to forego the deduction and amortization of the costs. pp. C:8-2, C:8-3, C:8-6, and C:8-38 and Chapter C:3.

C:8-29 Hawkeye's $260,000 of losses are SRLY losses because Hawkeye was not affiliated with the Wildcat-Baker group in the years the losses arose. Consequently, the group's use of the NOLs is subject to the SRLY limitation. The group's use of the $260,000 is limited to the lesser of (1) Wildcat's contribution to consolidated taxable income (CTI) since joining the group, (2) CTI, or (3) the unused NOL. If the group's profits expectations are accurate, the group's annual use of the NOLs will be limited to the lesser of (1) $50,000, (2) $300,000, or (3) the unused NOL. Thus, the group will be able to use $50,000 (Wildcat's expected annual profit) of the NOLs in each of the next five years and the remaining $10,000 ($260,000 - (5 × $50,000)) in the sixth year.

The corporations could manipulate the transfer prices charged for goods and services between Hawkeye and the other two corporations so as to increase Hawkeye's profits, enabling the group to use the NOLs more quickly. However, Sec. 482 allows the IRS to reallocate income, deductions, and other tax return items for non-arm's length transfer pricing arrangements. pp. C:8-30 through C:8-34.

Problems

C:8-30 a. B, C, and D comprise an affiliated group because B owns at least 80% of at least one includible corporation's stock (i.e., C and D) and at least 80% of C's and D's stock is owned by other corporations in the group.

b. B, C, D, and E comprise an affiliated group. B owns at least 80% of another includible corporation's stock, and at least 80% of each corporation's stock (except for B, the parent) is owned by other group members. F is not a group member because group members do not own at least 80% of F's stock (and F is not the parent corporation).

c. An affiliated group does not exist because a parent corporation does not own at least 80% of another corporation's stock. Although Luciano owns all of M's and N's stock, Luciano is not a corporation. However, M and N comprise a brother-sister controlled group.

d. W and Y comprise an affiliated group, and X and Z comprise another affiliated group. The four corporations do not comprise an affiliated group because an individual, rather than a corporation, owns all of W's and X's stock. However, the four corporations comprise a combined controlled group. pp. C:8-2 through C:8-4.

C:8-31 a. P and S comprise an affiliated group because P owns at least 80% of S's stock. T and U are not members of the group because, as foreign corporations, they are not includible corporations.

b. P and S comprise an affiliated group because P owns at least 80% of S's stock. T is not a member of the group because, as a foreign corporation, it is not an includible corporation. U is not a member of the group, even though it is an includible corporation, because P and S do not own at least 80% of U's stock. P, S, and U comprise a parent-subsidiary controlled group; P is treated as owing all of U's stock because of the Sec. 1563(e) attribution rules.

c. An affiliated group does not exist because P does not own at least 80% of S's stock. P and S comprise a brother-sister controlled group because of the Sec. 1563(e) attribution rules.

d. P and S comprise an affiliated group because P owns at least 80% of S's stock. G is not a member of the group because it is a foreign corporation. P and S are includible corporations even though P's sole shareholder, G, is not an includible corporation.

e. At a minimum, P and S comprise an affiliated group; T might or might not also be a member of the group. As an unincorporated entity, T can choose whether to be taxed as a corporation under the check-the-box regulations. If T so chooses, P, S, and T will comprise an affiliated group. If T does not choose to be treated as a corporation, it will be treated as a partnership and will not be a member of the affiliated group. pp. C:8-2 through C:8-4.

C:8-32 a. Pierre and Salem will not be eligible to file a consolidated tax return because they will not comprise an affiliated group. To comprise an affiliated group, Pierre would have to own at least 80% of Salem's total voting power and at least 80% of the total value of Salem's outstanding stock. Salem's total voting power is 250,000 [(4 × 60,000) + (1 × 10,000)] votes, so Pierre would have to acquire Salem stock having at least 200,000 (250,000 × 80%) votes. Pierre would possess 240,000 (60,000 × 4) votes after the acquisition, so this stock ownership requirement would be met. The value of Salem's outstanding stock is $3.15 million [(60,000 × $40) + (10,000 × $75)], so Pierre would have to acquire Salem stock that is worth at least $2.52 million ($3,150,000 × 80%). If Pierre were to acquire all of Salem's common stock and none of Salem's preferred stock, Pierre would own Salem stock worth $2.4 million (60,000 × $40) after the acquisition, so this stock ownership requirement would not be met.

b. Many combinations of Salem common stock and/or preferred stock Pierre could acquire would qualify the two corporations to file a consolidated tax return. As noted above, Pierre would have to acquire Salem stock with at least 200,000 votes and worth at least $2.52 million. If Pierre acquired all of Salem's common stock, it also would have to acquire Salem preferred stock worth at least $120,000 [$2,520,000 - $2,400,000], which would be at least 1,600 ($120,000 ÷ $75) shares.

Alternatively, if Pierre acquired all of Salem's preferred stock, the stock would possess 10,000 (1 × 10,000) votes and be worth $750,000 (10,000 × $75). Pierre would have to acquire Salem common stock possessing at least 190,000 (200,000 - 10,000) votes and worth at least $1.77 million ($2,520,000 - $750,000). Pierre would satisfy the 80%-by-vote stock ownership requirement by acquiring at least 47,500 (190,000 ÷ 4) Salem common shares, and it would satisfy the 80%-by-value stock ownership requirement by acquiring at least 44,250 ($1,770,000 ÷ $40) Salem common shares. Because Pierre's ownership of Salem stock must satisfy both requirements, Pierre would have to acquire at least 47,500 common shares for it to file a consolidated tax return with Salem.

Many other combinations of Salem common and preferred stock that Pierre could acquire would allow the two corporations to file a consolidated tax return. One way to determine these combinations is to graphically depict them using the number of common shares as the horizontal axis and the number of preferred shares as the vertical axis. All points lying on or to the northeast of the line connecting the solution's data points are feasible combinations.

c. Pierre does not have to acquire any of the nonvoting preferred stock because the stock is ignored for both 80% stock ownership requirements. The stock is ignored because it is nonvoting, limited and preferred as to dividends, does not participate in corporate growth to any significant extent, has redemption and liquidation rights limited to its issue price (plus a reasonable redemption or liquidation premium), and is not convertible into another class of stock. pp. C:8-2 through C:8-4.

C:8-33 a. The affiliated group does not terminate; it merely includes T as another member.

b. The affiliated group does not terminate. Even though the corporation with which P is affiliated at the beginning of the year is not affiliated with P at the end of the year, an affiliated group continues to exist if the common parent remains as the common parent and is affiliated with at least one subsidiary at the beginning of the year with which it was affiliated at the end of the prior year. In this case, P is affiliated with S at the end of the prior year and the beginning of the current year, and P is affiliated with T at the end of the current year and the beginning of the next year.

c. The affiliated group does not terminate even though P was not affiliated with any corporation from April 2 through September 1. P is affiliated with S at the end of the prior year and the beginning of the current year, and P is affiliated with T at the end of the current year and the beginning of the next year.

d. The affiliated group terminates because P is not affiliated with any subsidiary at the end of the current year. A new affiliated group, comprised of P and T, begins its existence on January 2 of the next year.

e. The affiliated group terminates because P is no longer its common parent. A new affiliated group, comprised of R, P, and S, begins its existence on June 2 of the current year.

f. The P-S affiliated group terminates because P is no longer its common parent. P and S join R's affiliated group, which continues its existence. pp. C:8-5 and C:8-6.

C:8-34 a. The consolidated tax return includes P's and S's taxable income or loss for January 1 through December 31 and T's taxable income or loss for February 2 through December 31. T must file a separate tax return for the short period January 1 through February 1.

b. The consolidated tax return includes P's taxable income or loss for January 1 through December 31, S's taxable income or loss for January 1 through October 1, and T's taxable income or loss for March 2 through December 31. S must file a separate tax return for October 2 through December 31, and T must file a separate tax return for January 1 through March 1.

c. The consolidated tax return includes P's taxable income or loss for January 1 through December 31, S's taxable income or loss for January 1 through April 1, and T's taxable income or loss for September 2 through December 31. S must file a separate tax return for April 2 through December 31, and T must file a separate tax return for January 1 through September 1.

d. The current year consolidated tax return includes P's taxable income or loss for January 1 through December 31 and S's taxable income or loss for January 1 through May 1. S must file a separate tax return for May 2 through December 31. T is unaffiliated with P in the current year, so it must file a separate tax return for January 1 through December 31. In the next year, P and T may elect to file a consolidated tax return but are not required to do so.

e. The P-S consolidated tax return includes P's and S's taxable income or loss for January 1 through June 1. If the newly created R-P-S affiliated group elects to file a consolidated tax return in the current year, it will include R's taxable income or loss for January 1 through December 31 and P's and S's taxable income or loss for June 2 through December 31. If the R-P-S group does not elect to file a consolidated tax return, R must file a separate tax return including its income or loss for January 1 through December 31, and P and S must each file a separate tax return including its taxable income or loss for June 2 through December 31.

f. The P-S consolidated tax return includes P's and S's taxable income or loss for January 1 through July 1. Another consolidated tax return includes P's and S's taxable income or loss for July 2 through December 31 and R's and its other wholly owned subsidiaries' taxable income or loss for January 1 through December 31. pp. C:8-6 through C:8-8.

C:8-35 The sale could have several effects on the group's current year consolidated taxable income:

1. S1's taxable income or loss for January 1 through September 15 must be included in current year consolidated taxable income. S1's taxable income or loss for September 16 through December 31 must be included in its separate tax return.
2. Any deferred income, gain, deduction, or loss from intercompany transactions involving S1 may need to be included in current year consolidated taxable income under the acceleration rule.
3. The group must determine the amount attributable to S1 of any consolidated net operating loss carryovers, consolidated capital loss carryovers, and consolidated charitable contribution carryovers remaining after calculating current year consolidated taxable income.
4. P's gain or loss on the sale of S1's stock must be taken into account for current year consolidated taxable income. P's basis in its S1 stock must be adjusted for the preceding three items. pp. C:8-6 through C:8-8, C:8-10 through C:8-12, C:8-20 through C:8-22, C:8-28 through C:8-30, and C:8-34 through C:8-36.

C:8-36 a. S must change its tax year to the calendar year because the consolidated group files its tax return using P's tax year.

b. P and S are not required to change their accounting methods when they begin filing consolidated tax returns. P and S can continue to use the accrual method and cash method, respectively as their overall accounting methods. However, P and S also comprise a parent-subsidiary controlled group. C corporations generally cannot use the cash method if they do not meet a $5 million gross receipts test, and a controlled group of corporations is treated as a single entity for this purpose.

c. The 2012 consolidated tax return includes P's taxable income or loss for January 1, 2012 through December 31, 2012 and S's taxable income or loss for August 1, 2012 through December 31, 2012. S must file a separate tax return for July 1, 2011 through June 30, 2012 and another separate return for July 1, 2012 through July 31, 2012. pp. C:8-6 through C:8-8.

