Chapter 8
Consolidated Tax Returns (2011) updated: June 2, 2011

Learning Objectives:

- Explain the advantages and disadvantages of filing a consolidated tax return.
- Determine whether a group of corporations is an affiliated group.
- Calculate consolidated taxable income for an affiliated group.
- Explain how to report/account for intercompany transactions of a consolidate group.
- Explain how to compute deductions & credits (group items) on a consolidated basis.
- Compute a parent's stock basis in a subsidiary.

I. Consolidated Tax Returns – In General

A. Context of the consolidated tax return rules – approximately 90% of the 5.5 million corporate income returns filed in the U.S. are for closely-held businesses, but the vast majority of corporate income and assets are held by no more than 50,000 large entities that are eligible to file on a consolidated basis.

B. Overall objective – organizational neutrality – a group of closely related corporations should have neither a tax advantage nor tax disadvantage relative to taxpayers who file separate tax returns

C. Source of authority regarding consolidate tax returns – primarily the Treasury Regulations which have the *force* & *effect* of law (some of the longest & most complex rules in tax)

D. Advantages

1. current losses can offset income of other members and reduce current regular tax or AMT (alternative minimum tax)
2. operating and capital loss carryovers of one member may be used to offset income of other members
3. intercompany dividends are eliminated
4. income on certain intercompany transactions can be deferred
5. certain deductions and tax credits can be better utilized when subject to limitations of overall group rather than individual members (may avoid carryovers)
6. basis in stock owned in lower tier entities is increased as income is reported (on subsequent sale – gain is reduced or loss is increased)

E. Disadvantages

1. election is binding on all members for current and all subsequent years' returns (all eligible subs MUST be included in the election)
2. members must use the same tax year (may initially require short tax year)
3. election may be terminated if membership in group changes and new member is not included in election
4. losses on intercompany transactions are deferred
5. certain deductions and tax credits may be reduced if limitations are determined based on activities of entire group
6. basis in stock owned in lower tier entities is reduced if losses from the subsidiary are reported
7. additional reporting requirements exist & additional administrative procedures are necessary (along with the increased compliance costs)
8. rights of minority shareholders must be respected – legally & ethically

II. The Consolidated Tax Return (for an Affiliated Group)

A. A corporation can ***elect*** to join in a consolidated return if:

1. it is a member of an <u>affiliated group</u> (stock ownership test)
2. it is not <u>ineligible</u> to file on a consolidated basis
3. it meets the initial and ongoing filing requirements (Code and Regs.)

B. An affiliated group (defined):

1. a parent must directly own 80% of the voting power and 80% of the total value of the stock of at least one subsidiary (there must be an identifiable parent),
   AND
2. the parent and/or other group members must own 80% of the voting power and 80% of the value of each corporation to be included in the group (multiple tiers and chains of corporations are allowed)

Notes: Attribution rules are NOT applied in identifying the identifiable parent of the affiliated group. In addition, the 80-percent ownership test must be met every day of the tax year. Need to distinguish between direct & indirect ownership.

C. Cannot be an ineligible corporation, ineligible corporations/entities include:

1. S corporations
2. tax-exempt charitable corporations under Sec. 501
3. insurance companies (some can make a special election after 5 years)
4. foreign corporations or corporations in a U.S. possession
5. regulated investment companies
6. real estate investment trusts (REITs)
7. All noncorporate entities – partnerships, trusts, estates, limited liability entities – are also ineligible.

D. An affiliated group is similar to, but not identical to, a parent-subsidiary controlled group (see section VIII, page 8-13 for more on controlled groups). Members of a controlled group:

1. are required to share a number of tax benefits, including:
   - the lower (15% and 25%) tax rates that apply to the first $75,000 of taxable income
   - the $150,000 or $250,000 accumulated earnings credit (a special accumulated earnings tax is imposed on C corporations that accumulate (rather than distribute) their earnings beyond the *reasonable needs of the business*)
   - the $40,000 exemption in computing AMT liability (the alternative minimum tax (AMT) is a separate and parallel federal income tax system – with different tax rates, different definitions of income, deductions and credits – designed to measure the taxpayer's "economic" income.
2. must defer recognition of realized loss on intercompany sales until the asset is sold at a gain to a nongroup member (members are related parties under Sec. 267)
3. must recognize ordinary income from the sale of property between group members

Note: The controlled group test can use the attribution rules to find the parent & the ownership test is applied only on the last day of the tax year.

E. Affiliated group members can file tax returns in two ways:

1. each member files a separate return
    - claim a 100% dividends received deduction for intercompany dividends

2. elect to file consolidated tax returns
    - no 100% dividends received deduction is allowed for intercompany dividends; however dividend is an eliminating adjustment

Note: See Table 8-1 (page 8-10) for a complete comparison of the tax consequences of filing a consolidated tax return vs. separate tax returns.

