

CHAPTER

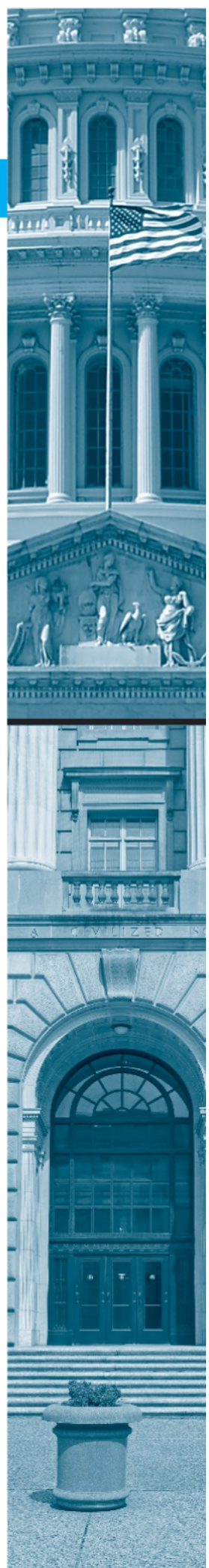
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CONSOLIDATED TAX RETURNS

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- 1** Determine whether a group of corporations is an affiliated group
- 2** Describe how an affiliated group makes a consolidated return election and how it discontinues the election
- 3** Calculate consolidated taxable income for a consolidated group
- 4** Apply the rules for reporting intercompany transactions
- 5** Compute on a consolidated basis deductions and credits subject to limitations
- 6** Determine a consolidated group's NOL, calculate the carryover of a consolidated NOL, and apply the SRLY restrictions on NOL usage
- 7** Adjust the parent's basis in stock of a consolidated subsidiary
- 8** Compare the advantages and disadvantages of filing a consolidated tax return
- 9** Comply with the procedures for making a consolidated return election
- 10** Explain the financial statement implications of various consolidated transactions



CHAPTER OUTLINE

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Many corporations have complex entity structures. For example, a corporation may have one or more subsidiaries, and some of these subsidiaries may have their own subsidiaries. A group of corporations form into complex entity structures for many reasons. For example, a parent corporation may want to insulate itself from liabilities related to its subsidiaries, or it may want to make it easier to implement a plan that links the compensation of the subsidiary's managers to the subsidiary's performance.

An affiliated group of corporations generally is a parent corporation and all its domestic subsidiaries that are at least 80%-owned by the parent and other subsidiaries in the group (this topic will be discussed later in the chapter). The affiliated group has two options for filing its federal income tax returns:

- Each member of the group files a separate tax return that reports its own income, deductions, credits, and other items.¹
- The affiliated group files a single, consolidated tax return that reports a combined result for all its group members.

If the affiliated group elects to file a consolidated tax return, it does not merely add up the members' incomes, deductions, and other items. Instead, the group must make adjustments so that it generally is treated as if it were a single corporation, as discussed in more detail later in the chapter. For example, the capital gains and losses for all group members are netted to determine the deductibility of capital losses against capital gains rather than netting these items separately for each group member. The group also must make adjustments for transactions among themselves, called *intercompany transactions*, so the consolidated tax return reflects the correct amount of consolidated taxable income.

Some consolidated tax returns include as few as two corporations. Other consolidated tax returns include hundreds of corporations. Most of the nation's largest corporate groups file consolidated tax returns. In 2013, only 35,185 consolidated tax returns were filed, which was less than 3% of all Form 1120s filed. However, these tax returns reported more than 97% of total taxable income and paid more than 97% of total income taxes of all corporations filing Form 1120.²

This chapter discusses the requirements for a group of corporations to qualify as an affiliated group that can elect to file a consolidated tax return. It also explains several rules that pertain to computing consolidated taxable income and the consolidated tax liability. The discussion then turns to some issues that arise when corporations enter or leave an affiliated group that is filing a consolidated tax return, such as when subsidiaries are bought and sold. The chapter also considers the advantages and disadvantages of filing a consolidated tax return instead of separate tax returns and discusses some financial statement implications.

DEFINITION OF AN AFFILIATED GROUP

OBJECTIVE 1

Determine whether a group of corporations is an affiliated group

REQUIREMENTS

Stock Ownership Requirements. Only an affiliated group of corporations can elect to file a consolidated tax return. A group of corporations must satisfy the following stock ownership requirements to qualify as an affiliated group:

- The parent corporation must own directly at least 80% of the stock in one or more includible corporations (defined below).
- At least 80% of the stock of *each* corporation in the group (other than the parent corporation) must be owned directly by the parent corporation and other group members.

¹ If the affiliated group members file separate tax returns, some special tax rules apply because group members are related taxpayers under Sec. 267. These rules include, but are not limited to, matching of income and deductions (Sec. 267(a)(2)), deferral of loss on intragroup sales (Sec. 267(f)(2)),

and ordinary income recognition on intragroup sales of depreciable property (Sec. 1239). The members also may constitute a parent-subsidiary controlled group under Sec. 1563(a)(1). See Chapter C:3 for details.

² Internal Revenue Service, Statistics of Income Division (www.irs.gov).

- ▶ Both 80% stock ownership requirements must be satisfied in two ways for each includible corporation (other than the parent): the stock owned directly must be at least 80% of the total voting power of all the includible corporation's outstanding stock entitled to vote, and it must be at least 80% of the total value of all the includible corporation's outstanding stock.³

EXAMPLE C:8-1 ▶ P Corporation owns 95% of S1 Corporation's stock, and S1 owns 100% of S2 Corporation's stock. Unrelated individuals own the remainder of S1's stock. P, S1, and S2 comprise an affiliated group because P owns at least 80% of S1's stock, and S1 owns at least 80% of S2's stock. The P-S1-S2 affiliated group can elect to file a consolidated tax return with P as the common parent.⁴ ◀

EXAMPLE C:8-2 ▶ P Corporation owns 90% of S1 Corporation's stock and 35% of S2 Corporation's stock. S1 owns 50% of S2's stock. Unrelated individuals own the remainder of S1's and S2's stock. P, S1, and S2 comprise an affiliated group because P owns at least 80% of S1's stock, and P and S1 together own 85% (50% + 35%) of S2's stock. ◀

EXAMPLE C:8-3 ▶ Ted (an individual) owns all the stock of Alpha and Beta Corporations. Alpha and Beta are not an affiliated group because a parent-subsidary relationship is not present even though the same individual owns 100% of each corporation. Alpha and Beta cannot elect to file a consolidated tax return. The Tax Strategy Tip on page C:8-4 suggests ways to restructure the corporations so they qualify as an affiliated group. ◀

EXAMPLE C:8-4 ▶ S Corporation has 1,000 shares of common stock and 600 shares of preferred stock outstanding. Each share of common stock has two votes and is worth \$45. Each share of preferred stock has one vote and is worth \$75. P Corporation owns all 1,000 shares of S's common stock and 150 shares of S's preferred stock. Unrelated individuals own the remaining preferred stock.

The total voting power of S's stock is 2,600 [(1,000 × 2) + (600 × 1)] votes, and the total value of S's stock is \$90,000 [(1,000 × \$45) + (600 × \$75)]. P's ownership of S's stock possesses 2,150 [(1,000 × 2) + (150 × 1)] votes and is worth \$56,250 [(1,000 × \$45) + (150 × \$75)]. This ownership is 82.69% (2,150 ÷ 2,600) of S's total voting power and 62.50% (\$56,250 ÷ \$90,000) of the value of S's stock. Because both 80% stock ownership requirements are not met, P and S are not an affiliated group. ◀

BOOK-TO-TAX ACCOUNTING COMPARISON

The group of corporations included in a consolidated tax return may be quite different from the group of corporations included in a set of consolidated financial statements because of different stock ownership requirements and the different types of corporations that are included in or excluded from the groups. Page 1 of Schedule M-3 reconciles these differences (see Appendix B).

Includible Corporation Requirement. All corporations are includible except certain specified corporations having special tax statuses. Important types of corporations that are not includible are:

- ▶ Corporations exempt from tax under Sec. 501
- ▶ Life insurance companies subject to tax under Sec. 801⁵
- ▶ Foreign corporations⁶
- ▶ Regulated investment companies
- ▶ Real estate investment trusts
- ▶ S corporations

Most of the nation's largest corporations have a great number of subsidiaries, many of which are not part of an affiliated group because they are not includible corporations. Consequently, they cannot be included in a consolidated tax return, and they usually file their own separate corporate tax returns (if required to do so). Moreover, their stock ownership of other group members cannot be counted toward satisfying the 80% stock ownership requirement for an affiliated group.

³ When determining whether these stock ownership requirements are met, nonvoting preferred stock is ignored if it is limited and preferred as to dividends (and 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 (Sec. 1504(a)(4)).

⁴ All corporations in this chapter are includible corporations and have a single class of stock unless otherwise indicated.

⁵ Two or more Sec. 801 life insurance companies may elect to file a consolidated tax return. If an affiliated group contains one or more Sec. 801 domestic

life insurance companies, Sec. 1504(c)(2)(A) permits the parent corporation to elect to treat as includible corporations all such companies that have met the affiliated group stock ownership tests for the five immediately preceding tax years.

⁶ Section 1504(d) allows a domestic corporation to elect to treat a 100%-owned Canadian or Mexican corporation as a domestic corporation if such foreign corporation is maintained solely for the purpose of complying with local law regarding title and operation of property.

EXAMPLE C:8-5 ► P Corporation owns all the stock of S1 and S2 Corporations. S1 owns all of S3 Corporation's stock, and S2 (a foreign corporation) owns all of S4 Corporation's stock. S2 is not a member of the affiliated group because, as a foreign corporation, it is not an includible corporation. P, S1, S3, and S4 are includible corporations, but only P, S1, and S3 qualify as an affiliated group. Although S4 is an includible corporation, it is not a member of the affiliated group because the group's members (P, S1, and S3) do not own at least 80% of S4's stock. S2's ownership of S4's stock is disregarded because S2 is not an includible corporation even though S2 is wholly-owned by a group member. ◀

ADDITIONAL COMMENT

In Example C:8-5, P, S1, S3, and S4 (but not S2, generally) comprise a parent-subsidary controlled group. P constructively owns all of S4's stock for controlled group purposes but not for affiliated group purposes. Thus, S4 is in the same controlled group as P, S1, and S3 even though it is not in their affiliated group.

TYPICAL MISCONCEPTION

The terms *controlled group*, *affiliated group*, and *consolidated group* are easily confused. These terms have different definitions and applications.

TAX STRATEGY TIP

A brother-sister controlled group cannot file a consolidated tax return. One way to convert it into an affiliated group is for the owner(s) of one of the group's corporations to transfer 80% or more of the corporation's stock to one of its sibling corporations in a nontaxable transaction meeting the Sec. 351 requirements (see Chapter C:2). The two corporations, being in a parent-subsidary relationship, then can make the consolidated return election and begin filing on a consolidated basis. Alternatively, the owner(s) could transfer the stock of all the sibling corporations to a new corporation, e.g., a holding company that would be the common parent.