C:8-37 a. The intercompany item is S1's $155,000 ($275,000 - $120,000) Sec. 1231 gain on the sale of the land to S2 in Year 1. The corresponding item is S2's $125,000 ($400,000 - $275,000) Sec. 1231 gain on the sale of the land to a third party in Year 3. The recomputed corresponding item is the $280,000 ($400,000 - $120,000) Sec. 1231 gain that would be realized on the Year 3 land sale if S1 and S2 were two divisions of one corporation.

b. The group includes S1's gain in consolidated taxable income according to the matching rule, under which S1's intercompany item is matched with S2's corresponding item so as to reflect the group's recomputed corresponding item in consolidated taxable income:

	Year 1	**Year 3**
Recomputed corresponding item	$-0-	$280,000
Minus: S2's corresponding item	-0-	125,000
S1's intercompany item taken into account	$-0-	$155,000

S1's $155,000 gain is not included in consolidated taxable income until Year 3, when S2 reports its $125,000 corresponding item. Because the recomputed corresponding item is $280,000, all $155,000 of S1's intercompany item is included in Year 3 consolidated taxable income. S2's gain arises from a sale to a third party and not from an intercompany transaction, so it is included in Year 3 consolidated taxable income. The group can report these transactions using the following worksheet format:

	Consolidated Taxable Income	**Adjustments & Eliminations**	**S1's Separate Reporting**	**S2's Separate Reporting**
S1's sale to S2 in Year 1	$ -0-	$(155,000)	$155,000	
S2's sale to third party in Year 3	280,000	155,000		$125,000
Total	$280,000	$ -0-	$155,000	$125,000

pp. C:8-10 through C:8-13.

C:8-38 a. The intercompany item is P's $36,000 (2,400 × ($45 - $30)) capital gain on the sale of the stock to S1 in Year 1. The corresponding items are S1's $4,200 (1,400 × ($48 - $45)) capital gain on the sale of the 1,400 shares in Year 1 and S1's $7,000 (1,000 × ($52 - $45)) capital gain on the sale of the 1,000 shares in Year 2. The recomputed corresponding items are the $25,200 (1,400 × ($48 - $30)) capital gain on the sale of the 1,400 shares in Year 1 and the $22,000 (1,000 × ($52 - $30)) capital gain on the sale of the 1,000 shares in Year 2 that would be realized if P and S1 were two divisions of one corporation.

b. The group includes P's gain in consolidated taxable income according to the matching rule, under which P's intercompany item is matched with S1's corresponding item so as to reflect the group's recomputed corresponding item in consolidated taxable income:

	Year 1	Year 2
Recomputed corresponding item	$25,200	$22,000
Minus: S1's corresponding item	(4,200)	(7,000)
P's intercompany item taken into account	$21,000	$15,000

The group includes $21,000 of P's $36,000 gain in Year 1 consolidated taxable income and includes the remaining $15,000 in Year 2, as S1 reports its corresponding items of $4,200 in Year 1 and $7,000 in Year 2. S1's gains arise from sales to third parties and not from intercompany transactions, so their inclusion in consolidated taxable income is not subject to the matching rule. The group can report the transactions using the following worksheet format:

	Consolidated Taxable Income	Adjustments & Eliminations	P's Separate Reporting	S1's Separate Reporting
P's sale to S1 and S1's sale to third party in Year 1	$25,200	$(15,000)[a]	$36,000	$ 4,200
S1's sale to third party in Year 2	22,000	15,000[a]		7,000
Total	$47,200	$ -0-	$36,000	$11,200

[a]P's $36,000 intercompany item minus $21,000 of it taken into account in Year 1.

c. When P sells S1's stock, the consolidated group has included in its taxable income under the matching rule only $21,000 of P's $36,000 gain and has not included the other $15,000. When S1 sells the 1,000 shares to a third party in Year 2, the P-S2 consolidated group will be unable to match S1's $7,000 gain with P's $15,000 gain because S1 will not be a member of the group. Under the acceleration rule, the P-S1-S2 consolidated group must include this $15,000 gain in Year 1 consolidated taxable income, immediately before S1 departs the group.

d. S1's Year 2 corresponding item is now a $1,000 capital loss (1,000 × ($44 - $45)), and the Year 2 recomputed corresponding item is now a $14,000 capital gain (1,000 × ($44 - $30)). P's intercompany item is the same $36,000 capital gain as in Parts a and b, and S1's Year 1 corresponding item is the same $4,200 capital gain as in Parts a and b. Under the matching rule, the group includes P's gain in consolidated taxable income in the following manner:

	Year 1	Year 2
Recomputed corresponding item	$25,200	$14,000
Minus: S1's corresponding item	(4,200)	1,000*
P's intercompany item taken into account	$21,000	$15,000

*Because S1's Year 2 corresponding item is a $1,000 capital loss, a negative $1,000 is subtracted, which is equivalent to adding $1,000.

As in Part b, the group includes $21,000 of P's $36,000 gain in Year 1 consolidated taxable income, and it includes the other $15,000 in Year 2 consolidated taxable income. The group can report these transactions using the following worksheet format:

	Consolidated Taxable Income	**Adjustments & Eliminations**	**P's Separate Reporting**	**S1's Separate Reporting**
P's sale to S1 and S1's sale to third party in Year 1	$25,200	$(15,000)*	$36,000	$ 4,200
S1's sale to third party in Year 2	14,000	15,000*		(1,000)
Total	$39,200	$ -0-	$36,000	$ 3,200

*P's $36,000 intercompany item minus $21,000 of it taken into account in Year 1.

pp. C:8-10 through C:8-13.

C:8-39 a. The intercompany item is P's $40,000 ($60,000 - $20,000) gain on the sale of the land to S in Year 3. When S sells the land to Z, it realizes a $120,000 ($180,000 - $60,000) gain. Assuming the installment method applies (see Chapter I:11), S's gross profit percentage is 66.67% ($120,000 ÷ $180,000). S receives $36,000 in each of Years 7 through 11, so S reports $24,000 ($36,000 × 66.67%) of gain in each of those years. Each of these $24,000 amounts is a corresponding item. If P and S were two divisions of one corporation, the gain realized on the land sale to Z would be $160,000 ($180,000 - $20,000). Assuming the installment method applies, the gross profit percentage would be 88.89% ($160,000 ÷ $180,000), and $32,000 ($36,000 × 88.89%) of gain would be reported in each of Years 7 through 11. Each of these $32,000 amounts is a recomputed corresponding item.

b. P's $40,000 gain is not included in consolidated taxable income until S reports a corresponding item related to it. In each of Years 7 through 11 S reports a $24,000 corresponding item. The recomputed corresponding item is $32,000 in each of those years, so the group includes $8,000 ($32,000 - $24,000) of P's gain in consolidated taxable income in each of Years 7 through 11.

c. S reports the interest income earned on the installment sale to Z in its separate taxable income. The timing of the interest recognition depends on the accounting method that S uses (e.g., cash or accrual). The interest income is not an intercompany item because it pertains to a transaction with a non-group member, so it is included in consolidated taxable income when S reports it. pp. C:8-10 through C:8-14.

C:8-40 a. S1's intercompany item is its $65,000 ($100,000 – $35,000) gain on the sale of land to P in Year 1. When P sells the land to the third party in Year 3, it realizes a $15,000 ($115,000

- $100,000) gain. Assuming the installment method applies (see Chapter I:11), P's gross profit percentage is 13.0435% ($15,000 ÷ $115,000), and P reports the gain as follows:

Year 3:	$50,000 × 13.0435%	=	$ 6,522
Year 4:	$40,000 × 13.0435%	=	5,217
Year 5:	$25,000 × 13.0435%	=	3,261
			$15,000

Each of these amounts is a corresponding item, and the group includes them in consolidated taxable income as P reports them.

If P and S1 were two divisions of a single corporation, the gain realized on the Year 3 land sale to the third party would be $80,000 ($115,000 - $35,000). Assuming the installment method applies, the gross profit percentage would be 69.5652% ($80,000 ÷ $115,000), so the single corporation would report the gain as follows:

Year 3:	$50,000 × 69.5652%	=	$34,783
Year 4:	$40,000 × 69.5652%	=	27,826
Year 5:	$25,000 × 69.5652%	=	17,391
			$80,000

Each of these amounts is a recomputed corresponding item.

To determine the portion of S1's $65,000 gain included in consolidated taxable income each year, the consolidated group applies the matching rule, thereby subtracting the corresponding item from the recomputed corresponding item each year as follows:

Year 3:	$34,783 - $6,522	=	$28,261
Year 4:	$27,826 - $5,217	=	22,609
Year 5:	$17,391 - $3,261	=	14,130
			$65,000

The total amount of S1's gain and P's gain the group includes in consolidated taxable income is as follows:

Year 3:	$28,261 + $6,522	=	$34,783
Year 4:	$22,609 + $5,217	=	27,826
Year 5:	$14,130 + $3,261	=	17,391
			$80,000

b. When P sells S1's stock, the group has included in its consolidated taxable income only $50,870 ($28,261 + $22,609) of S1's gain from the intercompany transaction. P's sale of the S1 stock triggers the acceleration rule because it can no longer match P's corresponding items with S1's remaining intercompany item, so the group includes in its Year 4 consolidated taxable income the remaining $14,130 ($65,000 - $50,870) of S1's intercompany item.

c. S1's intercompany item is its $85,000 ($120,000 - $35,000) gain on the land's sale to P in Year 1. P's corresponding item is the $5,000 ($115,000 - $120,000) loss it realizes when it sells the land to the third party in Year 3. P reports the entire loss in Year 3 because the installment method does not apply to losses. The recomputed corresponding items are the same as in Part a: $34,783 in Year 3, $27,826 in Year 4, and $17,391 in Year 5. The group applies the matching rule and includes S1's gain in its consolidated taxable income as follows:

Year 3: $34,783 - (-$5,000)*	=	$39,783
Year 4: $27,826 - $0*	=	27,826
Year 5: $17,391 - $0*	=	17,391
		$85,000

*The corresponding items subtracted are P's $5,000 loss in Year 3 and $0 gain or loss in Years 4 and 5.

The total amount of S1's and P's gains the group includes in consolidated taxable income is as follows:

Year 3: $39,783 - $5,000	=	$34,783
Year 4: $27,826 + $0	=	27,826
Year 5: $17,391 + $0	=	17,391
		$80,000

pp. C:8-10 through C:8-14.

C:8-41 a. P Corporation claims depreciation in Years 1 through 3 as follows:

Year	Calculation	Depreciation Amount
Year 1	$20,000 x 0.20	$ 4,000
Year 2	$20,000 x 0.32	6,400
Year 3	$20,000 x 0.192 x 3/12*	960
Total		$11,360

*MACRS rules for sales of depreciable property within a consolidated group allocate depreciation for the month of purchase to the purchaser.