F. Liability for taxes:

1. each member is jointly and severally liable for entire consolidated tax liability, penalties and interest
2. starting with third consolidated tax year, estimated tax payments must be made on consolidated basis
3. benefits accruing from graduated corporate tax rates are apportioned equally among group members unless all members consent to some other method. The most common tax-sharing agreements are the *relative taxable income* and *relative tax liability* methods.

    a. relative taxable income method – consolidated tax liability is allocated among the members based on their relative amounts of separate taxable income.

    b. relative tax liability method – consolidated tax liability is allocated based on the relative hypothetical separate tax liabilities of the members.

Note: The two methods also refer to how payments are made between group members.

G. Tax accounting periods and methods:

1. All members of a consolidated group must use the parent's tax year.
2. Differences among group members tax accounting methods are allowed.

Note: Federal elections may not be binding for state income tax returns.

III. Compute Consolidated Taxable Income

A. Compute separate taxable income for each member of the affiliated group – taxable income “as if” it were going to file a separate return.

B. Two groups of transactions are then removed from the member’s separate tax returns and receive special treatment:

1. intercompany items
    - deferrals/restorations
    - permanent eliminations
    - distributions

2. group items – anything affected by taxable income limits, or items that require netting
    - capital gains & losses
    - Sec. 1231 gains & losses
    - domestic production activities deduction (DPAD)
    - casualty/theft gains & losses
    - charitable contributions
    - dividends received deduction
    - net operating loss (subject to same limitations as NOL carry forwards and carry backs)

C. Remaining separate incomes are combined with group and intercompany items, applying the consolidated tax return rules, resulting in consolidated taxable income

Note: See chapter 8 handout (on my web page) for an example of how to compute consolidated taxable income using the “worksheet” approach (used in the text book) which starts with separate consolidated income and an alternative “trial balance” approach.

IV. Intercompany Items

A. Most intercompany transactions remain in the members' separate taxable income

1. unlike financial accounting – both parties report their side of the transaction in determining separate taxable income
2. effectively cancel each other out on a consolidated basis
3. for example – services provided by one member to another member
    - service provider recognizes income
    - service purchaser recognizes deductible expense
    - net result is a zero addition to consolidated taxable income

B. If the members use different accounting methods, adjustments to match income and expense are required

1. payor's deduction for intercompany expenditure is deferred until year in which recipient recognizes the related gross income (similar to the related party rules under Sec. 267; accrual-basis payor's deduction is deferred until cash basis taxpayer recognizes the income)

C. Dividends received from other group members

1. eliminated from recipient's separate taxable income
2. no dividends received deduction allowed
3. if dividend is a noncash asset
    - payor member realizes gain but defers recognition until asset leaves the group
    - the amount of the dividend = fair value of asset received

D. Deferred intercompany transactions & the “matching rule” – sale or exchange of property (including inventory)

1. group members recognize gain or loss in computing separate taxable income in year of transfer
2. gain or loss is then excluded from consolidated income until a later event triggers recognition
3. recognition triggers:
    - subsequent sale to an unrelated third party outside the group
    - buyer claims depreciation, amortization or depletion on the purchased asset (over time)
    - amortization of capitalized services
    - departure from the group by either buyer or seller (the acceleration rule)
    - parent starts a separate return year (the acceleration rule)

Note: The matching rule also applies to the performance of services (or any other transaction) where acquirer <u>capitalizes</u> the expenditure

V. Group Items

A. Several items are netted and/or the limitations are applied on a consolidated basis including:

1. net capital gain/loss
2. Section 1231 gain/loss
3. casualty/theft gain/loss
4. charitable contributions
5. dividends received deduction
6. net operating loss (subject to same 2-year carryback and 20-year carry forward provisions; however complications arise when entering or departing group members carry NOLs with them. See item xxx)

B. All of these items are removed from members' separate taxable income.

C. Then we use consolidated taxable income to determine statutory limitations for group-basis gains, losses, income, and deductions (using the same ordering rules)

1. charitable contributions – the deduction is computed on a consolidated basis
    - sum the individual contributions
    - compare with 10% of adjusted consolidated taxable income
    - carryover any excess for 5 years

2. Dividends
    - dividends received from other group members are excluded from consolidated taxable income
    - the DRD applies to combined income for dividends from non-group member corporations

    Note: Any/all 80% DRD are deducted first, then the 70% DRDs. The DRD is NOT based on the combined ownership percentage but the <u>individual</u> ownership percentage.