Under the check-the-box regulations discussed in Chapter C:2, noncorporate entities can elect to be treated as a corporation. A partnership or LLC that makes this election is an affiliated group member and is eligible to participate in a consolidated tax return provided it satisfies the stock ownership requirements and is an includible corporation (e.g., it does not elect to be treated as an S corporation). If a partnership or LLC does not elect to be treated as a corporation, it cannot be a member of the affiliated group and cannot participate in a consolidated tax return. Instead, the partnership's or LLC's income and losses pass through to each affiliated group member having an ownership interest in it.

COMPARISON WITH CONTROLLED GROUP DEFINITIONS

Chapter C:3 discusses the three types of controlled groups: parent-subsidary, brother-sister, and combined controlled groups. Special tax rules apply to controlled groups of corporations to prevent them from avoiding taxes. For example, when computing the accumulated earnings tax, a controlled group's members generally are limited to one \$250,000 accumulated earnings credit, which is apportioned among the group's members. A brother-sister controlled group cannot elect to file a consolidated tax return because it does not qualify as an affiliated group, as illustrated in Example C:8-3. However, a parent-subsidary controlled group and the parent-subsidary portion of a combined controlled group often also qualify as an affiliated group and can elect to file a consolidated tax return if they so qualify.

The criteria for a parent-subsidary controlled group and those for an affiliated group are similar but not identical. Differences in the criteria include:

- The stock ownership requirement for a parent-subsidary controlled group is at least 80% of voting power *or* value. For an affiliated group, it is at least 80% of voting power *and* value.
- Through stock attribution rules, stock owned by certain related persons is taken into account in determining whether a controlled group exists. They are not used to determine whether an affiliated group exists.
- The types of corporations excluded from a controlled group differ from those excluded from an affiliated group.
- The controlled group definition is tested only on December 31, but the affiliated group definition is tested on each day of the year.

Because of these differences, a corporation could be a member of a controlled group but not be a member of an affiliated group.

CONSOLIDATED TAX RETURN ELECTION

OBJECTIVE 2

Describe how an affiliated group makes a consolidated return election and how it discontinues the election

CONSOLIDATED RETURN REGULATIONS

A consolidated group is an affiliated group of corporations that files a consolidated tax return. The IRC contains very few rules pertaining to consolidated tax returns, and these few rules primarily address the composition of affiliated groups. Instead of enacting voluminous IRC rules, Congress gave the Treasury Department the authority to issue regulations addressing the determination of the consolidated tax liability and the filing of consolidated tax returns. Thus, the IRC allows an affiliated group to elect to file a consolidated

TYPICAL MISCONCEPTION

A corporation's tax year can be both a consolidated return year and a separate return year. For example, P1 Corporation sells all of S Corporation's stock to P2 Corporation at the end of Year 1. If P1 and S file a consolidated tax return for Year 1, Year 1 is a consolidated return year for S with respect to the P1-S consolidated group, but it is a separate return year with respect to the P2-S consolidated group.

ADDITIONAL COMMENT

Filing a consolidated income tax return does not affect the reporting of other taxes, such as payroll, sales, or property taxes. Also, some states do not allow the filing of consolidated tax returns for state income tax purposes.

tax return, but it does so on the condition that all the group's members abide by the consolidated return regulations.

Terminology. A consolidated return year is a corporation's tax year for which it files a consolidated tax return with the other members of its affiliated group. A separate return year is a corporation's tax year for which it files a separate tax return or files a consolidated tax return with another affiliated group. A corporation could have a separate return year because it was not a member of the affiliated group or because the group did not file a consolidated tax return.⁷

An affiliated group elects to file its tax return on a consolidated basis by filing a corporate tax return (Form 1120) that includes the income, expenses, etc. of all its members. The group must make the election no later than the due date for the common parent's tax return including any permitted extensions. Each corporation that is a member of the affiliated group during the initial consolidated return year must consent to the election. The Compliance and Procedural Considerations section later in this chapter provides further details about the election process.

TERMINATION OF CONSOLIDATED TAX RETURN FILING

Termination of the Affiliated Group. Once an affiliated group has elected to file a consolidated tax return, it must continue to file on a consolidated basis as long as the affiliated group exists unless the IRS permits it to file separate tax returns. An affiliated group "remains in existence for a tax year if the common parent remains as the common parent and at least one subsidiary that was affiliated with it at the end of the prior year remains affiliated with it at the beginning of the year."⁸ The parent corporation need not own the *same* subsidiary throughout the entire tax year nor own any subsidiary throughout the entire tax year as long as the parent owns a subsidiary at the beginning of the current tax year that it owned at the end of the prior tax year.

EXAMPLE C:8-6

P and S1 Corporations have filed a consolidated tax return for several calendar years. At the close of business on August 31 of the current year, P purchases all of S2 Corporation's stock. At the close of business on September 30, P sells all its S1 stock. The affiliated group, P-S1-S2, must file a consolidated tax return for the current year because P remained the common parent and at least one subsidiary that was affiliated with it at the end of the prior year remained affiliated with it at the beginning of the current year (i.e., S1).

Alternatively, assume the order of the purchase and sale transactions are reversed, i.e., P sells the S1 stock on August 31 and purchases the S2 stock on September 30. In this case, the affiliated group still must file a consolidated tax return for the current year. Even though P did not have a subsidiary from September 1 through September 30, it nevertheless remained as the common parent, and S1 was affiliated with it at the end of the prior year and at the beginning of the current year. In both cases, the consolidated tax return will include S1's and S2's income only for the portion of the year S1 and S2 were in the group. In addition, P and S2 generally will be required to file a consolidated tax return for the next year because their affiliated group has not terminated.

EXAMPLE C:8-7

P and S Corporations have filed a consolidated tax return for several calendar years. At the close of business on December 31 of the current year, P sells all its S stock to an unrelated individual. On January 1 of the next year, P purchases all of T Corporation's stock. P and S must file a consolidated tax return for the current year. However, the P-S affiliated group terminates at the end of the current year and a new affiliated group, P-T, forms in the next year. P and T may elect to file a consolidated tax return in the next year but are not required to do so.

ADDITIONAL COMMENT

The IRS seldom grants permission to discontinue the filing of consolidated tax returns when the request relates to a change in the tax situation of the affiliated group that is not related to a tax law change.

Good Cause Request to Discontinue Consolidation. The IRS may give an affiliated group permission to discontinue filing a consolidated tax return, even though the group remains in existence, if it makes a "good cause" request. The IRS ordinarily will grant the request if changes to the IRC or Treasury Regulations having effective dates in

⁷ Reg. Sec. 1.1502-1.

⁸ Reg. Sec. 1.1502-75(d)(1).

that tax year create a substantial adverse effect on the consolidated tax liability for the tax year (relative to what the aggregate tax liability would be if the group members filed separate tax returns).⁹

Effects on Former Members. The termination of a consolidated group affects its former members in several ways, two of which are examined later in this chapter.

- Any gains and losses that have been deferred on intercompany transactions (e.g., profits on inventory sales between group members) may have to be recognized under the acceleration rule.
- Consolidated tax attributes (e.g., NOLs, capital losses, tax credits, and charitable contribution carryovers) may have to be allocated among the former group members.

If a corporation departs an affiliated group and had been included in the group's consolidated tax return, it cannot be included again in the group's consolidated tax return (or that of another affiliated group with the same common parent corporation) until after the 60-month period beginning with the first tax year in which the corporation ceased to be a group member.¹⁰ The IRS can waive this five-year rule.

CONSOLIDATED TAXABLE INCOME

OBJECTIVE 3

Calculate consolidated taxable income for a consolidated group

ACCOUNTING PERIODS AND METHODS

Accounting Periods. Beginning with the first year the affiliated group files a consolidated tax return, each subsidiary corporation in the group must adopt the parent corporation's tax year, and the group must file its return using the parent's tax year. The requirement for a common tax year also applies when a new member joins the affiliated group, such as when its stock is acquired.¹¹ Unless the IRS grants permission otherwise, a subsidiary that leaves a consolidated group must retain its former group's tax year (or adopt the tax year of the acquiring consolidated group, if applicable).

Accounting Methods. Each group member determines the accounting methods it uses by applying the same rules as if it were filing a separate tax return unless the IRS grants it permission to change its accounting method.¹² This requirement applies when the group makes a consolidated tax return election and when a new corporation joins an existing consolidated group. Thus, one group member may use the cash method and another group member may use the accrual method with respect to the same consolidated tax return. The possibility of finding a mixture of cash and accrual basis corporations in an affiliated group is limited because of the Sec. 448 restrictions on the use of the cash method by C corporations (see Chapter C:3).

KEY POINT

Even though members of a consolidated group must use the same tax year-end, members are not required to use the same tax accounting methods. For example, different inventory methods (e.g., LIFO and FIFO) can occur within the same consolidated group.

INCOME INCLUDED IN THE CONSOLIDATED TAX RETURN

An affiliated group includes in its consolidated tax return the parent corporation's income for its entire tax year except for any part of the year it was a member of another affiliated group that filed a consolidated tax return. The group includes a subsidiary corporation's income in the consolidated tax return only for the part of the year that it was a group member. The subsidiary's income for any part of the year it was not a group member is included in its own separate tax return or the consolidated tax return of another affiliated group.¹³

EXAMPLE C:8-8 ►

P and S Corporations were unaffiliated prior to 2019 and filed separate tax returns. P uses a fiscal year ending May 31 as its tax year, and S uses a calendar year. At the close of business on February 12, 2019, P acquires all of S's stock, and the P-S affiliated group elects to file a

⁹ Reg. Sec. 1.1502-75(c).

¹⁰ Sec. 1504(a)(3).

¹¹ Reg. Sec. 1.1502-76(a).

¹² Reg. Sec. 1.1502-17(a).

¹³ Sec. 1501 and Reg. Sec. 1.1502-76(b)(1)(i).

consolidated tax return. S must change its tax year to a fiscal year ending May 31. The group's first consolidated tax return will include P's income for June 1, 2018, through May 31, 2019, and S's income for February 13, 2019, through May 31, 2019. S must file a separate, short-period tax return for January 1, 2019, through February 12, 2019. ◀

EXAMPLE C:8-9 ▶ P1 Corporation owns all of S Corporation's stock, and the two corporations have filed consolidated tax returns for several years on a calendar year basis. At the close of business on August 8 of the current year, P1 sells all of S's stock to P2 Corporation, which has a September 30 tax year. P2 has filed consolidated tax returns for several years with its other subsidiaries. S must change its tax year from a calendar year to a fiscal year ending September 30 when it leaves the P1 consolidated group and enters the P2 consolidated group. ◀

EXAMPLE C:8-10 ▶ P and S1 Corporations have filed consolidated tax returns for several calendar years. At the close of business on August 31 of the current year, P sells all its S1 stock to an unrelated individual. At the close of business on September 30 of the current year, P purchases all of S2 Corporation's stock from an unrelated individual. S2 had been using a fiscal year ending March 31 as its tax year. As discussed in Example C:8-6, the affiliated group, with P as the parent corporation, does not terminate. The current year's consolidated tax return includes P's income for the entire year, S1's income for January 1 through August 31 of the current year, and S2's income for October 1 through December 31 of the current year. S1 must file a short-period, separate tax return for September 1 through December 31 of the current year (unless the IRS grants it permission to change its tax year), and S2 must file a short-period, separate tax return for April 1 through September 30 of the current year. ◀

KEY POINT

Two basic rules determine what income must be included in a consolidated tax return: the common parent's income for the entire tax year and each subsidiary's income for the part of the tax year it is a member of the consolidated group.