P's basis in the machine when P sells it to S is $8,640 ($20,000 - $11,360). P's gain is $9,360 ($18,000 - $11,360). The entire gain is Sec. 1245 ordinary income.

b. S's basis in the machine is $18,000, its cost. S must use two depreciation methods for its newly acquired asset. S continues to use the MACRS depreciation method used by P to depreciate the $8,640 "carryover basis" and claims nine months of depreciation in Year 3, a full year of depreciation in Year 4, and a half-year of depreciation in Year 5. S treats the $9,360 ($18,000 - $8,640) "new basis" as a new asset and depreciates it as such. S's depreciation deductions for Years 3 through 5 are:

Year	Depreciation Calculation	S's Depreciation on Carryover Basis	S's Depreciation on New Basis	S's Total Depreciation
Year 3	0.192 x $20,000 x 9/12	$2,880		$ 4,752
	0.20 x $9,360		$1,872	
Year 4	0.1152 x $20,000	2,304		5,299
	0.32 x $9,360		2,995	
Year 5				
	0.1152 x $20,000 x 1/2	1,152		2,051
	0.1920 x $9,360 x 1/2		899	
		$6,336	$5,766	$12,102

c. S's adjusted basis in the machine when S sells it to the third party in Year 5 is $5,898 ($18,000 - $12,102), so S reports a $9,102 ($15,000 - $5,898) gain on the sale. The entire gain is Sec. 1245 ordinary income.

d. The intercompany item is P's $9,360 gain when it sells the machine to S. The corresponding items are S's total depreciation deductions for the machine ($4,752 in Year 3, $5,299 in Year 4, and $2,051 in Year 5) and S's $9,102 gain when it sells the machine to the third party in Year 5. The recomputed corresponding items are the income, gains, deductions, or losses that would occur if P and S were two divisions of a single corporation:

Year 3: $2,880 depreciation deduction ($20,000 × 0.192 × 9/12)
Year 4: $2,304 depreciation deduction ($20,000 × 0.1152)
Year 5: $1,152 depreciation deduction ($20,000 × 0.1152 × 1/2)
$12,696 gain ($15,000 - $2,304 adjusted basis)
(Adjusted basis = $20,000 - $11,360 - $6,336)

e. The group includes in its consolidated taxable income P's $9,360 gain as S's corresponding items occur. Subtracting S's corresponding items from the group's recomputed corresponding items, the group includes P's gain in consolidated taxable income as follows (depreciation deductions are expressed as negative numbers, and gains are expressed as positive numbers):

Year 3: $(2,880) - $(4,752)	=	$1,872
Year 4: $(2,304) - $(5,299)	=	2,995
Year 5: [$(1,152) + $12,696] - [$(2,051) + $9,102]	=	4,493
		$9,360

In effect, the group includes P's gain in consolidated taxable income as S reports depreciation deductions on the machine, and the group includes in consolidated taxable income at the time of the sale to the third part any gain that has not yet been included. pp. C:8-10 through C:8-12 and C:8-14 through C:8-16.

C:8-42 a. P Corporation claims depreciation in Years 1 through 4 as follows:

Year	Calculation	Depreciation Amount
Year 1	$50,000 x 0.1429	$ 7,145
Year 2	$50,000 x 0.2449	12,245
Year 3	$50,000 x 0.1749	8,745
Year 4	$50,000 x 0.1249 x 5/12*	2,602
Total		$30,737

*The MACRS rules for sales of depreciable property within a consolidated group allocate depreciation for the month of sale to the purchaser.

P's basis for the machine when P sells it to S is $19,263 ($50,000 - $30,737). P's gain is $18,237 ($37,500 - $19,263). The entire gain is Sec. 1245 ordinary income.

S computes its depreciation deductions for the machine as follows:

Year	Depreciation Calculation[a]	S's Depreciation On Carryover Basis	S's Depreciation on New Basis	S's Total Depreciation
Year 4	$50,000 x 0.1249 x 7/12 $18,237 x 0.1429	$ 3,643	$ 2,606	$ 6,249
Year 5	$50,000 x 0.0893 $18,237 x 0.2449	4,465	4,466	8,931
Year 6	$50,000 x 0.0892 $18,237 x 0.1749	4,460	3,190	7,650
Year 7	$50,000 x 0.0893 x 1/2 $18,237 x 0.1249 x 1/2	2,233	1,139	3,372
		$14,801	$11,401	$26,202

[a]S's initial basis in the machine is $37,500, its cost. S continues to use the MACRS depreciation method used by P to depreciate the machine's $19,263 "carryover basis" and claims nine months of depreciation in Year 4, a full year of depreciation in Years 5 and 6, and a half-year of depreciation in Year 7. S treats the $18,237 ($37,500 - $19,263) "new basis" as a new asset and claims depreciation deductions for Years 4 through 7 according to the general MACRS rules.

S's adjusted basis in the machine when S sells it to the third party in Year 7 is $11,298 ($37,500 - $26,202), so S has an $8,702 gain on the sale ($20,000 - $11,298).

b. P's intercompany item is the $18,237 gain on its Year 4 sale of the machine to S. S's corresponding items are its depreciation deductions for Years 4 through 7 and its gain on the machine's sale to the third party in Year 7. The recomputed corresponding items are the depreciation deductions that would have been allowed for the machine and the gain that would have been realized on its sale if P and S were two divisions of a single corporation, computed as follows:

Year 4: $3,643 depreciation deduction ($50,000 × 0.1249 × 7/12)
Year 5: $4,465 depreciation deduction ($50,000 × 0.0893)
Year 6: $4,460 depreciation deduction ($50,000 × 0.0892)
Year 7: $2,233 depreciation deduction ($50,000 × 0.0893 × 1/2)
$15,538 gain ($20,000 - $4,462 adjusted basis)
(Adjusted basis = $50,000 - $30,737 - $14,801).

S's corresponding items cause P's $18,237 gain to be included in consolidated taxable income under the matching rule as follows (depreciation deductions are expressed as negative numbers, and gains are expressed as positive numbers):

Year 4: $(3,643) - $(6,249)	=	$ 2,606
Year 5: $(4,465) - $(8,931)	=	4,466
Year 6: $(4,460) - $(7,650)	=	3,190
Year 7: [$(2,233) + $15,538] - [$(3,372) + $8,702]	=	7,975
		$18,237

In effect, the group includes in its consolidated taxable income P's gain as S reports depreciation deductions on the machine, and any gain that has not yet been included in consolidated taxable income when the machine is sold will be included at that time. S's sale to the third party is not an intercompany transaction, so the group includes the $8,702 gain in its Year 7 consolidated taxable income.

c. The answer to Part a would not change. P's gain is $18,237, and S's gain is $8,702. The answer to Part b would change because R's sale of P's stock triggers the acceleration rule. After the sale, P's remaining intercompany item cannot be matched with S's subsequent corresponding items because P will have departed the group. At the time of the sale, the group already has included in its consolidated taxable income $7,072 ($2,606 + $4,466) of P's gain, so it will have to include the remaining $11,165 ($18,237 - $7,072) of P's gain in Year 5 consolidated taxable income, immediately before P departs the group. pp. C:8-10 through C:8-12 and C:8-14 through C:8-16.

C:8-43 Assuming P and S have elected to file a consolidated tax return, both transactions are intercompany transactions. Under the matching rule, the group will report the transactions as follows:

P's $12,000 ($30,000 – $18,000) gain is an intercompany item. The group will not fully include the gain in consolidated taxable income in the year of sale. Instead, it will gradually include the gain in its consolidated taxable income as S depreciates the automobile; S's depreciation deductions are the corresponding items. S will continue to use P's depreciation method for the $18,000 of its basis that carries over from P, and S will depreciate the remaining

$12,000 ($30,000 – $18,000) of the automobile's basis as newly acquired MACRS property. The net effect on the group's consolidated taxable income over the automobile's remaining life is an $18,000 decrease (S's $30,000 of depreciation deductions minus P's $12,000 gain on the intercompany sale).

The group will match S's cleaning service revenues (the intercompany item) with P's cleaning service expense (the corresponding item) in the year S provides the services to P. The recomputed corresponding item is zero. The two $6,000 amounts offset, so the net effect on consolidated taxable income is zero. pp. C:8-10 through C:8-18.

C:8-44 P's intercompany items are its interest income of $12,500 ($250,000 x 0.12 x 5/12) in Year 1 and $17,500 ($250,000 × 0.12 × 7/12) in Year 2. S's corresponding items are its interest expense of $12,500 in Year 1 and $17,500 in Year 2. The recomputed corresponding items are zero in Years 1 and 2 because no income or deduction would result from the intercompany loan if P and S were two divisions of a single corporation. Under the matching rule, the group matches P's $12,500 ($0 recomputed corresponding item minus -$12,500 corresponding item) of interest income with S's $12,500 of interest expense in Year 1, and it matches P's $17,500 ($0 recomputed corresponding item minus -$17,500 corresponding item) of interest income with S's $17,500 of interest expense in Year 2. The interest income and interest expense offset one another in determining consolidated taxable income. pp. C:8-10 through C:8-12 and C:8-16 through C:8-18.

C:8-45 The transaction is an intercompany transaction because P and S are members of the same consolidated group immediately after the transaction. S's intercompany item is the $120,000 ($10,000 × 12) of rental income it earned from renting the warehouse to P. P's corresponding item is the $120,000 of rental expense it incurred from renting the warehouse from S. The recomputed corresponding item is zero. Under the matching rule, the group matches S's $120,000 of rental income with P's $120,000 of rental expense. The rental income and rental expense offset one another in determining consolidated taxable income. pp. C:8-10 through C:8-12 and C:8-16 through C:8-18.

C:8-46 The intercompany items are P's $75,000 and $240,000 profits on its inventory sales to S in Years 1 and 2. The corresponding items are S's profits on reselling the inventory items it purchased from P. These profits are $25,000 in Year 1 and $127,000 ($22,000 + $105,000) in Year 2. The recomputed corresponding items are the group's total profits when S sells the inventory items to third parties. These total profits are $65,000 ($40,000 + $25,000) in Year 1 and $322,000 ($35,000 + $22,000 + $160,000 + $105,000) in Year 2. Under the matching rule, the P-S group includes $40,000 ($65,000 - $25,000) of P's intercompany inventory profits in its Year 1 consolidated taxable income, and it includes $195,000 ($322,000 - $127,000) of P's intercompany inventory profits in its Year 2 consolidated taxable income. The following table summarizes these results:

	Year 1	Year 2
Recomputed corresponding item	$65,000	$322,000
Minus: S's corresponding item	(25,000)	(127,000)
P's intercompany item taken into account	$40,000	$195,000

The group can report these transactions using the following worksheet format:

	Consolidated Taxable Income	Adjustments & Eliminations	P's Separate Reporting	S's Separate Reporting
P's sales to S and S's sales to third parties in Year 1	$ 65,000	$(35,000)[a]	$ 75,000	$ 25,000
P's sales to S and S's sales to third parties in Year 2	322,000	35,000[b] (80,000)[b]	240,000	127,000
Total	$387,000	$(80,000)	$315,000	$152,000

[a]P's $75,000 intercompany item minus $40,000 taken into account in Year 1.
[b]Net $(45,000): P's $240,000 intercompany item minus $195,000 taken into account in Year 2.