3. Net operating losses
    - NOL carryback (2 years) and carryforward (20 years) are permitted on a consolidated basis if the group has not changed its members
    - when computing consolidated NOL
        - remove consolidated charitable contributions and capital gain or loss from taxable income (these items have their own carryover periods and rules)
        - consolidated dividends received deduction remains a part of the consolidated NOL

    - if membership has changed, consolidated NOLs <u>may</u> be carried back or forward to separate return years only under certain circumstances

VI. More on Net Operating Losses (NOLs)

A. Complications arise when group member enter or depart from the consolidated group.

1. members' NOLs are either incurred in a "separate return year" and deducted in a "consolidated return year" or vice versa
2. several restrictions limit the availability of such NOL deductions

B. Current year consolidated NOLs can be carried back to subsidiary's separate tax return to extent subsidiary is responsible for loss.

C. When group members change over time, an apportionment of the consolidated NOL is necessary When more than one group member generates a loss for the consolidated tax year, the loss must be apportioned as follows:

$$\frac{\text{Member's separate NOL}}{\text{Members' aggregate NOL}} \times \text{consolidated NOL} = \text{Member's apportioned NOL}$$

D. When member leaves the group, any apportioned share of unused NOL carryforwards can be used on its subsequent separate returns.

E. Separate return limitation year (SRLY) rules apply when NOLs are carried forward from a separate return year onto a consolidated return. The consolidated return can include deductions only to the extent of the lesser of the:

1. new member's current-year contribution to consolidated taxable income, or
2. new member's cumulative positive contribution to current-year consolidated taxable income.

Note: The SRLY limitations do not apply to the parent corporation.

VII. Stock Basis Adjustment

A. Parent corporation's basis in the subsidiary's stock is:

1. initially, the acquisition price
2. adjusted at end of each tax year – the adjustments parallel the "equity" method of accounting for investments (GAAP) but uses tax numbers instead of book income numbers
3. prevents double taxation of gain or loss from the ultimate disposal of the subsidiary's shares

B. Positive adjustments – basis in subsidiary is increased by:

1. allocable share of consolidated taxable income for year
2. allocable share of consolidated operating or capital loss of subsidiary that could not use the loss through carryback to a prior year
3. contributions to capital of subsidiary

C. Negative adjustments – basis in subsidiary is reduced by:

1. allocable share of consolidated taxable loss for year
2. allocable share of operating or capital loss carryover deducted on consolidated return which did not previously reduce basis in subsidiary's stock
3. dividends paid by subsidiary to the parent out of the subsidiary's E & P

Note: There is no such concept as consolidated E & P (each entity accounts for its share of consolidated taxable income & each entity reduces E & P by an allocable share of consolidated tax liability)

D. Excess loss account:

1. If cumulative (net) negative adjustments exceed the parent's basis in subsidiary stock, an "excess loss account" is established; this prevents the group from reporting a negative stock basis in the subsidiary.

2. If stock is sold when an excess loss account exists, the gain from sale of stock (usually a LTCG) will generally include the balance of the excess loss account.

Note: The Tax Code avoids any use of negative basis amounts, but a negative basis is very close to what the excess loss account represents. Losses continue to be deductible, even though there is no subsidiary stock basis left to offset. In contrast, in the partnership and S corporation areas "excess losses" are suspended under the basis limitations (and carried forward).

E. In a chain of more than one tier of subsidiaries, begin computation of stock basis in lowest-level subsidiary & then proceed up the ownership structure to the top-level parent.

VIII. More on Controlled Groups

A. Two or more corporations that are owned directly, or indirectly, by the same shareholder or group of shareholders

B. Types of controlled groups

1. Parent-subsidiary – one corporation must directly own at least:

    - 80% of the voting power of all classes of voting stock,
      OR
    - 80% of the total value of all classes of stock of the subsidiary corporation

2. Brother-sister – if five or fewer individuals, trusts or estates own:

    - more than 50% of the voting power, or more than 50% of the value of the stock of each corporation (total ownership test),
      AND
    - more than 50% of the voting power, or more than 50% of the value of the stock held by common owners (identical ownership test)

C. Controlled groups are especially vulnerable to Sec. 482 – which permits the IRS to reallocate income, deductions, and credits between two or more corporations in the controlled group in order to "more clearly reflect income".

D. Special controlled group rules:

1. the following must be allocated among the members of the controlled group:

    - the benefit of the graduated corporate tax rates (the first \$50,000/\$75,000 of taxable income is taxed at 15%/25%)
    - the \$150,000/\$250,000 minimum accumulated earnings credit (which is designed to prevent companies from retaining "excessive" amounts of income in the corporation)
    - the \$40,000 AMT exemption amount (a separate parallel tax system to ensure that corporation's pay their "fair" share of taxes)
    - the Sec. 179 expense amount

2. no loss on sale of assets between members may be recognized