A corporation that becomes or ceases to be a member of an affiliated group filing a consolidated tax return generally does so at the end of the day its status changes.¹⁴ A corporation entering the consolidated group will have to file a separate tax return (or participate in the consolidated tax return of the affiliated group in which it previously was a member), and this tax return often will be a short-period return, which is a return for less than one year. However, the separate tax return does not require annualization of the corporation's taxable income.¹⁵

A corporation entering a consolidated group does not have to change its tax year if it already is using the same tax year as the group. In this case, the group can elect to ratably allocate the entering member's income, except for extraordinary items, between the separate return and consolidated return portions of the year. The group also can make this election for a departing group member that does not have to change its tax year.¹⁶

WHAT WOULD YOU DO IN THIS SITUATION?



The P-S-T affiliated group has filed consolidated tax returns for many years using the calendar year as its tax year. On October 1, P Corporation created a new subsidiary, X Corporation, with a \$10,000 initial capital contribution, and X issued its stock to P. X opened a bank account and obtained a federal tax identification number. X did not conduct any business activities before year-end. Its only income was \$125 in interest earned from the bank account. Due to a lack of communication or oversight, P's tax department did not include X's income in the current year's consolidated tax return.

Your CPA firm has provided tax advice to P for several years, but P's tax department has handled the

federal tax return filings. Most of your work for P has been in the state and local tax area and on special federal tax assignments. You were aware of the affiliated group's future business plans for creating X. Will the oversight with respect to X disqualify the group from filing a consolidated tax return for the current year and future years? Can you avoid having to file a federal income tax return for X because of the small amount of its income? Does the failure to include X in this year's consolidated tax return prevent it from being included in future years? What advice can you give your client about needing to include X in the consolidated tax return?

¹⁴ Reg. Sec. 1.1502-76(b)(1)(ii)(A).

¹⁵ Reg. Sec. 1.1502-76(b)(2)(i).

¹⁶ Reg. Sec. 1.1502-76(b)(2)(ii). The group can make this election only if the entering corporation does not have to change its accounting method (e.g.,

entering the group allows the corporation to retain the cash method because the group's gross receipts do not exceed the \$26 million limit (in 2019).

EXAMPLE C:8-11 ► P Corporation acquires all the stock of S Corporation on February 26 of the current year (the 57th day of the year, which is not a leap year). P has been filing consolidated tax returns on a calendar year basis for several years with its other subsidiaries. S previously was unaffiliated and had been filing separate tax returns using a calendar year. S's income for the current year is \$730,000 and includes no extraordinary items. The consolidated group can elect to ratably allocate the \$730,000 because S does not have to change its tax year when entering the group. If it so elects, \$114,000 ($\$730,000 \times (57 \text{ days} \div 365 \text{ days})$) will be allocated to S's separate tax return for January 1 through February 26, and the other \$616,000 ($\$730,000 \times (308 \text{ days} \div 365 \text{ days})$) will be allocated to the consolidated tax return for the current year. ◀

If the consolidated group does not elect to ratably allocate an entering or departing group member's income, the group must allocate the member's income according to its accounting method, i.e., a closing of its books. This treatment also applies to extraordinary items, even if a ratable allocation is elected, and to an entering or departing member that must change its tax year. Extraordinary items include capital gains and losses, Sec. 1231 gains and losses, NOL carryovers, and several other items that are beyond the scope of this textbook.

CALCULATION OF CONSOLIDATED TAXABLE INCOME AND TAX

To arrive at its consolidated federal income tax liability, the group first must calculate consolidated taxable income. The process is more complicated than merely adding the consolidated group members' taxable incomes and losses. Instead, the group must make adjustments so that it generally is treated as if it were a single corporation. The calculation of consolidated taxable income involves the five steps presented in Table C:8-1. Later in the chapter, after discussing the various components of consolidated taxable income, we will discuss the consolidated tax calculation.

INTERCOMPANY TRANSACTIONS

OBJECTIVE 4

Apply the rules for reporting intercompany transactions

Corporations in an affiliated group filing a consolidated tax return may engage in transactions with each other. The discussion here usually will designate the two consolidated group members involved in the intercompany transaction as S and B Corporations instead of the usual P and S Corporations. This designation makes it easier to remember which group member is the seller (S) or provider of services and which group member is the buyer (B) or recipient of services.

BASIC CONCEPTS

An **intercompany transaction** is a transaction between two corporations that are in the same consolidated group immediately after the transaction.¹⁷ Intercompany transactions include:

- S's sale, exchange, contribution, or other transfer of property to B whether or not S recognizes gain or loss
- S's performance of services for B, and B's payment or accrual of its expense for the services
- S's licensing of technology, renting of property, or lending of money to B, and B's payment or accrual of its expense for these items
- A distribution by a subsidiary to its parent corporation in connection with the parent's investment in the subsidiary's stock, such as a dividend or a redemption

In general, S and B are treated as separate entities. S and B each report on their own books any income, gains, deductions, and losses related to intercompany transactions using the same basic rules that would apply if they were unaffiliated corporations. For

¹⁷ Reg. Sec. 1.1502-13(b)(1)(i).

▼ **TABLE C:8-1**
Consolidated Taxable Income Calculation

<p>Step 1: Compute each group member's taxable income (or loss) based on the member's own accounting methods as if it were filing its own separate tax return.</p> <p>Step 2: Adjust each group member's taxable income as follows:</p> <ol style="list-style-type: none"> 1. Income, gains, and losses on intercompany transactions occurring in the current year may be deferred until a later year. 2. Income, gains, and losses on intercompany transactions occurring in prior years may be taken into account in the current year. 3. Dividends received by one group member from another group member are excluded from the recipient's gross income. <p>Step 3: Remove certain items from each member's taxable income because they must be computed on a consolidated basis (see Step 5):</p> <ol style="list-style-type: none"> 1. Section 1231 gains and losses 2. Capital gains and losses 3. Charitable contributions deduction 4. Dividends-received deduction 5. Net operating loss (NOL) deduction <p>The result of making the adjustments to a member's taxable income in Steps 2 and 3 is the member's separate taxable income (loss).</p> <p>Step 4: Combine the members' separate taxable incomes and losses. This amount is called the group's combined taxable income.</p> <p>Step 5: Adjust the group's combined taxable income for the following items computed on a consolidated basis (see Step 3):</p> <ol style="list-style-type: none"> 1. Determine the consolidated net Sec. 1231 gain or loss. Add any net Sec. 1231 gain treated as ordinary income due to the five-year lookback rule, or deduct any net Sec. 1231 loss as an ordinary loss. 2. Determine the consolidated net capital gain or loss (taking into account any capital loss carrybacks and carryovers and any net Sec. 1231 gain not treated as ordinary income). Add the consolidated net capital gain to combined taxable income. 3. Determine and deduct the consolidated charitable contribution deduction (taking into account any charitable contribution carryovers). 4. Determine and deduct the consolidated dividends-received deduction. 5. Determine and deduct the consolidated NOL deduction (taking into account any allowable NOL carryovers). <hr/> <p>Consolidated taxable income (or consolidated NOL)¹⁸</p> <hr/>
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example, if B purchases some property from S for cash, B's adjusted basis in the property would be B's cost to acquire it, and B's holding period for it would begin the day after B purchases the property.

To determine consolidated taxable income, S and B give special treatment to income, gains, deductions, and losses related to intercompany transactions. Specifically, the consolidated return regulations usually require that S's income, gains, deductions, or losses be deferred, and therefore excluded, in determining consolidated taxable income until a subsequent event occurs for B. These subsequent events include the following situations:

- ▶ B sells property it acquired in an intercompany transaction to a party outside the consolidated group.
- ▶ S or B leaves the consolidated group while B still owns property it acquired from S in an intercompany transaction.
- ▶ B claims a depreciation, depletion, or amortization deduction on property it acquired in an intercompany transaction.

¹⁸ Reg. Sec. 1.1502-11.

- The corporations in an affiliated group discontinue filing a consolidated tax return and begin filing separate tax returns.

The intercompany transaction rules, in effect, have the members calculate consolidated taxable income as though S and B were a single entity. That is, if S and B were two divisions of a single corporation, any transactions between them would not affect the single corporation's taxable income. Likewise, consolidated taxable income should reflect only the consolidated group's income, gains, deductions, and losses from transactions with parties outside the group. The intercompany transaction rules adjust the consolidated group members' income, gains, deductions, and losses related to intercompany transactions, which the members reported on their separate books. Thus, the intercompany adjustments transform separate entity treatment into single entity treatment for calculating consolidated taxable income. This coexistence of separate entity treatment and single entity treatment is a challenging aspect of consolidated tax returns.

EXAMPLE C:8-12 ► S and B Corporations are members of a consolidated group. S owns marketable securities having a \$120,000 basis. S sells the securities to B in the current year for \$200,000 cash. S's \$80,000 (\$200,000 – \$120,000) gain is determined and reported on its books on a separate entity basis in the current year. However, the \$80,000 gain is not included in the current year's consolidated taxable income. On a single entity basis, the consolidated group did not sell the securities to an outside party, so it makes an adjustment to remove the gain from consolidated taxable income in the current year. B's basis in the securities is its \$200,000 cost, and B's holding period begins the day after it purchases the securities from S. The group will take the \$80,000 gain into account for consolidated taxable income at a later time, in accordance with the matching and acceleration rules discussed below. ◀

MATCHING AND ACCELERATION RULES

Treasury Regulations have two principal rules regarding intercompany transactions: the matching rule and the acceleration rule. Unlike many tax rules, the matching and acceleration rules are not detailed and mechanical. Instead, they are broad and conceptual, thereby allowing enough flexibility to apply to the wide variety of intercompany transactions that arise in practice.¹⁹ The purpose of the intercompany transaction rules is to clearly reflect a consolidated group's taxable income by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income.²⁰ The following three terms will be used in the discussion of the intercompany transaction rules:²¹

- **Intercompany item:** S's income, gain, deduction, and loss from an intercompany transaction
- **Corresponding item:** B's income, gain, deduction, and loss from an intercompany transaction or from property acquired in an intercompany transaction
- **Recomputed corresponding item:** The corresponding item B would take into account if S and B were divisions of a single corporation and the transaction occurred between those divisions

EXAMPLE C:8-13 ► S and B Corporations are members of a consolidated group. S owns property having a \$70 basis. S sells this property to B for \$100. A few years later, B sells the property to a third party for \$110. The sale from S to B is an intercompany transaction. The intercompany item is S's \$30 (\$100 – \$70) gain on its sale of the property to B. The corresponding item is B's \$10 (\$110 – \$100) gain on its sale of the property to the third party. The recomputed corresponding item is the \$40 (\$110 – \$70) gain that B would realize on the sale to the third party had S and B been divisions of a single corporation. ◀

ADDITIONAL COMMENT

The intercompany transaction rules are an excellent example of the additional recordkeeping necessary to file consolidated tax returns.

Matching Rule. To determine consolidated taxable income, the matching rule requires a consolidated group to take into account an intercompany item in a manner that produces the same result as if the transaction were between two divisions of a single

¹⁹ Preamble to T.D. 8597.