An alternative way of obtaining this answer is to recognize that the group will defer inclusion of P's intercompany inventory profits in consolidated taxable income from the year of the intercompany sale to the year S sells the inventory to third parties. Thus, the group will defer $35,000 from Year 1 to Year 2 and will defer $80,000 from Year 2 to Year 3, as shown in the following table:

	Year 1	Year 2
Consolidated taxable income before adjusting for profits on intercompany inventory sales	$100,000	$367,000
Adjustments for P's deferred profits on sales to S:		
Inventory sold to S in Year 1	(35,000)	35,000
Inventory sold to S in Year 2		(80,000)
Consolidated taxable income	$ 65,000	$322,000

Assuming S sells to third parties in Year 3 the items in its inventory at the end of Year 2, the P-S group makes a positive $80,000 adjustment when determining its Year 3 consolidated taxable income.

pp. C:8-10 through C:8-12, C:8-18, and C:8-19.

C:8-47

The intercompany items are S's \$400,000 (50,000 x \$8) and \$720,000 (80,000 x \$9) profits on its inventory sales to P in Years 1 and 2. The corresponding items are P's profits on reselling the inventory items it purchased from S. These profits are \$225,000 (37,500 x \$6) in Year 1, \$465,000 [(12,500 + 65,000) x \$6)] in Year 2, and \$105,000 (15,000 x \$7) in Year 3, assuming P realizes a \$7 per widget profit on its Year 3 sales. The recomputed corresponding items are the group's total profits when P sells the inventory items to third parties. These total profits are calculated as follows:

Year 1:	37,500 x (\$8 + \$6) =	\$ 525,000
Year 2:	12,500 x (\$8 + \$6) =	\$ 175,000
	65,000 x (\$9 + \$6) =	975,000
	Total for Year 2	\$1,150,000
Year 3:	15,000 x (\$9 + \$7) =	\$ 240,000

Under the matching rule, the P-S group includes \$300,000 of S's intercompany inventory profits in its Year 1 consolidated taxable income, it includes \$685,000 of S's intercompany inventory profits in its Year 2 consolidated taxable income, and it includes \$135,000 of S's intercompany profit in its Year 3 consolidated taxable income. The following table calculates these results:

	Year 1	**Year 2**	**Year 3**
Recomputed corresponding item	\$525,000	\$1,150,000	\$240,000
Minus: P's corresponding item	(225,000)	(465,000)	(105,000)
S's intercompany item taken into account[a]	\$300,000	\$ 685,000	\$135,000

[a]These amounts also can be calculated as follows: Year 1, 37,500 x \$8 = \$300,000; Year 2, (12,500 x \$8) + (65,000 x \$9) = \$685,000; Year 3, 15,000 x \$9 = \$135,000.

The group can report these transactions using the following worksheet format for each year:

Year 1	Consolidated Taxable Income	Adjustments & Eliminations	P's Separate Reporting	S's Separate Reporting
Profit (loss) from other bus. activities in Year 1	$460,000		$(40,000)	$500,000
S's sales to P and P's sales to third parties in Year 1	525,000	$(100,000)[a]	225,000	400,000
Total for Year 1	$985,000	$(100,000)	$185,000	$900,000

[a]S's $400,000 intercompany item minus $300,000 taken into account in Year 1.

Year 2	Consolidated Taxable Income	Adjustments & Eliminations	P's Separate Reporting	S's Separate Reporting
Profit (loss) from other bus. activities in Year 2	$ 460,000	$ 100,000[a]	$ (40,000)	$ 500,000
S's sales to P and P's sales to third parties in Year 2	1,150,000	(135,000)[a]	465,000	720,000
Total for Year 2	$1,610,000	$ (35,000)	$425,000	$1,220,000

[a]Net $(35,000): S's $720,000 intercompany item minus $685,000 taken into account in Year 2.

Year 3	Consolidated Taxable Income	Adjustments & Eliminations	P's Separate Reporting	S's Separate Reporting
Profit (loss) from other bus. activities in Year 3	$460,000		$(40,000)	$500,000
P's sales to third parties in Year 3	240,000	$135,000[a]	$105,000	-0-
Total for Year 3	$700,000	$135,000	$ 65,000	$500,000

[a]S's intercompany item taken into account in Year 3.

An alternative way of obtaining this answer is to recognize that the group will defer inclusion of S's intercompany inventory profits in consolidated taxable income from the year of the intercompany sale to the year P sells the inventory to third parties. Thus, the group will defer

$100,000 from Year 1 to Year 2 and will defer $135,000 from Year 2 to Year 3, as shown in the following table:

	Year 1	Year 2	Year 3
Consolidated taxable income before adjusting for profits on intercompany inventory sales	$1,085,000[a]	$1,645,000[b]	$565,000[c]
Adjustments for S's deferred profits on sales to P:			
Inventory sold to P in Year 1	(100,000)[d]	100,000[d]	
Inventory sold to P in Year 2		(135,000)[e]	135,000[b]
Consolidated taxable income	$ 985,000	$1,610,000	$700,000

[a]$500,000 - $40,000 + $400,000 + $225,000.
[b]$500,000 - $40,000 + $720,000 + $465,000.
[c]$500,000 - $40,000 + $105,000.
[d]12,500 units x $8 per unit = $100,000.
[e]15,000 units x $9 per unit = $135,000.

pp. C:8-10 through C:8-12, C:8-18, and C:8-19.

C:8-48a. Consolidated adjusted taxable income = ($200,000 - $30,000) + $150,000 + $10,000 + $4,000 = $334,000
Charitable contribution deduction before limitation = $45,000 + $5,000 = $50,000
Charitable contribution deduction limitation = 10% × $334,000 = $33,400
Charitable contribution deduction = lesser of $50,000 or $33,400 = $33,400
Dividends-received deduction before limitation = 70% x ($10,000 + $4,000) = $9,800
Dividends-received deduction limitation = 70% x ($334,000 - $33,400) = $210,420
Dividends-received deduction = lesser of $9,800 or $210,420 = $9,800
Consolidated taxable income = $334,000 - $33,400 - $9,800 = $290,800

b. Consolidated charitable contribution carryover = $50,000 - $33,400 = $16,600. The group can carry forward the $16,600 for five years, subject to limitations in carryover years. Excess charitable contributions do not carry back.

c. Consolidated regular tax liability = $22,250 + (39% × ($290,800 - $100,000)) = $96,662.

pp. C:8-19 through C:8-24.

C:8-49a. Mobile: Net Sec. 1231 gain = $18,000 - $12,000 = $6,000; treated as a long-term capital gain under the Sec. 1231 rules
Capital gain net income = $3,500 - $2,000 + $0 - $2,400 + $6,000 = $5,100
Taxable income = $300,000 + $5,100 = $305,100

Newark: Net Sec. 1231 loss = $9,000 - $14,000 = $5,000; treated as an ordinary loss under the Sec. 1231 rules
Capital gain net income = $0 - $0 + $8,100 - $7,300 = $800
Taxable income = $200,000 - $5,000 + $800 = $195,800

Omaha: Net Sec. 1231 gain = $0
Net capital loss = $0 - $6,200 + $5,500 - $0 = $700; not deductible in current year but carries back three years and forward five years
Taxable income = $100,000

b. Consolidated net Sec. 1231 gain = $27,000 - $26,000 = $1,000; treated as a long-term capital gain under the Sec. 1231 rules
Consolidated capital gain net income = $3,500 - $8,200 + $13,600 - $9,700 + $1,000 = $200
Consolidated taxable income = $300,000 + $200,000 + $100,000 + $200 = $600,200

p. C:8-21 and C:8-22 and Chapter I:13.

C:8-50 a. Alpha: Capital gain net income = $20,000 - $11,900 = $8,100
Taxable income = $80,000 + $8,100 = $88,100

Beta: Net capital loss = $15,000 - $17,000 = $2,000; not deductible in current year but carries back three years and forward five years
Taxable income = $70,000

The intercompany transaction rules do not defer taxation of Alpha's $4,400 gain on its transaction with Beta because the two corporations do not file a consolidated tax return.

b. Consolidated capital gain net income = ($35,000 - $4,400) - $28,900 = $1,700. Under the matching rule, the group does not take into account in the current year Alpha's $4,400 gain from its intercompany transaction with Beta.

Consolidated taxable income = $80,000 + $70,000 + $1,700 = $151,700.

p. C:8-21 and C:8-22.

C:8-51 a. P Corporation excludes from its taxable income the $125,000 dividend that it receives from T because the dividend apparently will reduce P's basis for its T stock. The group includes the other three dividends in its consolidated taxable income. Therefore, P, S, and T include $65,000 ($15,000 + $40,000 + $10,000) of dividends in consolidated taxable income.

b. P's dividend from the 100%-owned nonconsolidated U.S.-based life insurance company qualifies for a 100% dividends-received deduction. S's dividend from the 25%-owned domestic corporation qualifies for an 80% dividends-received deduction. P's dividend from the 51%-owned foreign corporation generally does not qualify for a dividends-received deduction, but the group may be eligible for a foreign tax credit with respect to the dividend. (See Chapters C:3 and C:16.) The total dividends received deduction is $47,000 (($15,000 × 100%) + (80% × $40,000)).

c. Consolidated taxable income = \$200,000 + \$(70,000) + \$175,000 + \$65,000 - \$47,000 = \$323,000

Consolidated regular tax liability = \$22,250 + (39% × (\$323,000 - \$100,000)) = \$109,220

pp. C:8-22 through C:8-23.

C:8-52 a. If Miami and Tampa file separate tax returns, they must allocate among themselves the 15% and 25% brackets in the corporate tax rate schedule. If they do not elect a special apportionment plan for allocating the brackets, they must allocate them equally, i.e., one-half to each corporation. Thus, each corporation's regular tax liability is:

Miami	\$11,125	(15% × (\$50,000 × 0.5)) + (25% × (\$25,000 × 0.5)) + [34% × (\$50,000 - (\$50,000 × 0.5) - (\$25,000 × 0.5))]
Tampa	5,000	(15% × (\$50,000 × 0.5)) + [25% × (\$30,000 - (\$50,000 × 0.5))]
Total	\$16,125	

If Miami and Tampa file a consolidated tax return, they do not have to allocate the brackets in the corporate tax rate schedule because the group has only one taxable income. The group's consolidated taxable income is \$80,000 (\$50,000 + \$30,000), and the regular tax liability is \$15,450 [\$13,750 + (34% × (\$80,000 - \$75,000))]. Thus, the consolidated regular tax liability is \$675 (\$16,125 - \$15,450) less than the total regular tax liabilities if Miami and Tampa file separate tax returns.