²⁰ Reg. Sec. 1.1502-13(a)(1).

²¹ Reg. Secs. 1.1502-13(b)(2), (3), and (4).

corporation.²² That is, the amount of S's intercompany item taken into account for consolidated taxable income is such that, when combined (i.e., matched) with B's corresponding item, the result is the same as if the consolidated group were a single corporation. The amount of S's intercompany item taken into account for consolidated taxable income can be calculated as follows:

$$\begin{array}{r} \text{Amount of recomputed corresponding item} \\ \text{Minus: Amount of B's corresponding item} \\ \hline \text{Amount of S's intercompany item taken into account for consolidated taxable income} \end{array}$$

Working backwards from the desired outcome for consolidated taxable income, the starting point of the calculation is the amount of the recomputed corresponding item. The portion of the desired outcome comprised of B's corresponding item is subtracted out, leaving the amount of S's intercompany item that needs to be taken into account.²³

EXAMPLE C:8-14 ▶ S and B Corporations are members of a consolidated group. S owns property having a \$150 basis. S sells this property to B for \$200 in Year 1. In Year 3, B sells the property to an unrelated corporation, X, for \$215.

S's intercompany item is the \$50 ($\$200 - \150) gain on its sale of the property to B. B's corresponding item is the \$15 ($\$215 - \200) gain in Year 3 on its sale of the property to X. The recomputed corresponding item is the \$65 ($\$215 - \150) gain in Year 3 that B would realize on the sale to X had S and B been divisions of a single corporation.

Year 1: If S and B were two divisions of a single corporation, the single corporation would realize no gain or loss, so the recomputed corresponding item for Year 1 is zero. B has no gain or loss in Year 1, so its corresponding item is zero. Thus, none of S's gain is taken into account for consolidated taxable income.

Year 3: If S and B were two divisions of a single corporation, it would realize a \$65 gain. Subtracting B's \$15 corresponding item from this \$65 recomputed corresponding item yields the \$50 amount of S's intercompany item taken into account for Year 3. Thus, recognition of S's \$50 gain in Year 1 is deferred for consolidated taxable income until Year 3. In Year 3, S's \$50 gain is matched with B's \$15 gain to produce the \$65 gain that accrued while the group held the property. ◀

EXAMPLE C:8-15 ▶ Assume the same facts as in Example C:8-14 except B sells the property to X for \$180. The intercompany item again is S's \$50 gain. However, B's corresponding item now is a \$20 ($\$180 - \200) loss, and the recomputed corresponding item is a \$30 ($\$180 - \150) gain.

TAX STRATEGY TIP

A member of a consolidated group should consider selling property with a built-in loss to a party outside the group rather than to another group member. For example, S Corporation owns Sec. 1231 property with a \$15,000 adjusted basis and a \$9,000 FMV. If S sells the property to another group member, the \$6,000 loss will not be deducted for consolidated taxable income until a later time. If S sells the property to an unrelated third party, the \$6,000 loss will be deductible immediately for consolidated taxable income. Thus, the income tax savings from the \$6,000 loss is accelerated.

Year 1: The property has not yet been sold outside the group, and B has not yet sold the property, so the recomputed corresponding item and B's corresponding item are both zero. None of S's gain is taken into account for consolidated taxable income.

Year 3: The property now has been sold to a person outside the consolidated group. Subtracting B's corresponding item (\$20 loss) from the recomputed corresponding item (\$30 gain) results in all of S's \$50 intercompany item being taken into account for consolidated taxable income ($\$30 - (-\$20) = \$50$). Note that a negative number is being subtracted because B's corresponding item is a loss. In summary, S's \$50 gain is matched with B's \$20 loss to produce the net \$30 gain that accrued while the group held the property. ◀

Acceleration Rule. In some situations, it may not be possible to match S's intercompany item with B's corresponding item to produce the same outcome as if S and B were two divisions of a single corporation. For example, S may sell property to B while they are members of the same consolidated group, but B then departs the group before it has sold the property. In this situation, B's corresponding item will occur when B is outside the consolidated group, so it cannot be matched with S's intercompany item. The acceleration rule requires that the consolidated group take into account S's intercompany item immediately before the time it first becomes impossible to apply the matching rule.²⁴

²² Reg. Sec. 1.1502-13(c).

²³ In addition to the timing of income, gain, deduction, or loss, the matching rule requires that various other attributes be redetermined, such as the character and source of such amounts.

²⁴ Reg. Sec. 1.1502-13(d).

EXAMPLE C:8-16 ► Assume the same facts as in Examples C:8-14 and C:8-15 except P, the common parent of S and B, sells all of its B stock to an unrelated corporation, Y, on June 4 of Year 2, which is before B sells the property to X. On that date, B departs the consolidated group, so it becomes impossible to match B's subsequent corresponding item in Year 3 with S's intercompany item. This situation triggers the acceleration rule, and the portion of S's intercompany item that has not yet been taken into account, which is all \$50, is taken into account in Year 2, immediately before the stock sale on June 4. ◀

APPLICATIONS OF MATCHING AND ACCELERATION RULES

The matching and acceleration rules are two principles used to implement the single entity approach to reporting intercompany transactions. The discussion below provides several examples to illustrate the two rules. Unless otherwise stated, S Corporation and B Corporation are in the same affiliated group, with P Corporation as their common parent. Also, the group has filed consolidated tax returns for several years on a calendar year basis.

EXAMPLE C:8-17 ► S purchased 1,000 shares of publicly traded stock as an investment several years ago for \$175,000. In the current year (Year 1), S sells all the stock to B for \$200,000. B sells 400 shares of the stock (40%) to a third party for \$78,000 in Year 3, and B sells the other 600 shares (60%) to another third party for \$134,000 in Year 5. S's intercompany item is its \$25,000 (\$200,000 – \$175,000) gain on the sale to B. The timing of and extent to which S's intercompany item is taken into account for consolidated taxable income is as follows:

Year 1: No corresponding item or recomputed corresponding item occurs this year because B has not yet sold the stock. Therefore, none of S's \$25,000 gain is taken into account.

Year 3: B's corresponding item is its \$2,000 ($\$78,000 - (40\% \times \$200,000)$) loss on the sale of 400 shares to the third party. From the perspective of a single entity, the consolidated group acquired the 400 shares for \$70,000 ($40\% \times \$175,000$) and sold them for \$78,000, producing an \$8,000 gain (the recomputed corresponding item). To achieve this result in consolidated taxable income, \$10,000 of S's intercompany item is taken into account. The \$10,000 gain, when matched with B's \$2,000 loss, results in the \$8,000 gain.

Year 5: B's corresponding item is its \$14,000 ($\$134,000 - (60\% \times \$200,000)$) gain on the sale of the 600 shares. The recomputed corresponding item, from a single-entity perspective, is a \$29,000 gain ($\$134,000 - (60\% \times \$175,000)$). The remaining \$15,000 ($\$25,000 - \$10,000$) of S's gain is taken into account. The matching of this \$15,000 with B's \$14,000 corresponding item produces a \$29,000 gain in consolidated taxable income, which is the outcome that would occur if S and B were two divisions of a single corporation. ◀

The timing and extent to which S's \$25,000 gain in Example C:8-17 is taken into account for consolidated taxable income can be determined by applying the formula for the matching rule.

ADDITIONAL COMMENT

Note that, for Year 3, a negative \$2,000 is subtracted, which is equivalent to adding \$2,000. Subsequent examples of this type use similar notation.

	<u>Year 1</u>	<u>Year 3</u>	<u>Year 5</u>
Recomputed corresponding item	\$-0-	\$ 8,000	\$29,000
Minus: B's corresponding item	-0-	(-2,000)	(14,000)
S's intercompany item taken into account	<u>\$-0-</u>	<u>\$10,000</u>	<u>\$15,000</u>

The consolidated group can report the three sales made by S and B in Example C:8-17 by using a worksheet format such as that illustrated in the consolidated tax return example in Appendix B (see partial worksheet below). Each transaction initially is reported in the selling corporation's separate tax return column. The adjustments for the deferred gain on S's sale of the stock to B appear as negative and positive entries in the adjustments and eliminations column of the worksheet. The Year 1 negative adjustment removes the \$25,000 gain realized on the intercompany transaction from Year 1 consolidated taxable income. The Year 3 and Year 5 positive adjustments restore the deferred gain when B sells the stock outside the consolidated group.

<u>Transaction</u>	<u>Consolidated Taxable Income</u>	<u>Adjustments & Eliminations</u>	<u>S Corporation's Separate Reporting</u>	<u>B Corporation's Separate Reporting</u>
S's sale to B in Year 1	\$ -0-	\$(25,000)	\$25,000	
B's sale to third party in Year 3	8,000	10,000		\$(2,000)
B's sale to third party in Year 5	<u>29,000</u>	<u>15,000</u>		<u>14,000</u>
Total	<u>\$37,000</u>	<u>\$ -0-</u>	<u>\$25,000</u>	<u>\$12,000</u>

EXAMPLE C:8-18 ▶ Assume the same facts as in Example C:8-17 except S's and B's common parent corporation, P, sells all its B stock to a third party in Year 4. B's departure from the consolidated group triggers the acceleration rule in Year 4 because it is not possible to match B's subsequent corresponding item with the \$15,000 portion of S's intercompany item that has not yet been taken into account. Thus, the \$15,000 is included in Year 4 consolidated taxable income rather than Year 5 consolidated taxable income. B still has a \$14,000 gain in Year 5, but B includes the gain in its separate tax return (or the consolidated tax return of the affiliated group to which B belongs at that time). The \$15,000 inclusion in Year 4 consolidated taxable income would be the same if the common parent sold all of S's stock in Year 4 rather than all of B's stock. ◀

Installment Sale of Property from Buyer to Third Party. Under the installment method, if some or all of the proceeds from the sale of property are to be received after the taxable year of sale, the seller spreads recognition of any gain on the sale over the years it collects the proceeds (see Chapter I:11). The installment method does not apply if the seller realizes a loss. Also, in a gain situation, the seller can elect to not use the installment method. Applying the matching rule to an installment sale requires an understanding of how the installment method operates on both a separate and single entity basis.

EXAMPLE C:8-19 ▶ S owns land having a \$64,000 basis. In Year 1, S sells the land to B for \$90,000. In Year 3, B sells the land to a third party for \$100,000. The third party is to pay B \$60,000 of the \$100,000 in Year 4 and the remaining \$40,000 in Year 5. B charges the third party an interest rate acceptable to the IRS on the unpaid balance.

Because S's sale of the land to B is an intercompany transaction, S's \$26,000 (\$90,000 – \$64,000) gain on the sale will not be taken into account until a later time. When B sells the property in Year 3, it realizes a \$10,000 (\$100,000 – \$90,000) gain. Under the installment method, B's gross profit percentage on the sale is 10% (\$10,000 ÷ \$100,000), so B has a \$6,000 (10% × \$60,000) corresponding item in Year 4 and a \$4,000 (10% × \$40,000) corresponding item in Year 5. From the perspective of a single entity, the consolidated group acquired the land for \$64,000 and sold it for \$100,000, which produces a \$36,000 gain. The group's gross profit percentage is 36% (\$36,000 ÷ \$100,000), so the recomputed corresponding items are \$21,600 (36% × \$60,000) in Year 4 and \$14,400 (36% × \$40,000) in Year 5.

S's \$26,000 gain on the intercompany transaction is taken into account for consolidated taxable income such that, when matched with B's corresponding items, they combine to be the same as the recomputed corresponding items as follows:

	<u>Year 1</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Recomputed corresponding item	\$-0-	\$-0-	\$21,600	\$14,400
Minus: B's corresponding item	-0-	-0-	(6,000)	(4,000)
S's intercompany item taken into account	<u>\$-0-</u>	<u>\$-0-</u>	<u>\$15,600</u>	<u>\$10,400</u> ◀

In Example C:8-19, all of S's \$26,000 gain is removed in the calculation of Year 1 consolidated taxable income, \$15,600 of it is restored in the calculation of Year 4 consolidated taxable income, and the other \$10,400 of it is restored in Year 5.²⁵

²⁵ Reg. Sec. 1.1502-13(c)(7) Example 5.

<u>Transaction</u>	<u>Consolidated Taxable Income</u>	<u>Adjustments & Eliminations</u>	<u>S Corporation's Separate Reporting</u>	<u>B Corporation's Separate Reporting</u>
S's sale to B in Year 1	\$ -0-	\$(26,000)	\$26,000	
B's sale to third party in Year 3	-0-			
B's collection of first installment in Year 4	21,600	15,600		\$ 6,000
B's collection of second installment in Year 5	14,400	10,400		4,000
Total	<u>\$36,000</u>	<u>\$ -0-</u>	<u>\$26,000</u>	<u>\$10,000</u>

EXAMPLE C:8-20 ► Assume the same facts as in Example C:8-19 except B sells the land to a third party for \$80,000 in Year 3. The third party is to pay B \$48,000 of the \$80,000 in Year 4 and the remaining \$32,000 in Year 5. B's corresponding item is now its \$10,000 (\$80,000 - \$90,000) loss in Year 3. The installment method does not apply to losses, so B reports the entire loss in the year of sale. From a single entity perspective, the consolidated group realizes a \$16,000 (\$80,000 - \$64,000) gain, which produces a 20% (\$16,000 ÷ \$80,000) gross profit percentage. The group's recomputed corresponding items are \$9,600 (20% × \$48,000) in Year 4 and \$6,400 (20% × \$32,000) in Year 5. S's \$26,000 gain on the intercompany transaction taken into account for consolidated taxable income is determined as follows:

	<u>Year 1</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Recomputed corresponding item	\$-0-	\$ -0-	\$9,600	\$6,400
Minus: B's corresponding item	-0-	(-10,000)	-0-	-0-
S's intercompany item taken into account	<u>\$-0-</u>	<u>\$10,000</u>	<u>\$9,600</u>	<u>\$6,400</u> ◀

Example C:8-20 illustrates the process underlying the matching rule. It requires an understanding of how the transactions affect each of the group members on a separate entity basis and how the transactions would affect the corporations in the consolidated group if they were a single entity. Applying the same worksheet format used above, Example C:8-20 is presented as:

<u>Transaction</u>	<u>Consolidated Taxable Income</u>	<u>Adjustments & Eliminations</u>	<u>S Corporation's Separate Reporting</u>	<u>B Corporation's Separate Reporting</u>
S's sale to B in Year 1	\$ -0-	\$(26,000)	\$26,000	
B's sale to third party in Year 3	-0-	10,000		\$(10,000)
B's collection of first installment in Year 4	9,600	9,600		
B's collection of second installment in Year 5	6,400	6,400		
Total	<u>\$16,000</u>	<u>\$ -0-</u>	<u>\$26,000</u>	<u>\$(10,000)</u>

BOOK-TO-TAX ACCOUNTING COMPARISON

The intercompany rental income and expense in Example C:8-21 are eliminated in preparing the consolidated financial statements.

Performance of Services. Some intercompany transactions involve one consolidated group member performing services for another group member. For example, one group member may rent property or lend money to another group member. The matching rule generally applies in a manner similar to that for intercompany property transactions, matching S's intercompany item to B's corresponding item so their net effect results in the recomputed corresponding item.

EXAMPLE C:8-21 ▶ S rents land to B for \$25,000 per year. S and B both use the accrual method of accounting. S's rental income is its intercompany item, and B's rental expense is its corresponding item. The recomputed corresponding item is zero because, from the perspective of a single corporation with divisions S and B, the single entity would have no rental income or expense. The group will take into account \$25,000 ($\$0 - (-\$25,000)$) of S's annual rental income as B reports the \$25,000 annual rental expense. Note that B's corresponding item is negative because it is an expense. S's rental income and B's rental expense are recognized simultaneously for consolidated taxable income and thus offset each other. ◀

EXAMPLE C:8-22 ▶ On March 1 of Year 1, S lends B \$100,000 for one year. B pays the \$100,000 debt, plus 12% annual interest, to S on March 1 of Year 2. S and B each use the accrual method of accounting. In determining their separate taxable incomes, S reports interest income of \$10,000 ($\$100,000 \times 12\% \times 10/12$) in Year 1 and \$2,000 ($\$100,000 \times 12\% \times 2/12$) in Year 2, and B reports interest expense of \$10,000 in Year 1 and \$2,000 in Year 2. The recomputed corresponding item is zero in Year 1 and in Year 2. Application of the matching rule results in S's intercompany items being reported in consolidated taxable income at the same time S reports them in its separate taxable income.

	<u>Year 1</u>	<u>Year 2</u>
Recomputed corresponding item	\$ -0-	\$ -0-
Minus: B's corresponding item	<u>(-10,000)</u>	<u>(-2,000)</u>
S's intercompany item taken into account	<u>\$ 10,000</u>	<u>\$ 2,000</u>

Applying the worksheet format used for the earlier intercompany transactions, S and B report the interest income and expense as follows:

<u>Year</u>	<u>Consolidated Taxable Income</u>	<u>Adjustments & Eliminations</u>	<u>S Corporation's Separate Reporting</u>	<u>B Corporation's Separate Reporting</u>
Year 1	\$-0-		\$10,000	\$(10,000)
Year 2	<u>-0-</u>		<u>2,000</u>	<u>(2,000)</u>
Total	<u>\$-0-</u>		<u>\$12,000</u>	<u>\$(12,000)</u>

If S and B use different accounting methods, they might not report their respective sides of the intercompany transaction at the same time in determining their separate taxable incomes. The principle of the matching rule still applies, with S's intercompany item being matched with B's corresponding item.

EXAMPLE C:8-23 ▶ Assume the same facts as in Example C:8-22 except B uses the cash method of accounting. For its separate books, S reports interest income of \$10,000 in Year 1 and \$2,000 in Year 2, and B reports interest expense of \$0 in Year 1 and \$12,000 in Year 2. For consolidated taxable income, all \$12,000 of S's interest income is reported in Year 2 under the matching rule.

	<u>Year 1</u>	<u>Year 2</u>
Recomputed corresponding item	\$-0-	\$ -0-
Minus: B's corresponding item	<u>-0-</u>	<u>(-12,000)</u>
S's intercompany item taken into account	<u>\$-0-</u>	<u>\$ 12,000</u>

ADDITIONAL COMMENT

Corporations filing a consolidated tax return are related parties under Sec. 267 because they also are members of the same controlled group. One consequence of their related status is that B cannot deduct its expense from an intercompany transaction with S before S reports its income from the transaction. This rule also can apply to transactions with corporations that are in the same controlled group but not the same consolidated group, such as brother-sister corporations.

Applying the worksheet format used previously, S and B report the interest income and expense as follows:

<u>Year</u>	<u>Consolidated Taxable Income</u>	<u>Adjustments & Eliminations</u>	<u>S Corporation's Separate Reporting</u>	<u>B Corporation's Separate Reporting</u>
Year 1	\$-0-	\$(10,000)	\$10,000	\$ -0-
Year 2	-0-	10,000	2,000	(12,000)
Total	<u>\$-0-</u>	<u>\$ -0-</u>	<u>\$12,000</u>	<u>\$(12,000)</u>

In some circumstances, B might capitalize its expenditure for the services S provides. B's corresponding item still would be its income, gain, deduction, and loss from an intercompany transaction or from property in an intercompany transaction. However, the corresponding item might occur at a time later than S's intercompany item, requiring that some or all of S's intercompany item be deferred under the matching rule.

EXAMPLE C:8-24 ►

S operates a drilling business, and B operates a farming business. S and B both use the accrual method of accounting. In Year 1, S drills a water well and charges B \$9,000 for the service. S incurs \$8,000 of expenses in drilling the well, realizing a \$1,000 profit. B capitalizes the \$9,000 cost of its well and amortizes it over the four-year period Years 2 through 5.

From a single entity perspective, the group's cost of the well is \$8,000, so its recomputed corresponding item is \$2,000 ($\$8,000 \div 4$ years) for each of Years 2 through 5. B's annual corresponding item is its \$2,250 ($\$9,000 \div 4$ years) amortization deduction. S's \$1,000 intercompany item is reported for consolidated taxable income as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Recomputed corresponding item	\$-0-	\$(2,000)	\$(2,000)	\$(2,000)	\$(2,000)
Minus: B's corresponding item	-0-	(-2,250)	(-2,250)	(-2,250)	(-2,250)
S's intercompany item taken into account	<u>\$-0-</u>	<u>\$ 250</u>	<u>\$ 250</u>	<u>\$ 250</u>	<u>\$ 250</u>

<u>Transaction</u>	<u>Consolidated Taxable Income</u>	<u>Adjustments & Eliminations</u>	<u>S Corporation's Separate Reporting</u>	<u>B Corporation's Separate Reporting</u>
Drilling of well in Year 1	\$ -0-	\$(1,000)	\$1,000	
Amortization deductions:				
Year 2	(2,000)	250		\$(2,250)
Year 3	(2,000)	250		(2,250)
Year 4	(2,000)	250		(2,250)
Year 5	(2,000)	250		(2,250)
Total	<u>\$(8,000)</u>	<u>\$ -0-</u>	<u>\$1,000</u>	<u>\$(9,000)</u>

Intercompany Sale of Inventory. Many consolidated groups have sales of inventory within the group. For example, one group member (S) may manufacture goods and sell them to another group member (B). B subsequently resells the goods to third-party customers. The matching rule applies in this situation and allows the consolidated group to defer taxation of profit from the intercompany transaction until B sells the inventory to a third party.²⁶

EXAMPLE C:8-25 ►

P, S, and B Corporations comprise a consolidated group with P being the common parent of subsidiaries S and B. S begins selling inventory items to B in Year 1, and both subsidiaries use the first-in, first-out (FIFO) inventory method. Information and treatment regarding S's inventory sales to B during Years 1 and 2 follow:

²⁶ Reg. Sec. 1.1502-13(e)(1) provides simplifying rules for intercompany inventory sales when S or B uses a dollar-value LIFO method to account for intercompany transactions.