If Miami and Tampa file separated tax returns, they can eliminate this \$675 difference by electing an appropriate special apportionment plan (see Chapter C:3). For example, they could elect to apportion the entire 15% bracket to Miami, the entire 25% bracket to Tampa, and the remaining 34% bracket to Tampa, which would result in the following tax liabilities:

Miami	\$ 7,500	(15% x \$50,000)
Tampa	7,950	((25% x \$25,000) + (34% x \$5,000))
Total	\$15,450	

b. If Miami and Tampa file separate tax returns, each corporation's regular tax liability is:

Miami	\$17,925	(15% × (\$50,000 × 0.5)) + (25% × (\$25,000 × 0.5)) + [34% × (\$70,000 - (\$50,000 × 0.5) - (\$25,000 × 0.5))]
Tampa	-0-	No regular tax liability because Tampa has an NOL
Total	\$17,925	

If Miami and Tampa file a consolidated tax return, the group's consolidated taxable income is \$55,000 (\$70,000 - \$15,000), and the regular tax liability is \$8,750 [\$7,500 + (25% × (\$55,000 - \$50,000))]. Thus, the consolidated regular tax liability is \$9,175 (\$17,925 - \$8,750) less than the total regular tax liabilities if Miami and Tampa file separate tax returns. However, Tampa's loss does not carry over to other years as an NOL because it offsets some of Miami's current year taxable income.

If Miami and Tampa file separate tax returns, they can reduce their total tax liability from $17,925 to $12,500 by electing a special apportionment plan that allocates all of the 15% and 25% tax brackets to Miami. In this case, the tax liabilities would be as follows:

Miami	$12,500	((15% x $50,000) + (25% x $20,000))
Tampa	-0-	No regular tax liability because Tampa has an NOL
Total	$12,500	

Note that the $12,500 tax liability is $3,750 more than the $8,750 consolidated tax liability case because Tampa's $15,000 NOL does not offset any of Miami's income.

c. If Miami and Tampa file separate tax returns, each corporation's regular tax liability is:

Miami	$ 9,425	(15% × ($50,000 × 0.5)) + (25% × ($25,000 × 0.5)) + [34% × ($45,000 - ($50,000 × 0.5) - ($25,000 × 0.5))]
Tampa	7,725	(15% × ($50,000 × 0.5)) + (25% × ($25,000 × 0.5)) + [34% × ($40,000 - ($50,000 × 0.5) - ($25,000 × 0.5))]
Total	$17,150	

If Miami and Tampa file a consolidated tax return, the group's consolidated taxable income is $85,000 ($45,000 + $40,000), and the regular tax liability is $17,150 [$13,750 + (34% × ($85,000 - $75,000))]. Thus, the consolidated regular tax liability equals the total regular tax liabilities if Miami and Tampa file separate tax returns. p. C:8-24.

C:8-53

	Separate Tax Returns		Consolidated
	Dallas	**Houston**	**Tax Return**
Taxable income	$500,000	$400,000	$ 900,000
Plus: AMT preferences & adjustments	175,000	210,000	385,000
Preadjustment AMTI	$675,000	$610,000	$1,285,000
ACE adjustment[a]	48,750	82,500	131,250
Alternative minimum taxable income	$723,750	$692,500	$1,416,250
Minus: AMT exemption amount[b]	-0-	-0-	-0-
AMT base	$723,750	$692,500	$1,416,250
Times: Tax rate	20%	20%	20%
Tentative minimum tax	$144,750	$138,500	$ 283,250
Minus: Regular tax[c]	170,000	136,000	306,000
Alternative minimum tax	$ -0-	$ 2,500	$ -0-

[a]Dallas: 75% × ($740,000 - $675,000) = $48,750
Houston: 75% × ($720,000 - $610,000) = $82,500
Consolidated: 75% × ($1,460,000 - $1,285,000) = $131,250
[b]AMT exemption is fully phased out because AMTI exceeds $310,000.
[c]34% of taxable income. The lower graduated tax rates that apply to the first $75,000 of taxable income are fully phased out because taxable income exceeds $335,000.
p. C:8-24 and C:8-25.

C:8-54 a.

Regular tax [$22,250 + (0.39 × ($300,000 - $100,000))]		$100,250
Alternative minimum tax calculation:		
Preadjustment AMTI		$400,000
Adjusted current earnings	$750,000	
Minus: Preadjustment AMTI	(400,000)	
Difference	$350,000	
Times: ACE percentage	x 0.75	
ACE adjustment	$262,500	
AMTI		$662,500
Minus: AMT exemption amount (fully phased-out)		(-0-)
Tax base		$662,500
Times: tax rate		x 0.20
Tentative minimum tax		$132,500
Minus: Regular tax (see previous tax calculation)		(100,250)
Alternative minimum tax		$ 32,250
Total tax ($100,250 regular tax + $32,250 AMT - $0 GBC[a])		$132,500

[a]The general business credit (GBC) limit is the excess of the taxpayer's net income tax ($100,250 regular tax + $32,250 AMT) reduced by the credits allowed under Secs. 21 through 29 ($0) over the greater of (a) the tentative minimum tax ($132,500) or (b) 25% of the net regular tax over

$25,000 [($100,250 - $25,000) x 0.25 = $18,813]. Thus, the general business credit limit is zero ($132,500 - $132,500 = $0).

b. Two credit carryovers arise in the current year. The group has a $15,000 unused consolidated general business credit, which it can carry back one year and forward 20 years. The group also has a $32,250 minimum tax credit, which it can carry forward indefinitely.
pp. C:8-24 and C:8-25.

C:8-55 Year 3 consolidated NOL: The group first carries back the $4,000 NOL to Year 1, offsetting all of its consolidated taxable income that year. The group carries back the remaining $2,800 ($4,000 - $1,200) of the NOL to Year 2, reducing its consolidated taxable income that year to $9,200 ($12,000 - $2,800).

Year 4 consolidated NOL: The group first carries back the $10,000 NOL to Year 2, using $9,200 of it to reduce that year's consolidated taxable income to zero. The group carries forward the remaining $800 ($10,000 - $9,200) to Year 5. Thus, Year 5 consolidated taxable income is $24,200 ($25,000 - $800). pp. C:8-27 and C:8-28.

C:8-56 a. The group first carries back the Year 2 $70,000 NOL to Year 1, resulting in a full refund of taxes paid by the consolidated group that year. The $43,000 ($70,000 - $27,000) remaining NOL carries over to Year 3 and offsets the group's $19,000 consolidated taxable income that year. This carryback and carryover treatment leaves $24,000 ($43,000 - $19,000) of NOL carryover to be allocated between the P-S1 consolidated group and S2 Corporation. The group allocates the NOL to S2 as follows:

$$\frac{\text{\$28,000 S2's Year 2 separate NOL}}{\text{\$70,000 total Year 2 separate NOLs}} \times \text{\$24,000 NOL carryover} = \text{\$9,600 allocated to S2}$$

The group allocates the remaining $14,400 ($24,000 - $9,600) of the NOL to the P-S1 consolidated group to be used in its consolidated tax returns for Year 4 and later years. S2 uses $8,000 of its allocated amount in its Year 3 separate return, and $1,600 ($9,600 - $8,000) carries over to S2's Year 4 separate return. The consolidated group's and S2's allocated NOLs can carry over for 20 years from Year 2, the year the NOLs arose.

b. The group first carries over the $70,000 NOL to Year 3, offsetting the group's $19,000 consolidated taxable income that year. This treatment leaves $51,000 ($70,000 - $19,000) of NOL carryover to be allocated between the P-S1 consolidated group and S2. The group allocates the NOL to S2 as follows:

$$\frac{\text{\$28,000 S2's Year 2 separate NOL}}{\text{\$70,000 total Year 2 separate NOLs}} \times \text{\$51,000 NOL carryover} = \text{\$20,400 allocated to S2}$$

The group allocates the remaining $30,600 ($51,000 - $20,400) of the NOL to the P-S1 consolidated group to be used in its consolidated tax returns for Year 4 and later years. S2 uses $8,000 of its allocated amount in its Year 3 separate return, and $12,400 ($20,400 - $8,000) carries over to S2's Year 4 separate return. The consolidated group's and S2's allocated NOLs can carryover for 20 years from Year 2, the year the NOLs arose. pp. C:8-27 through C:8-30.

C:8-57 a. If the affiliated group files a consolidated tax return in Year 2, it reports a $10,000 consolidated NOL. This NOL is entirely allocable to P. P can carry back the $10,000 to offset part of its Year 1 taxable income. Alternatively, the group can elect to forego the carryback period and carry over the NOL to Year 3. S's Year 1 NOL cannot be used to offset P's Year 1 taxable income because the corporations do not file a consolidated tax return in Year 1. S's Year 1 NOL cannot be carried over and used in Year 2 because the group reports a consolidated NOL in Year 2.

If P and S file separate tax returns in Year 2, P can carry back to Year 1 its $30,000 NOL and reduce that year's taxable income to $10,000 ($40,000 - $30,000). S can use $20,000 of its Year 1 NOL to offset its Year 2 taxable income. S carries over to Year 3 and later years the remaining $9,000 ($29,000 - $20,000) of its Year 1 NOL. If P and S continue to be affiliated, they can elect to file a consolidated tax return in Year 3, even if they did not so elect in Year 2.

b. S's $29,000 NOL from Year 1 is a SRLY loss. Under the SRLY rules, the loss can offset in Year 3 the lesser of S's cumulative contribution to consolidated taxable income since joining the consolidated group, $26,000 ($20,000 + $6,000); consolidated taxable income, $27,000 ($21,000 + $6,000); or the remaining NOL carryover, $29,000. Thus, $26,000 of the Year 1 NOL reduces Year 3's consolidated taxable income to $1,000 ($21,000 + $6,000 - $26,000), assuming the group does not elect to forego the two-year carry back of the $10,000 Year 2 consolidated NOL. The remaining NOL of $3,000 ($29,000 - $26,000) carries over to Year 4. pp. C:8-27 through C:8-34.

C:8-58 a. S2's intercompany item is the $15,000 ($90,000 - $75,000) gain on its Year 1 land sale to S1. S1's sale of the land in Year 2 creates a $1,000 ($91,000 - $90,000) corresponding item and a $16,000 ($91,000 - $75,000) recomputed corresponding item that year. Thus, the group includes in its Year 2 consolidated taxable income all $15,000 ($16,000 - $1,000) of S2's intercompany item under the matching rule.

The group's Year 2 consolidated NOL is $80,000 (-95,000 + $15,000). The group does not use any of this NOL in Year 3 because it has a net loss that year, so the fraction of the Year 2 consolidated NOL apportioned to S2 carries over to S2's Year 3 separate tax return. The group members' separate Year 2 NOLs sum to $245,000: zero for P, $120,000 for S1, and $125,000 (-$140,000 + $15,000) for S2. S1's Year 2 reported taxable loss includes the $1,000 gain from selling the land to the third party. Of the $80,000 consolidated NOL, the group apportions $40,816 ($80,000 × ($125,000 ÷ $245,000)) to S2. This amount is available to S2 on its Year 3 separate tax return.

b. As in Part a, S2's intercompany item is its $15,000 gain, S1's corresponding item is its $1,000 gain, and the recomputed corresponding item is the $16,000 gain. However, the $1,000 and $16,000 gains now occur in Year 3. The group's Year 2 consolidated NOL is now $95,000. The group does not use any of this NOL in Year 3 because it has a $28,000 (- $43,000 + $15,000) net loss that year, so the fraction of the Year 2 consolidated NOL apportioned to S2 carries over to S2's Year 3 separate tax return. The group members' separate NOLs sum to $260,000: zero for P, $120,000 for S1, and $140,000 for S2. Of the $95,000 consolidated NOL, the group apportions $51,154 ($95,000 × ($140,000 ÷ $260,000)) to S2. This amount is available to S2 on its Year 3 separate tax return. pp. C:8-10 through C:8-12 and C:8-28 through C:8-30.