Year 1: S sells inventory to B for \$400,000. The cost of this inventory to S was \$300,000. Thus, S realizes a profit of \$100,000 ($\$400,000 - \$300,000$) on the sale, which is S's intercompany item. During the year, B sells 88% of this inventory to third parties for \$414,000. B's cost for this inventory is \$352,000 ($\$400,000 \times 0.88$). Thus, B realizes a profit of \$62,000 ($\$414,000 - \$352,000$) on the sale to third parties, which is B's corresponding item. S's cost for this same inventory had been \$264,000 ($\$300,000 \times 0.88$). Thus, S realized a profit of \$88,000 ($\$352,000 - \$264,000$) when it sold this portion of the inventory to B, which is S's intercompany item taken into account. From the perspective of a single entity, the consolidated group realizes a profit of \$150,000 ($\$414,000 - \$264,000$) on the sale to third parties, which is the recomputed corresponding item. At year-end, B's inventory includes the remaining 12% of inventory it purchased from S in Year 1. B's cost in this remaining inventory is \$48,000 ($\$400,000 \times 0.12$), and S's cost for this same inventory was \$36,000 ($\$300,000 \times 0.12$). Thus, the remaining inventory contains a deferred profit of \$12,000 ($\$48,000 - \$36,000$). Applying the matching rule, these transactions are summarized as follows:

Recomputed corresponding item	\$150,000
Minus: B's corresponding item	(62,000)
S's intercompany item taken into account	<u>\$ 88,000</u>

Year 2: B sells to third parties the remaining inventory it purchased from S in Year 1. The selling price is \$55,000 and is deemed sold first in Year 2 under FIFO. Thus, B realizes a profit of \$7,000 ($\$55,000 - \$48,000$) on this sale. From the perspective of a single entity, the consolidated group realizes a profit of \$19,000 ($\$55,000 - \$36,000$) on this sale to third parties.

Also in Year 2, S sells additional inventory to B for \$550,000. The cost of this inventory to S was \$420,000. Thus, S realizes a profit of \$130,000 ($\$550,000 - \$420,000$) on the sale. During the year, B sells 80% of this inventory to third parties for \$515,000. B's cost for this inventory is \$440,000 ($\$550,000 \times 0.80$). Thus, B realizes a profit of \$75,000 ($\$515,000 - \$440,000$) on the sale to third parties. S's cost for this same inventory had been \$336,000 ($\$420,000 \times 0.80$). Thus, S realized a profit of \$104,000 ($\$440,000 - \$336,000$) when it sold this portion of the inventory to B. From the perspective of a single entity, the consolidated group realizes a profit of \$179,000 ($\$515,000 - \$336,000$) on this sale to third parties. At year-end, B's inventory includes the remaining 20% of inventory it purchased from S in Year 2. B's cost in this remaining inventory is \$110,000 ($\$550,000 \times 0.20$), and S's cost for this same inventory was \$84,000 ($\$420,000 \times 0.20$). Thus, the remaining inventory contains a deferred profit of \$26,000 ($\$110,000 - \$84,000$). Applying the matching rule, these transactions are summarized as follows:

Recomputed corresponding item ($\$19,000 + \$179,000$)	\$198,000
Minus: B's corresponding item ($\$7,000 + \$75,000$)	(82,000)
S's intercompany item taken into account ($\$12,000 + \$104,000$)	<u>\$116,000</u>

Applying the worksheet format for the intercompany transactions in Years 1 and 2, S and B report their inventory profits as follows:

<u>Year</u>	<u>Consolidated Taxable Income</u>	<u>Adjustments & Eliminations</u>	<u>S Corporation's Separate Reporting</u>	<u>B Corporation's Separate Reporting</u>
Year 1	\$150,000	\$(12,000)	\$100,000	\$ 62,000
Year 2	<u>198,000</u>	<u>(14,000)*</u>	<u>130,000</u>	<u>82,000</u>
Total	<u>\$348,000</u>	<u>\$(26,000)</u>	<u>\$230,000</u>	<u>\$144,000</u>

* Positive \$12,000 adjustment for inventory S sold to B in Year 1 that B sells to third parties in Year 2, minus \$26,000 adjustment for inventory S sells to B in Year 2 that B has not sold to third parties by the end of Year 2.

EXAMPLE C:8-26

Assume the same facts as in Example C:8-25 except P sells all of B's stock on December 31 of Year 2. Because B no longer is a member of the consolidated group after that date, the remaining group cannot match S's intercompany items with B's corresponding items. Thus, the acceleration rule is triggered, and the \$26,000 ($\$110,000 - \$84,000$) of S's intercompany inventory profits that otherwise would be included in Year 3 consolidated taxable income is now included in Year 2 consolidated taxable income.

ADDITIONAL COMMENT

The matching and acceleration rules also apply to intercompany sales of depreciable property and involve complex depreciation adjustments that are beyond the scope of this textbook.

RELEVANCE OF MATCHING AND ACCELERATION RULES

The matching and acceleration rules are broad and conceptual, thereby allowing enough flexibility to apply to a wide variety of intercompany transactions that arise in practice. Applying the rules can seem tedious and irrelevant, possibly causing one to wonder why it is necessary to determine the intercompany items and corresponding items if the consolidated group's taxable income ultimately reflects the recomputed corresponding items. In response, we can cite the following reasons why the rules are important (some of which receive further discussion later in this chapter). The rules affect:

- The time for recognizing intercompany transactions, i.e., how much gain or loss to recognize currently or in the future.
- The amount by which a parent corporation adjusts the basis of stock it owns in its subsidiary corporations.
- The amount of consolidated net operating losses attributed to a particular consolidated group member.
- The amount of a member's separate return net operating losses that the group may use.
- The amount of each member's earning and profits (E&P).

Topic Review C:8-1 summarizes the intercompany transaction rules.

ITEMS COMPUTED ON A CONSOLIDATED BASIS**OBJECTIVE 5**

Compute on a consolidated basis deductions and credits subject to limitations

An affiliated group filing a consolidated tax return generally is treated as if it were a single corporation. To accomplish this treatment, the group calculates on a consolidated basis its deductions and credits that are subject to limitations. The computation of these items for a consolidated tax return is similar to their computation for an unaffiliated corporation. The group also must calculate its regular tax and tax credits on a consolidated basis.

TOPIC REVIEW C:8-1**Reporting Intercompany Transactions****INTERCOMPANY TRANSACTIONS**

1. **Intercompany transaction:** A transaction between two corporations that are in the same consolidated group immediately after the transaction.
2. **Three concepts of reporting intercompany transactions:**
 - a. **Intercompany item:** The selling corporation's income, gain, deduction, and loss from an intercompany transaction.
 - b. **Corresponding item:** The buying corporation's income, gain, deduction, and loss from an intercompany transaction or from property acquired in an intercompany transaction.
 - c. **Recomputed corresponding item:** The corresponding item the buying corporation would have if it and the selling corporation were two divisions of a single corporation and the transaction occurred between those divisions.
3. **Separate entity concept:** The selling and buying corporations involved in the intercompany transaction generally are treated as separate entities in determining the amount of income, gain, deduction, and loss that each one incurs.
4. **Matching rule:** The selling corporation's intercompany item is taken into account for consolidated taxable income so that, when it is combined with the buying corporation's corresponding item, the result is the same as if the consolidated group were a single corporation (i.e., the recomputed corresponding item).
5. **Acceleration rule:** If it is not possible to apply the matching rule to match the selling corporation's intercompany item with the buying corporation's corresponding item, the consolidated group takes into account the selling corporation's intercompany item immediately before the time it first becomes impossible to apply the matching rule.
6. **Examples of events that can trigger recognition of an intercompany item:**
 - a. The buying corporation sells to a third party property acquired in an intercompany transaction (matching rule).
 - b. The selling corporation or buying corporation leaves the consolidated group (acceleration rule).
 - c. The buying corporation claims depreciation, amortization, or depletion deductions for property acquired in an intercompany transaction (matching rule).
 - d. The corporations in the affiliated group discontinue filing a consolidated tax return and begin filing separate tax returns (acceleration rule).

KEY POINT

The consolidated charitable contribution deduction could be equal to, greater than, or less than the total of the charitable contribution deductions if the group filed separate tax returns. The outcome depends on each individual situation.

CHARITABLE CONTRIBUTION DEDUCTION

Chapter C:3 discusses the charitable contribution deduction for an unaffiliated C corporation. Recall that the deduction is limited to 10% of adjusted taxable income. Adjusted taxable income is the corporation's taxable income computed without regard to its charitable contribution deduction, dividends-received deduction, and capital loss carryback (if a carryback year). The corporation can carry over to the five succeeding tax years its charitable contributions that exceed the 10% limitation. Any unused contributions remaining at the end of the five-year carryover period expire.

The consolidated charitable contribution deduction is calculated by first aggregating the consolidated group members' charitable contributions. The deductibility of the aggregate charitable contributions is limited to 10% of consolidated adjusted taxable income, and any aggregate contributions exceeding the 10% limitation carry over for five years.²⁷ Consolidated adjusted taxable income is determined similarly to an unaffiliated corporation's adjusted taxable income except the group uses consolidated amounts.²⁸

EXAMPLE C:8-27 ▶

P, S1, and S2 Corporations comprise a consolidated group. The group members have the following charitable contributions and adjusted taxable incomes for the current year:

<i>Group Member</i>	<i>Charitable Contributions</i>	<i>Adjusted Taxable Income</i>
P	\$12,500	\$150,000
S1	5,000	(40,000)
S2	2,000	10,000
Total	<u>\$19,500</u>	<u>\$120,000</u>

SELF-STUDY QUESTION

In Example C:8-27, what would be each corporation's current year charitable contribution deduction if the group filed separate tax returns?

The consolidated group's charitable contribution deduction is limited to \$12,000 (10% × \$120,000). Because its aggregate charitable contributions exceed this limitation, it can deduct only \$12,000 in the current year. The \$7,500 (\$19,500 – \$12,000) excess charitable contribution carries over to the next five tax years in successive order until used. If not used, they expire at the end of the five-year carryover period. ◀

ANSWER

\$12,500 for P, \$0 for S1, and \$1,000 for S2. The total of these three deductions is \$1,500 more than the \$12,000 consolidated charitable contribution deduction. However, the total of the charitable contribution carryovers is \$1,500 less than the consolidated charitable contribution carryover.

NET SEC. 1231 GAIN OR LOSS

An unaffiliated corporation determines its net Sec. 1231 gain or loss by netting its recognized gains and losses from the sale or exchange of Sec. 1231 property (see Chapter I:13). The corporation treats any net Sec. 1231 loss as an ordinary loss. A net Sec. 1231 gain generally is treated as a long-term capital gain, although some or all of it may be converted to ordinary income if the corporation has any unrecaptured net Sec. 1231 losses from the prior five years (the lookback rule). A consolidated group determines its net Sec. 1231 gain or loss by netting the members' Sec. 1231 gains and losses on a consolidated basis rather than for each member separately.²⁹

ADDITIONAL COMMENT

An affiliated group's ordinary gain or loss and capital gain or loss often will be different when it nets its various gains and losses on a consolidated basis rather than on a separate basis.

CAPITAL GAINS AND LOSSES

Chapter C:3 discusses the treatment of capital gains and losses for an unaffiliated corporation. The corporation's capital gain net income or net capital loss is determined by netting its capital gains, capital losses, and net Sec. 1231 gains (to the extent they are not recaptured as ordinary income under the five-year lookback rule). Unlike with individuals, a corporation's net capital gain receives no preferential tax treatment. Also, a corporation cannot deduct a net capital loss. Instead, it must carry back the net capital loss to the three previous tax years and five following tax years, using the net capital loss in the earliest year(s) possible.