C:8-59 a. The group must use S2's \$10,000 loss to offset P's and S1's Year 2 taxable incomes. P's year 1 NOL is not a SRLY loss because the SRLY rules generally do not apply to a consolidated group's parent corporation, so the \$8,000 offsets a portion of Year 2 consolidated taxable income. S1's and S2's Year 1 NOLs are SRLY losses. The Year 2 SRLY limitations for their NOLs are \$20,000 for S1 (S1's taxable income) and zero for S2 (because S2 reports a loss). In Year 2, the group can use \$20,000 of S1's Year 1 NOL (lesser of S1's \$24,000 NOL carryover or S1's \$20,000 SRLY limitation for Year 1). The group's use of P's \$8,000 Year 1 NOL and \$20,000 of S1's \$24,000 Year 1 NOL also is limited to the group's \$60,000 consolidated taxable income before the NOL deduction, but this \$60,000 is greater than the \$28,000 total NOL The group cannot use any of S2's Year 1 NOL. Thus, Year 2 consolidated taxable income is \$32,000 (\$60,000 - \$8,000 - \$20,000).

b. The NOL carryovers available to the group in Year 3 are \$4,000 (\$24,000 NOL for Year 1 - \$20,000 the group used in Year 2) for S1 and \$16,000 for S2. The Year 3 SRLY limitations are as follows:

S1: \$0 (\$20,000 taxable income in Year 2 - \$18,000 loss in Year 3 - \$20,000 NOL the group used in Year 2, which nets to a negative amount)
S2: \$5,000 (\$15,000 taxable income in Year 3 - \$10,000 loss in Year 2)

In Year 3, the group can use \$5,000 of S2's Year 1 NOL (lesser of S2's \$16,000 NOL carryover, S2's \$5,000 SRLY limitation for Year 3, or the group's \$7,000 consolidated taxable income). The group cannot use any of S1's remaining Year 1 NOL because of its \$0 SRLY limitation. Thus, Year 3 consolidated taxable income is \$2,000 (\$7,000 - \$5,000).

c. In Year 4, none of P's NOL is available (the group used it in Year 2), \$4,000 of S1's NOL is available, and \$11,000 (\$16,000 - \$5,000) of S2's NOL is available. S1's and S2's NOLs are subject to the Year 4 SRLY limitations, for which insufficient information is available because their Year 4 taxable incomes and losses are not given.

d. The SRLY rules will not apply to any of the Year 1 NOLs. As in Part a, P's NOL is not restricted by the SRLY limitation because P is the group's parent corporation. S1's and S2's NOLs are not subject to the SRLY limitation because they were a member of the affiliated group for every day of the Year 1 loss year. The Year 1 NOLs total \$48,000 (\$8,000 + \$24,000 + \$16,000). They carry over to Year 2 and reduce that year's consolidated taxable income to \$12,000 (\$60,000 - \$48,000). No NOL carryover remains to be used in Year 3 and later years.
pp. C:8-30 through C:8-34.

C:8-60 a. A Sec. 382 ownership change has taken place because P increases its stock ownership of T by more than 50 percentage points (from 49% to 100%). Assuming the value of T's stock equals \$1 million (\$510,000 ÷ 51%), the annual Sec. 382 limitation on the group's use of T's NOLs is \$50,000 (\$1,000,000 × 5%). Thus, the group can deduct \$50,000 of T's NOLs for its Year 2 consolidated taxable income, which is the lesser of the \$50,000 Sec. 382 limitation, \$740,000 (\$400,000 + \$250,000 + \$90,000) of Year 2 consolidated taxable income before the NOL deduction, or \$160,000 of T's NOL carryover.

P and S could not include T in their consolidated tax return prior to Year 2 because they did not own at least 80% of T's stock at that time. Thus, T's unused NOLs are SRLY losses. However, the losses are not subject to the SRLY limitation because of the overlap rule. The SRLY event occurs on December 31 of Year 1, when the P-S group first owns at least 80% of T.

The Sec. 382 event also occurs on December 31 of Year 1, when the P-S group increases its ownership of T by more than 50 percentage points. The two events occur within six months of each other, so the tax law waives the SRLY limitation's application after the Sec. 382 event.

b. A Sec. 382 ownership change has not taken place because P has increased its stock ownership by only 45 percentage points, which is not more than 50 percentage points. However, the SRLY limitation applies because the P-S group's December 31 of Year 1 acquisition of T's stock increases its T ownership from less than 80% to at least 80% (from 49% to 94%). The overlap rule does not apply because no Sec. 382 event has occurred. Thus, the group can deduct \$90,000 of T's NOLs for its Year 2 consolidated taxable income, which is the lesser of T's \$90,000 cumulative contribution to consolidated taxable income; \$740,000 (\$400,000 + \$250,000 + \$90,000) of Year 2 consolidated taxable income before the NOL deduction, or \$160,000 of T's NOL carryover.
pp. C:8-30 through C:8-34.

C:8-61 P Corporation determines the basis for its S stock as follows:

Initial basis (purchase price)		$2,000,000
Plus:	Taxable income	350,000
	Tax-exempt income	30,000
Minus:	Federal income taxes ($350,000 x 0.34)	(119,000)
	Distribution from S to P	(100,000)
Basis on December 31		$2,161,000

pp. C:8-34 and C:8-35.

C:8-62 a. S's basis for its T stock:

Basis on January 1	$3,000,000
Plus: T's taxable income	250,000
Minus: Federal income taxes on T's taxable income ($250,000 x 0.34)	(85,000)
Basis on December 31	$3,165,000

P's basis for its S stock:

Basis on January 1	$5,000,000
Plus: S's taxable income	350,000
Minus: Federal income taxes on S's taxable income ($350,000 x 0.34)	(119,000)
Plus: Tiering up of adjustments S makes to the basis for its T stock ($250,000 - $85,000)	165,000
Basis on December 31	$5,396,000

b. S's basis for its T stock:

Basis on January 1	$3,000,000
Plus: T's taxable income	250,000
Minus: Federal income taxes on T's taxable income ($250,000 x 0.34)	(85,000)
Distribution from T to S	(90,000)
Basis on December 31	$3,075,000

P's basis for its S stock:

Basis on January 1	$5,000,000
Plus: S's taxable income	350,000
S's tax-exempt dividend from T	90,000
Minus: Federal income taxes on S's taxable income ($350,000 x 0.34)	(119,000)
Distribution from S to P	(80,000)
Plus: Tiering up of adjustments S makes to the basis for its T stock ($250,000 - $85,000 - $90,000)	75,000
Basis on December 31	$5,316,000

See Reg. Sec. 1.1502-32(b)(5)(ii) Example 5(b) for tiering up of basis adjustments when a lower-tier subsidiary distributes cash to an intermediate-tier subsidiary.
pp. C:8-34 through C:8-36.

C:8-63 Because they file separately, P and S do not adjust their taxable incomes for the profits on the intercompany inventory sales. Thus, each year, P's federal income tax is $129,200 ($380,000 × 0.34), S's federal income tax is $102,000 ($300,000 × 0.34), and their total tax is $231,200 ($129,200 + $102,000).

P and S must file consolidated financial statements because P's 100% ownership of S gives P control of S. In preparing these statements, the group must defer inclusion of the profits on the intercompany inventory sales until P sells the inventory to third parties. Assuming no book-tax differences other than the intercompany inventory sales, consolidated net income before income tax expense is as follows:

	Year 1	Year 2	Year 3
Consolidated pre-tax net income before adjusting for profits on intercompany inventory sales	$680,000	$680,000	$680,000
S's profits deferred:			
From Year 1 to Year 2	(70,000)[a]	70,000[a]	
From Year 2 to Year 3		(90,000)[b]	90,000[b]
Pre-tax consolidated net income	$610,000	$660,000	$770,000

[a]10,000 units x $7.00 per unit = $70,000.
[b]12,000 units x $7.50 per unit = $90,000.

In Years 1 and 2, the group increases a prepaid asset account, such as prepaid taxes, by the tax S pays on the eliminated intercompany inventory profit, which is $23,800 ($70,000 × 0.34) in Year 1 and $30,600 ($90,000 × 0.34) in Year 2. In Years 2 and 3, the group decreases the prepaid taxes account by the tax S paid on the restored intercompany inventory profit, which is $23,800 in Year 2 and $30,600 in Year 3. Thus, the group records a $23,800 increase in prepaid taxes for Year 1, a net $6,800 ($30,600 - $23,800) increase in the account for Year 2, and a $30,600 decrease in the account for Year 3. Accordingly, the group makes the following book journal entries (the federal income tax expense equates (balances) the debits and credits):

		Debit	Credit
Year 1:	Federal income tax expense	207,400	
	Prepaid taxes	23,800[a]	
	Federal income taxes payable		231,200
Year 2:	Federal income tax expense	224,400	
	Prepaid taxes	6,800[b]	
	Federal income taxes payable		231,200
Year 3:	Federal income tax expense	261,800	
	Prepaid taxes		30,600[c]
	Federal income taxes payable		231,200

[a] $70,000 deferred profit × 34% tax rate = $23,800.
[b] ($90,000 deferred profit - $70,000 deferred profit) × 34% tax rate = $6,800.
[c] $90,000 deferred profit × 34% tax rate = $30,600.

pp. C:8-39 through C:8-41.

Comprehensive Problems

C:8-64

Description	Consolidated Taxable Income (CTI)	Adjustments And Eliminations	P's Separate Reporting	S's Separate Reporting	P's Basis Adjustments for S's Stock
P's basis in S stock at the beginning of the current year					$1,400,000
Separate return taxable income:	$450,000		$200,000	$250,000	250,000
a. Land – S's gain now included in CTI	22,000	$22,000			22,000
b. Adjustment for dividend exclusion	(12,000)	(12,000)			(12,000)
c. P's profit on inventory sales to S:					
1. Deferred from the previous year to the current year	5,000	5,000			
2. Deferred from the current year to the next year	(8,000)	(8,000)			
d. NOL carryover	(20,000)	(20,000)			(20,000)
e. Consolidated charitable contributions	(28,000)	(28,000)			(11,000)
f. Dividends received deduction	(7,000)	(7,000)			
Consolidated taxable income (CTI)	$402,000	$(48,000)	$200,000	$250,000	
Consolidated tax liability	$136,680*				
Other basis adjustments:					
g. Federal income taxes paid by S					(81,940)
h. S's tax-exempt income					1,600
P's basis in S stock at the end of the current year					$1,548,660

*$402,000 × 0.34 = $136,680.

(a) S's intercompany item is its \$22,000 (\$70,000 - \$48,000) gain when it sold the land to P two years ago. Under the matching rule, the P-S group includes the gain in CTI by matching it with P's corresponding item so as to result in the recomputed corresponding item. The corresponding item is P's \$10,000 (\$80,000 - \$70,000) gain when it sells the land to the third party. The recomputed corresponding item is the \$32,000 (\$80,000 - \$48,000) gain that would be realized on the current year land sale if P and S were two divisions of a single corporation. Under the matching rule, the group includes \$22,000 (\$32,000 - \$10,000) of S's gain in its current year CTI.

(b) Because P and S file a consolidated tax return, the P-S group excludes the \$12,000 dividend from its gross income, so it makes a negative adjustment to remove the \$12,000 because it was included in P's separate return taxable income. The group is not allowed a dividends-received deduction for the \$12,000 (see item f below). P decreases the basis for S's stock for the dividend it receives from S.

(c) Under the matching rule, the consolidated group does not include intercompany inventory profits in its CTI until the inventory is sold outside the group. The group defers inclusion of the \$5,000 from the previous year to the current year, and it defers inclusion of the \$8,000 from the current year to next year, thereby requiring a positive \$5,000 adjustment and a negative \$8,000 adjustment for current year CTI.

(d) Because S's separate return taxable income is before the NOL deduction, the group must adjust CTI to include the NOL. The SRLY and Sec. 382 limitations do not apply to the NOL because it arose in the previous year, which was a consolidated return year.

(e) Because P's and S's separate return taxable incomes are before the charitable contribution deduction, the group must adjust CTI to include this deduction. The consolidated charitable contributions deduction is limited to 10% of consolidated adjusted taxable income:

Consolidated adjusted taxable income: \$450,000 + \$22,000 - \$12,000 + \$5,000 - \$8,000 - \$20,000 = \$437,000
Limitation: \$437,000 x 0.10 = \$43,700
Consolidated charitable contributions: \$17,000 + \$11,000 = \$28,000
Consolidated charitable contribution deduction: Lesser of \$43,700 or \$28,000 = \$28,000

(f) The consolidated dividends-received deduction is limited to \$300,300 [0.70 × (\$450,000 + \$22,000 - \$12,000 + \$5,000 - \$8,000 - \$28,000)], which is greater than the \$7,000 (0.70 × \$10,000) dividends-received deduction that would be allowed in the absence of the limitation. No dividends-received deduction is allowed for the intercompany dividend S paid to P.

(g) P decreases the basis for S's stock by the federal income taxes paid by S. S's income included in CTI is as follows:

Separate return taxable income	\$250,000
Gain deferred from two years ago to the current year	22,000
NOL deducted	(20,000)
Charitable contribution deduction	(11,000)
S's income included in CTI	\$241,000

The federal income taxes paid by S are \$81,940 (\$241,000 × 0.34), assuming S pays the portion of the consolidated tax liability attributable to it.

(h) P increases the basis for S's stock by the tax-exempt income S receives.

Note: Under the matching rule, P's interest income and S's interest expense offset for CTI, so the group makes no adjustment for the $6,000 of interest.

C:8-65 Separate tax returns for Flying Gator and T Corporations

Line	Title	Flying Gator	T Corporation
1a	Gross Receipts	$2,500,000	$1,250,000
1b	Returns and allowances	-0-	-0-
1c	Net receipts/sales	2,500,000	1,250,000
2	Cost of goods sold	(1,500,000)	(700,000)
3	Gross profit	1,000,000	550,000[a]
4	Dividends	100,000[b]	50,000
5	Interest	15,000	-0-
6	Gross rents	-0-	-0-
7	Gross royalties	-0-	-0-
8	Capital gain net income	5,000[c]	23,000[d]
9	Net gain or loss/Form 4797	-0-	25,000
10	Other income	-0-	-0-
11	Total income	$1,120,000	$ 648,000
12	Compensation of officers	80,000	65,000
13	Salaries and wages	95,000	135,000
14	Repairs and maintenance	25,000	40,000
15	Bad debts	10,000	5,000
16	Rents	-0-	-0-
17	Taxes and licenses	18,000	24,000
18	Interest	30,000	20,000
19	Charitable contributions	22,000	5,900[e]
20	Depreciation	85,000	40,000
21	Depletion	-0-	-0-
22	Advertising	-0-	-0-
23	Pension and profit sharing plans	-0-	-0-
24	Employee benefit programs	-0-	-0-
25	U.S. production activities deduction	27,450[f]	-0-
26	Other deductions	160,000	260,000
27	Total deductions	552,450	594,900
28	TI before special deductions	567,550	53,100
29a	NOL deduction	(50,000)	-0-
29b	Special deductions–DRD	(100,000)	(40,000)[g]
30	Taxable income	$417,550	$ 13,100
	Gross tax liability (taxable income x 0.34)[h]	$141,967	$ 4,454
	Minus: Estimated tax payments	(125,000)	(25,000)
	Net tax liability (or refund)	$ 16,967	$(20,546)

Total taxes when filing separate tax returns = $141,967 + $4,454 = $146,421
Tax when filing consolidated tax return (see solution to Problem C:8-67)
= $387,590 × 0.34 = $131,781
Difference = $146,421 – $131,781 = $14,640

[a]T reports all the profits on its current year inventory sales to Flying Gator in the current year. They do not make any adjustments to defer inventory profits because they file separate tax returns.

[b]Flying Gator does not exclude from gross income the dividend received from T because they file separate tax returns, but Flying Gator is allowed a 100% dividends-received deduction for it (see item g).

[c]Flying Gator cannot deduct the $10,000 loss on the land sale to T because of the Sec. 267(a) related party rules. Adding back the $10,000 loss to the $5,000 net long-term capital loss results in a $5,000 net long-term capital gain.

[d]$(3,000) net STCL + $6,000 net LTCG + $20,000 net Sec. 1231 gain = $23,000 capital gain net income.

[e]Contribution limitation: T Corporation = ($648,000 - $65,000 - $135,000 - $40,000 - $5,000 - $24,000 - $20,000 - $40,000 - $260,000) x 0.10 = $5,900. Flying Gator Corporation = ($1,120,000 - $80,000 - $95,000 - $25,000 - $10,000 - $18,000 - $30,000 - $85,000 - $160,000 - $50,000) x 0.10 = $56,700. Flying Gator's charitable contributions are less than $56,700, so it can deduct all $22,000 on its separate tax return.

[f]The U.S. production activities deduction must be calculated on a consolidated basis even if the members file separate tax returns (see solution to Problem C:8-67). The entire deduction is allocated to Flying Gator because T has no positive qualified production activities income. The applicable percentage is 9% in 2010.

[g]Flying Gator can claim a 100% dividends-received deduction for dividends received from T when it files a separate return. T Corporation can claim an 80% dividends-received deduction on dividends from a corporation that is at least 20%-owned but less than 80%-owned by T.

[h]Flying Gator and T are a parent-subsidiary controlled group. Thus, Sec. 1563 limits the use of the 15% and 25% tax brackets. However, because total taxable income for the group ($417,550 + $13,100) exceeds $335,000, the benefit of the low brackets is completely phased out. Consequently, all taxable income for the group is taxed a flat 34% tax rate. Thus, T's taxable income is taxed at 34% even though it is only $13,100.

Tax Strategy Problem

C:8-66 Alpha and Beta Corporations comprise a brother-sister controlled group because Sandra and John together own 100% of Alpha and Beta. However, Alpha and Beta do not have a common parent corporation, so they do not comprise an affiliated group and cannot file a consolidated tax return.

If Sandra and John want to keep Alpha and Beta as separate corporations, they should consider converting Alpha and Beta from a brother-sister corporate structure into a parent-subsidiary corporate structure. As a parent-subsidiary group, Alpha and Beta could file a consolidated tax return, on which Beta's current year operating losses could offset Alpha's current year operating profits. Filing a consolidated tax return also could defer taxation of Alpha's profits on its inventory sales to Beta.

The corporations can form the parent-subsidiary group in two ways: (1) with Alpha as the parent or (2) with Beta as the parent. To make Alpha the parent, Sandra and John can contribute their Beta stock to Alpha in a nontaxable transfer under Sec. 351, or Alpha can acquire Beta stock in a nontaxable reorganization under Sec. 368 (i.e., Type B; see Chapter C:7). Similarly, Sandra and John can make Beta the parent by contributing their Alpha stock to Beta or by having Beta acquire the Alpha stock in a reorganization.

If Alpha is the parent, the NOL carryovers from its separate return years will not be SRLY losses. Thus, the consolidated group's use of Alpha's NOLs will be limited only by the group's consolidated taxable income. Beta's NOL carryovers from its separate return years are SRLY losses, so the consolidated group can use them only to the extent of Beta's positive earnings in consolidated return years. Given that Beta expects losses for the next five years, the group will not be able to use Beta's NOL carryovers for several years. Section 382 would not limit use of the NOLs because the requisite more than 50 percentage point increase in stock ownership of the loss corporation will not have occurred.

Alternatively, if Beta is the parent, its NOL carryovers generally will not be SRLY losses, so the consolidated group's use of them will be limited only by the group's consolidated taxable income. Alpha's NOL carryovers will be SRLY losses, but Alpha will generate positive income in the future, allowing the group to use Alpha's NOL carryovers. Thus, it appears that the best alternative is to have Beta be the parent, which allows the consolidated group to use both corporations' separate return year NOL carryovers. However, if Beta is smaller than Alpha, Beta's acquisition of Alpha likely would qualify as a reverse acquisition. If it does, Beta's NOL carryovers will be subject to a SRLY limitation and Alpha's NOL carryovers will not. Similarly, if Alpha acquires Beta and it qualifies as a reverse acquisition, Alpha's NOL carryovers will be subject to a SRLY limitation and Beta's NOL carryovers will not.

If John and Sandra conclude for business reasons that Alpha must be the parent and it does not qualify as a reverse acquisition, they have three possible ways to use Beta's NOLs from separate return years. First, they could consider ways to increase Beta's corporate profits (and taxable income). One way to accomplish this goal is to reduce the transfer price at which Alpha sells inventory to Beta, shifting some of the group's overall profit from Alpha to Beta. Sandra and John should be made aware of the Sec. 482 transfer pricing restrictions that may constrain their ability to increase Beta's profits so as to increase the use of Beta's NOLs.

Second, if Alpha and Beta have common costs that they allocate among themselves, they might allocate a higher percentage of the costs to Alpha in future years. This strategy would increase Beta's SRLY limitation, increasing the amount of Beta's SRLY NOLs the group could use, but Sec. 482 again may constrain the flexibility to allocate these items.

Third, Beta could liquidate into Alpha after the parent-subsidiary relationship is created. The liquidation might be prudent if management believes that having two separate corporations serves no substantial business purpose. The liquidation would be nontaxable under Secs. 332 and 337 (see Chapter C:6). Alpha and Beta then could operate as separate divisions of a single corporation. Alpha would assume Beta's NOL carryover under Sec. 381. The need to file consolidated tax returns to offset Beta's losses against Alpha's profits and to use up Beta's NOL carryovers would be eliminated. In addition, the use of Beta's NOLs would not be limited by the SRLY restrictions encountered with a consolidated filing. Sandra and John should be made aware that the IRS could disallow the liquidation's tax benefits under Sec. 269 if its principal purpose is to facilitate usage of Beta's NOLs. Note: Another way to combine Alpha and Beta into a single corporation would be a nontaxable merger of one into the other.