In a similar manner, the consolidated group determines its capital gain net income or net capital loss by netting the group members' capital gains and capital losses, as well as

²⁷ If a member leaves the consolidated group before the group fully uses its charitable contribution carryovers, the departing member takes with it its allocable share of the unused carryover. The allocation is based on the relative amount of the member's charitable contributions (when compared to the group's total charitable contributions) for the consolidated return year

in which they were made. The allocation is similar to that for unused NOL carryovers discussed later in the chapter.

²⁸ Reg. Sec. 1.1502-24.

²⁹ Reg. Sec. 1.1502-23.

any consolidated net Sec. 1231 gain not recaptured under the lookback rule. If the group has a net capital loss for a tax year, it cannot deduct it in that year but must carry it back to the three preceding and over to the five succeeding tax years. The consolidated net capital loss can offset any consolidated net capital gain in those eight carryback and carryover years.³⁰

EXAMPLE C:8-28 ►

P and S Corporations comprise a consolidated group. The group has no capital loss carryovers, and it has recognized no net Sec. 1231 losses in the previous five years. During the current year, the group reports \$200,000 of ordinary income before taking into account the following gains and losses:

KEY POINT

One member of the consolidated group may have a gain or loss from the sale of Sec. 1231 property or a capital asset to another group member. This sale is an example of an *intercompany transaction*, discussed earlier in the chapter. The consolidated group defers recognition of the gain or loss until a later time, and it does not include the gain or loss in the consolidated Sec. 1231 netting process or in the consolidated capital gain and loss netting process until that time.

Group Member	Capital Gains and Losses				Net Sec. 1231 Gain (Loss)
	Short-Term		Long-Term		
	Gains	Losses	Gains	Losses	
P	\$ -0-	\$ -0-	\$ 500	\$ 1,500	\$(3,100)
S	2,000	7,500	6,000	-0-	8,000
	<u>\$2,000</u>	<u>\$7,500</u>	<u>\$6,500</u>	<u>\$1,500</u>	<u>\$4,900</u>

The P-S group's \$4,900 consolidated net Sec. 1231 gain is treated as a long-term capital gain and is combined with the group's \$5,000 (\$6,500 - \$1,500) net long-term capital gain and its \$5,500 (\$2,000 - \$7,500) net short-term capital loss. Thus, the current year consolidated capital gain net income is \$4,400 (\$4,900 + \$5,000 - \$5,500). This amount is taxed at the 21% corporate tax rate. ◀

ADDITIONAL COMMENT

In Example C:8-28, if P and S had filed separate tax returns, P's \$3,100 net Sec. 1231 loss would have been treated as an ordinary loss, and P would have had a \$1,000 (\$500 - \$1,500) net capital loss that would not have been deductible in the current year. S's \$8,000 net Sec. 1231 gain would have been treated as a long-term capital gain, making S's capital gain net income \$8,500 (\$8,000 + \$6,000 + \$2,000 - \$7,500).

Departing Group Members' Capital Losses. A particular issue arises with consolidated groups of corporations that does not arise with unconsolidated corporations. This issue pertains to the carryback and carryover of unused capital losses when the composition of the consolidated group changes. For example, suppose a consolidated group has capital loss carryovers when the parent corporation sells the stock in one of its subsidiaries. To what extent are the unused capital losses available to the departed group member on its separate tax return versus the remaining group members on their consolidated tax return? The group must determine the portion of the net capital loss attributable to the departing group member, and this portion is available to the departing group member and is not available to the remaining consolidated group members. The apportionment procedure is similar to that for NOLs for departing group members, which will be discussed later in the chapter.

SRLY Limitation. A consolidated group member may have net capital losses available from another tax year in which it was not member of the group. The consolidated group can use the net capital loss from this *separate return limitation year*, but the group's use of a member's SRLY net capital loss is limited to the member's cumulative contribution to consolidated capital gain net income. This restriction on the use of net capital losses is similar to the SRLY limitation on the use of NOLs, which will be discussed later in the chapter.

ADDITIONAL COMMENT

The IRC does not allow corporations to forego the three-year carryback period for net capital losses. This restriction can complicate matters when some of the current year consolidated group members filed separate tax returns during any of the three prior years because they were not group members then.

DIVIDENDS-RECEIVED DEDUCTION

Chapter C:3 discusses the dividends-received deduction for an unaffiliated corporation. Corporations that own less than 20% of the distributing corporation's stock may deduct 50% of the dividends received. If the shareholder (distributee) corporation owns 20% or more of the distributing corporation's stock but less than 80% of such stock, it may deduct 65% of the dividends received. The dividends-received deduction is limited to 50% of taxable income computed without regard to any NOL deduction, any capital loss carryback, or the dividends-received deduction itself. The limitation is 65% of such taxable income for dividends received qualifying for the 65% deduction. The limitation

³⁰ Reg. Sec. 1.1502-22.

does not apply if, after taking into account the full dividends-received deduction, the corporation has an NOL for the year.

Dividends Received from Non-Group Members. The calculation of the consolidated dividends-received deduction for dividends received from corporations that are not members of the consolidated group is similar to the calculation for an unaffiliated corporation. The group members' dividends-received deductions, calculated without regard to the limitation on them, are added. The sum of these dividends-received deductions is limited to 50% (or 65%) of consolidated taxable income computed without regard to any NOL deduction, any capital loss carryback (if a carryback year), or the dividends-received deduction itself. Similar to an unaffiliated corporation, the limitation does not apply if the consolidated group would have an NOL for the year after taking the full dividends-received deduction.

EXAMPLE C:8-29 ▶

P and S Corporations comprise a consolidated group. Taxable income (without considering any dividends-received deductions, NOLs, or capital loss carrybacks) is \$16,000 for P and \$18,000 for S, or \$34,000 on a consolidated basis. P received \$20,000 of dividends from unaffiliated corporations that are less than 20%-owned, and S received \$15,000 of such dividends, or \$35,000 on a consolidated basis. The consolidated dividends-received deduction is \$17,000, computed as follows:

ADDITIONAL COMMENT

In Example C:8-29, if P and S did not file a consolidated tax return, P would report an \$8,000 dividends-received deduction on its separate tax return, which is the lesser of \$10,000 ($\$20,000 \times 0.50$) or \$8,000 ($\$16,000 \times 0.50$). S would report a \$7,500 dividends-received deduction, which is the lesser of \$7,500 ($\$15,000 \times 0.50$) or \$9,000 ($\$18,000 \times 0.50$). The total dividends-received deductions of \$15,500 ($\$8,000 + \$7,500$) would be less than the \$17,000 dividends-received deduction allowed when P and S file a consolidated tax return.

Dividends-received deduction before limitation	
(\$35,000 × 0.50)	\$17,500
Limitation (\$34,000 × 0.50)	\$17,000
Dividends-received deduction (lesser of \$17,500 or \$17,000)	\$17,000

Dividends Received from Group Members. The deduction for dividends received by one affiliated group member from another member is determined differently than the deduction for dividends received from a non-group member. If the corporations in the affiliated group do not file a consolidated tax return, the distributee corporation may claim a 100% dividends-received deduction on its separate tax return. Also qualifying for the 100% dividends-received deduction are dividends from a corporation that would be a member of the distributee's consolidated group but is not an includible corporation because it is a life insurance company. The 100% dividends-received deduction is not subject to the taxable income limitation and is taken before the 65% or 50% dividends-received deduction.

If the affiliated group members file a consolidated tax return, the distribution of a dividend from one group member to another group member (e.g., from subsidiary to parent) qualifies as an intercompany transaction. An intercompany dividend distribution is not included in the distributee member's gross income if it produces a corresponding negative adjustment to that member's basis of its stock in the distributing member (this basis adjustment is discussed later in the chapter).³¹ This exclusion eliminates the intercompany dividend from consolidated taxable income, but the consolidated group cannot also claim a 100% dividends-received deduction for the excluded dividend. If the intercompany distribution is in the form of property, the excess of the property's FMV over the distributing member's adjusted basis in it is reported by that member as a gain in its separate taxable income calculation under Sec. 311(b). However, the reporting of this gain for consolidated taxable income is deferred because it is an intercompany transaction. The consolidated group determines the timing of the gain's inclusion in consolidated taxable income by the matching and acceleration rules.³²

SELF-STUDY QUESTION

Are dividends received from members of the same affiliated group entitled to a dividends-received deduction?

ANSWER

Not if the affiliated group files a consolidated tax return because intercompany dividends are excluded; hence, no dividends-received deduction is necessary.

EXAMPLE C:8-30 ▶

P, S1, and S2 Corporations comprise a consolidated group. Consolidated taxable income (without considering any dividends-received deduction, NOLs, or capital loss carrybacks) is \$200,000. The group members receive the following dividend income from unaffiliated corporations that are less than 20%-owned: P, \$6,000; S1, \$10,000; and S2, \$34,000, or \$50,000 on a consolidated basis. In addition, P receives a \$40,000 dividend from S1, and the distribution reduces P's basis in its S1 investment.

³¹ Reg. Sec. 1.1502-13(f)(2)(ii).

³² Reg. Sec. 1.1502-13(f)(2)(iii).

REAL-WORLD EXAMPLE

When each corporation in an affiliated group prepares (but does not file) its own separate tax return, intercompany dividends might be included in gross income. In such a situation, the group needs to make a worksheet adjustment during the consolidation process to remove the dividend amount from consolidated taxable income.

- P excludes from its gross income the \$40,000 dividend received from S1 because the distribution reduces P's basis in its S1 investment.
- The 50% dividends-received deductions included in the separate taxable income calculations are P, \$3,000 ($\$6,000 \times 0.50$); S1, \$5,000 ($\$10,000 \times 0.50$); and S2, \$17,000 ($\$34,000 \times 0.50$). The total consolidated 50% dividends-received deduction of \$25,000 ($\$50,000 \times 0.50$) is not restricted by the \$100,000 dividends-received deduction limitation ($0.50 \times \$200,000$ consolidated taxable income given in the facts).

Thus, the consolidated dividends-received deduction is \$25,000. ◀

**STOP & THINK****SELF-STUDY QUESTION**

What is the dividends-received deduction in Example C:8-30 if the group has consolidated taxable income before special deductions of (a) \$25,000? (b) \$24,999? Should a \$1 difference in consolidated taxable income make a \$12,500 difference in the dividends-received deduction?

ANSWER

(a) \$12,500 ($50\% \times \$25,000$) due to the consolidated taxable income limitation. (b) All \$25,000 is allowed because the full dividends-received deduction creates an NOL. Maybe a \$1 difference should not have such a radical effect, but it does. Therefore, as a tax strategy, the corporation should plan its taxable income level to avoid losing a portion of the dividends-received deduction.

Question: Alpha Corporation has owned the stock of a 100%-owned subsidiary for many years. The CPA who has prepared both corporations' tax returns since their creation has been trying to persuade Alpha's Director of Federal Taxes to begin filing a consolidated tax return based on the tax exemption for intragroup dividends. Is the CPA right or wrong in this approach?