Tax Form/Return Preparation Problems

C:8-67 (See Instructor's Resource Manual)

Case Study Problem

C:8-68 The points listed below are the primary ones that should be included in the memorandum to the tax partner concerning Carol's tax problem. The student should include these points in a properly formatted memorandum using good grammar and punctuation.

P and J Corporations appear to be ideal candidates for filing a consolidated tax return because one corporation is operating profitably and the other corporation is operating unprofitably. The client foresees continued expansion of the automobile service franchises, and it appears that J will continue to incur losses in the short run because of the interest expense and MACRS depreciation deductions for the six additional locations.

P and J presently are not affiliated and cannot file a consolidated tax return because an individual, Carol, owns all the stock of both corporations. Carol could restructure her stock ownership to create the necessary parent-subsidiary relationship, making them eligible to file a consolidated tax return. One possibility is for Carol to create a holding company and transfer her P and J stock to it. A second possibility is for Carol to transfer the stock of one corporation to the other corporation. Either way, the transaction would be nontaxable under Sec. 351, and J would retain its NOL carryover. Note: A taxable transfer of J's assets (rather than its stock) to a holding company or to P should be discouraged because J's NOL carryovers would not be acquired by the transferee. A transfer by Carol of J's stock to a holding company or to P would preserve the existence of J's NOLs.

Affiliation of P and J will permit them to file a consolidated tax return. J's post-affiliation losses can offset P's post-affiliation profits. J's pre-affiliation losses are subject to the SRLY limitation (assuming a reverse acquisition does not occur), so the consolidated group can use the losses only to the extent of J's post-affiliation profits.

Carol should give some consideration to adjusting the lease arrangement between P and J. If P were to pay J more rent, J's SRLY limitation would increase, allowing the group to use J's pre-affiliation losses more quickly. Carol should identify business reasons for doing so because the IRS might view such changes as a scheme for increasing the usability of the NOLs. The transfer of the P and J stock to the holding company or the transfer of one corporation's stock to the other corporation would not trigger the application of the Sec. 382 loss limitation because Carol would own all the holding company's stock after the transfer.

The Tax Planning Considerations section of the text contains a summary of the other advantages and disadvantages of filing a consolidated tax return. Other advantages and disadvantages of filing on a consolidated basis that are relevant in this situation also should be included in the memorandum.

Tax Research Problems

C:8-69 P and S1 Corporations are members of an affiliated group at the beginning of the current year (a non-leap year). A and B Corporations are not included in the affiliated group because they are brother-sister corporations to P and fail to satisfy the Sec. 1504(a) stock ownership requirements (no single corporate ownership chain includes both A and P or B and P Corporations). The sale of the A stock has no effect on the affiliated group for consolidated tax return purposes because A is not a member of the affiliated group at any time in the current year. The acquisition of the S2 stock by S1 creates a new member of the affiliated group. S1 owns the necessary 80% of the voting power and value of the S2 stock (excluding the nonconvertible, nonvoting preferred stock that is not considered to be "stock" under Sec. 1504(a)(4)). The affiliated group includes the income and expenses of S2 starting with the day after the November 25 acquisition date through December 31 (Reg. Sec. 1.1502-76(b)).

The controlled group test applies on December 31st of the tax year in question (Sec. 1563(b)(1)). On that date B, P, S1, and S2 apparently would constitute a combined controlled group under Sec. 1563(a)(3). However, Sec. 1563(b)(3) considers a corporation to be a member of a controlled group under the "additional member" rule if the corporation (1) is a member of a controlled group of corporations at any time during a calendar year, (2) is not a member of the group on December 31st of the calendar year, and (3) is a member of such group for one-half (or more) of the number of days in such tax year which precede December 31st. A Corporation satisfies this requirement because it was a member of the controlled group from January 1 through July 10 (191 days) even though it is not a member of group on December 31st. A has been a member of the controlled group for more than half of the 365 days in the current year (assuming a non-leap year).

S2 is an excluded corporation under Sec. 1563(b)(2)(A) and, therefore, is not a part of the controlled group. S2 is excluded because it was a member of the group for 35 days in the tax year that preceded December 31st (it was a member for less than half of the 365 days in the current year). See. Reg. Sec. 1.1563-1(b)(4) for examples that illustrate the counting of days for this purpose.

The current year controlled group is thus comprised of P, S1, A, and B Corporations. This group is known as a combined group. The four corporations would share equally the reduced tax rate benefits of Sec. 11(b) unless a special allocation of these benefits was elected for the current year under. Reg. Sec. 1.1561-2, which provides guidance on allocating the reduced tax rate benefits in this circumstance. In future years, P, S1, S2, and B will be the only four members of the controlled group unless an acquisition or disposition takes place.

The required tax returns for the current year are as follows:

Corporation	**Period**	**Consolidated or Separate Return**
A	1/1 - 12/31	Separate
B	1/1 - 12/31	Separate
P	1/1 - 12/31	Consolidated
S1	1/1 - 12/31	Consolidated
S2	1/1 - 11/25	Separate
S2	11/26 - 12/31	Consolidated

If S2's books are not closed on November 25, S2 allocates its nonextraordinary items of income, gain, expense, loss, and credits to the periods before and after the acquisition date based on the relative number of days in each period, assuming it uses the same tax year as the P-S1 group (i.e., the calendar year). S2 allocates its extraordinary items to the day S2 reports them under its normal tax accounting methods.

The easiest way for B to become a member of the affiliated group is for Angela to contribute her B stock to one of the current members of the affiliated group (P, S1, or S2) in a nontaxable transfer under Sec. 351. Because P owns all the stock of S1 and S2, P may be the best choice to become B's parent corporation.

C:8-70 X Corporation would not be allowed to retain its S election because Sec. 1361(b)(1)(B) prevents an S corporation from having a shareholder that is other than an individual, an estate, a trust, or certain tax-exempt organizations. Therefore, under Sec. 1362(d)(2), the S election will terminate on June 30. X will join the affiliated group, which will continue to include P, R, and T. The group's current year consolidated tax return will include P's, R's, and T's income or loss for the entire tax year, and it will include X's income or loss for June 30 through December 31. (Normally, the group includes an entering member's income or loss starting the day after the acquisition date, but a special rule applies for the acquisition of an S corporation. See Reg. Sec. 1.1502-76(b)(1)(ii)(A)(2) and Reg. Sec. 1.1502-76(b)(5) Example 7 for more details.) X will file a separate S corporation tax return (Form 1120S) for January 1 through June 29.

Because X has always been an S corporation, it will not be bringing any tax attributes such as NOL carryovers or earnings and profits to the consolidated group. A number of its tax elections will carryover, such as its overall accounting method. X will continue to use a calendar year as its tax year because it is the same tax year used by the consolidated group.

C:8-71 The question to be answered is whether the affiliated group remained in existence for some period of time during the restructuring or whether it terminated. If the affiliated group remained during restructuring, can this group continue to file a consolidated return for the year of the restructuring?

Regulation Sec. 1.1502-75(a)(2) requires that, if a consolidated tax return has been filed in the past, a consolidated tax return must continue to be filed as long as the affiliated group continues and the group has not received permission to cease filing a consolidated return. Thus, Able, Baker, and Cross must file a consolidated return for the period up through October 23. The question arises as to whether a parent exists whose income must be included for the full taxable year since Able ceases to exist at the time of the restructuring.

Under Reg. Sec. 1.1502-75(d)(1), an affiliated group continues in existence as long as the parent corporation remains a parent corporation and at least one subsidiary remains affiliated with it at the beginning of the tax year. This fact situation seems not to follow the basic rule because Able goes out of existence in the restructuring. However, Reg. Sec. 1.1502-75(d)(2) contains two exceptions to the basic rule: (1) the group continues if the parent merely changes its identity, form, or place of organization or (2) the group continues even though the parent is no longer in existence if the group members become the owners of substantially all the assets of the former parent and a parent corporation was a member of the group prior to the time the parent ceased to exist (Reg. Sec. 1.1502-75(d)(2)(ii)). Our fact pattern fits within the second exception, so a consolidated return must be filed with Baker taking the role of the parent after the restructuring. The consolidated return must include Able and Cross from January 1 through October 23 and must include Baker's income for the entire year.

In The Falconwood Corporation v. U.S. 96 AFTR 2d 2005-5977, 2005-2 USTC ¶50,597 (Fed. Cir., 2005), the court faced essentially the same question and determined, as we did, that the regulations require the filing of a consolidated return that includes the substituted parent's full tax year results. However, the IRS and a lower court had decided that application of the step transaction doctrine was appropriate. If all the restructuring steps are collapsed into a single transaction, the affiliated group does not survive the restructuring, and the consolidated return year closes on October 23. The Federal Circuit Court carefully examined the wording of Reg. Sec. 1.1502-75(d)(2)(ii) with a focus on the word "remain" to see whether it provided any guidance as to how long the affiliated group must remain, but the court found no hint of a required time period. Because the form of this restructuring was chosen so that Baker could retain its valuable franchises (a business purpose), the Federal Circuit held that collapsing the steps of the restructuring was inappropriate. Because the form of the restructuring was established for a business purpose and that form resulted in an affiliated group "remaining" for a few hours, the Federal Circuit held that the Regulations required the group to file its return with Baker for the entire year plus Able and Cross from January 1 through October 23.

"What Would You Do In This Situation?" Solution

Ch. C:8, p. C:8-7. Omission of a Corporation From a Consolidated Tax Return.

The failure to include a new corporation in a consolidated federal income tax return cannot be justified under a de minimis income rule. Unlike individuals, who can avoid filing a federal tax return when they earn a small amount of income, C corporations do not have a minimum income amount that can go unreported. Therefore, P Corporation must include X Corporation in the P-S-T affiliated group's consolidated tax return for the current year.

Regulation Sec. 1.1502-75(e) states that, if a consolidated return is required for the taxable year, the tax liability of all group members must be computed on a consolidated basis, even if (1) separate returns are filed by one or more group members or (2) there has been a failure to include in the consolidated return the income of any group member. The oversight of excluding X Corporation from the consolidated group does not prevent the group from filing a consolidated tax return in the current year or in a future year. Likewise, the oversight cannot be used as a means to "break" the consolidated return election so that the companies can commence filing on a separate return basis.

The filing of the consolidated tax return requires the inclusion of all subsidiary corporations on the Form 851 (Affiliations Schedule) that is part of the return. The affiliations schedule provides a listing of all corporations included in the consolidated tax return. In addition, Form 1122 (Authorization and Consent of Subsidiary Corporation to be Included in a Consolidated Income Tax Return) must be completed by each group member. Failure to include a Form 1122 for X Corporation in the consolidated tax return, however, will not exclude the corporation from the consolidated tax return. Under Reg. Sec. 1.1502-75(b)(2), the IRS has the power to determine that a corporation is a group member even though the Form 1122 was not filed. The omitted corporation will be treated as if the Form 1122 had been filed. One situation where the IRS has used this power is in the case where a dormant or new subsidiary has been overlooked.