Solution: The CPA is wrong. If Alpha and its subsidiary file separate tax returns, Alpha can claim a 100% deduction for dividends received from its subsidiary, which will offset the dividend received. If the corporations file a consolidated tax return, Alpha can exclude the dividends from its gross income. Typically, these two alternatives result in the same outcome. The outcomes for these two alternatives may differ, however, when preparing state tax returns. The CPA should focus on other factors, such as deferring profits on intercompany transactions and offsetting profits and losses between the two corporations.

REGULAR TAX LIABILITY

A consolidated group determines its consolidated regular income tax liability similarly to an unaffiliated corporation by applying the 21% corporate tax rate to its consolidated taxable income.

EXAMPLE C:8-31 ►

P and S Corporations report \$600,000 of consolidated taxable income for the current year. Of this, \$400,000 is attributable to P, and \$200,000 is attributable to S. The P-S group's consolidated tax liability is \$126,000 ($\$600,000 \times 0.21$).

If P and S had filed separate tax returns, P's tax liability would be \$84,000 ($\$400,000 \times 0.21$), and S's tax liability would be \$42,000 ($\$200,000 \times 0.21$). Their \$126,000 ($\$84,000 + \$42,000$) total tax liability would be the same as the tax liability on a consolidated basis, in this example. However, the sum of their separate taxable incomes likely would differ from their consolidated taxable income because of intercompany transactions and items computed on a consolidated basis. ◀

EXAMPLE C:8-32 ►

Assume the same facts as in Example C:8-31 except the \$600,000 of consolidated taxable income is comprised of P's \$750,000 income and S's \$150,000 loss. The P-S group's consolidated tax liability is still \$126,000 ($\$600,000 \times 0.21$). If P and S had filed separate tax returns, however, P's tax liability would be \$157,500 ($\$750,000 \times 0.21$), and S's tax liability would be zero. The group thus saves \$31,500 ($\$157,500 - \$126,000$) of current year tax by filing a consolidated tax return rather than separate tax returns. However, the group does not have a \$150,000 net operating loss to carry over that S would have on a separate return basis. ◀

TAX CREDITS

A consolidated group can claim all tax credits available to corporate taxpayers. The group calculates these credits in much the same way as would an unaffiliated corporation. The discussion that follows examines the two major credits claimed by most consolidated groups—the general business credit and the foreign tax credit.

General Business Credit. A consolidated group determines its general business credit on a consolidated basis, combining its members' separate credit amounts into a

single amount.³³ (See Chapter I:14 for more detailed coverage of the general business credit.) The credit the group can claim in the current year is limited to the excess of (1) the group's consolidated net tax over (2) 25% of its consolidated net tax exceeding \$25,000. The net tax is the regular tax reduced by certain credits, e.g., foreign tax credit. Any credit exceeding this limitation carries back one year and over 20 years.³⁴

The corporations in a consolidated group may find that the general business credit allowed in the current year is smaller on a consolidated basis than it would be on a separate return basis. For example, if the credit is attributable to a profitable group member and another group member has a loss, consolidation may result in that member's loss reducing the group's credit limitation. However, if the credit is attributable to an unprofitable group member, consolidation may allow the members to claim a greater amount of credit on a consolidated basis than on a separate return basis because the credit limitation is higher on a consolidated basis due to other group members' profits.

EXAMPLE C:8-33 ▶

P and S Corporations comprise a consolidated group. For the current year, P and S have separate taxable income and losses of \$300,000 and (\$100,000), respectively. P has a \$40,000 research credit, and S has a \$10,000 employer provided child care credit.

The group has a \$50,000 (\$40,000 + \$10,000) tentative general business credit. The group's consolidated regular taxable income is \$200,000 (\$300,000 – \$100,000), assuming no intercompany transactions or other items that would cause consolidated taxable income to differ from the sum of the separate taxable income and loss. The group's regular tax is \$42,000 (\$200,000 × 0.21). Its general business credit limitation is calculated as follows:

Regular tax	\$42,000
Minus: Credits allowed under Secs. 21-30D	–0–
Net income tax	<u>\$42,000</u>
Minus: 25% of net tax exceeding \$25,000 [0.25 × (\$42,000 – \$25,000)]	<u>(4,250)</u>
General business credit limitation	<u><u>\$37,750</u></u>

The \$12,250 (\$50,000 tentative credit – \$37,750 credit limitation) of unused general business credits carries back one year and carries over 20 years. ◀

BOOK-TO-TAX ACCOUNTING COMPARISON

A general business credit carryover creates a deferred tax asset on the group's consolidated financial statements. The group also establishes a valuation allowance for any part of the deferred tax asset that does not have a more likely than not probability of being realized, and it should record a liability for unrecognized tax benefit for the portion of it that is not more likely than not to be realized upon effective settlement with the IRS (see Chapter C:3 regarding uncertain tax positions under ASC 740).

Foreign Tax Credit. A consolidated group determines its foreign tax credit on a consolidated basis.³⁵ The parent corporation makes the election to claim either a deduction or a credit for the group's foreign income taxes. If the parent chooses to claim a credit, the consolidated group computes its foreign tax credit limitation by taking into account its consolidated foreign-source income, consolidated taxable income, and consolidated regular tax in the manner described in Chapter C:16.

ESTIMATED TAX PAYMENTS

For the first two years for which an affiliated group files consolidated tax returns, it may elect to make estimated tax payments on either a consolidated or separate basis. Once an affiliated group has filed consolidated tax returns for two consecutive years, it must pay estimated taxes on a consolidated basis and continue doing so until the group's members again file separate tax returns.³⁶ The group's estimated tax payments and any underpayment exceptions or penalties are based on its consolidated tax liability for the current and preceding tax years without regard to the number of corporations comprising the group. If new, profitable corporations join the group, this treatment can be advantageous due to the time value of money.

³³ Reg. Sec. 1.1502-3.

³⁴ Sec. 39(a).

³⁵ Reg. Sec. 1.1502-4.

³⁶ Reg. Sec. 1.1502-5.

EXAMPLE C:8-34 ► The P-S1 affiliated group has filed consolidated tax returns for several years. In the preceding year, the group reported a \$100,000 consolidated tax liability. The P-S1 group acquires all of S2 Corporation's stock during the current year. S2 is profitable and causes the P-S1-S2 group to report a \$300,000 consolidated tax liability in the current year. Assuming the P-S1-S2 group does not fall under the large corporation rules discussed below, it can base its current year estimated tax payments on its \$100,000 consolidated tax liability from the prior tax year. The group will not incur an underpayment penalty if it makes \$25,000 ($\$100,000 \div 4$) of estimated tax payments by the fifteenth day of the fourth, sixth, ninth, and twelfth months of its tax year. The group must pay the balance of its consolidated tax liability by the due date of its consolidated tax return (without regard to any extensions) to avoid a penalty. ◀

Large Corporation Rule. Chapter C:3 discusses the special underpayment rules for large corporations imposed by Sec. 6655(d)(2)(B). A large corporation's estimated tax payments cannot be based on its prior year's tax liability except for the first installment. A large corporation is one whose taxable income was \$1 million or more in any of its three preceding tax years. A controlled group of corporations must allocate the \$1 million amount among its group members. An affiliated group that files a consolidated tax return is treated as a single corporation for this purpose. An affiliated group that files separate tax returns generally must allocate this \$1 million amount because it also qualifies as a parent-subsidiary controlled group.

Consolidated or Separate Basis. During the first two tax years of filing consolidated tax returns, a consolidated group sometimes can reduce its quarterly tax payments by making estimated tax payments on a separate basis in the first year and on a consolidated basis in the second year or vice versa. These reduced quarterly estimated tax payments will cause the group to pay a larger balance of tax by the due date of its tax return (without extensions). The group can apply different exceptions for the underpayment penalty (e.g., prior year's liability or annualization of current year's income) on a consolidated or separate basis the first two years. Determination of the actual required estimated tax payments on a consolidated or separate basis, however, is beyond the scope of this textbook.

Short-Period Return. If a corporation joins a consolidated group after the beginning of its tax year or leaves a consolidated group before its tax year ends, it generally must file a separate, short-period tax return covering the time period it was unaffiliated with the group (however, it would not file a separate tax return if it left one consolidated group to enter another consolidated group). Treasury Regulations provide rules covering estimated tax payments for short tax years.³⁷ No estimated tax payment is required for a short tax year that is less than four months.

NET OPERATING LOSSES (NOLs)

OBJECTIVE 6

Determine a consolidated group's NOL, calculate the carryover of a consolidated NOL, and apply the SRLY restrictions on NOL usage

One advantage of filing a consolidated tax return is the ability of the consolidated group to offset one member's NOLs against the taxable income of other group members. However, the profitable group members' taxable income may not be sufficient to fully offset the other members' NOLs, resulting in a consolidated NOL. A consolidated NOL arising in 2018 or later years carries over indefinitely. The group can deduct the NOL in the subsequent year, but the deduction is limited to 80% of consolidated taxable income computed without regard to the NOL deduction. Any portion of the NOL carryover not deducted in the subsequent year continues to carry over.³⁸

If a corporation departs the consolidated group between the year the consolidated NOL arose and the carryover year, the group must determine the portion of the NOL that carries to the departing corporation's separate return year. In addition, if a corporation entering the consolidated group has unused NOLs from years prior to its entry into the group, the group may be able to use the NOLs. Because of the potential for abuse, however, the tax law limits the group's ability to use a separate return NOL in a consolidated return year. In addition, NOL, capital loss, and tax credit carryovers can be subject to the consolidated limitations under Secs. 382-384. The rules that apply to NOL carryovers are discussed below.

³⁷ Reg. Sec. 1.6655-5.

³⁸ An NOL that arose before 2018 carries over for 20 years, and its deductibility is limited to 100% of taxable income computed without regard to the NOL deduction.

KEY POINT

Generally, the most significant benefit of filing a consolidated tax return is the group's ability to offset one member's losses against other members' income. This offsetting is not subject to the 80% of taxable income limitation on NOL deductions because it occurs within the same tax return.

CURRENT YEAR NOL

A consolidated group's NOL equals the excess of its deductions over its gross income (i.e., its negative taxable income).³⁹ The group combines each member's separate taxable income or loss to determine a combined taxable income before adjusting for NOL carryovers (see Table C:8-1). The combining process allows one group member's losses to offset the taxable income of other group members. The group determines its consolidated NOL after applying the intercompany transaction rules and after calculating on a consolidated basis the various items discussed earlier, such as Sec. 1231 and capital gains and losses. The group must use a member's current year loss to first offset other members' current-year profits. Only the consolidated group's NOL (if any) carries over.

EXAMPLE C:8-35 ▶ P and S Corporations comprise an affiliated group that has filed consolidated tax returns for several years. They report the following results for Years 1 and 2 (both 2018 or later years):

<u>Group Member</u>	<u>Taxable Income</u>	
	<u>Year 1</u>	<u>Year 2</u>
P	\$ 400,000	\$300,000
S	(650,000)	10,000
Consolidated taxable income before NOL deduction	<u>\$(250,000)</u>	<u>\$310,000</u>

Assume no intercompany transactions or other items would cause consolidated taxable income to differ from the sum of the separate taxable incomes or loss. In Year 2, the group's use of the \$250,000 consolidated NOL is limited to \$248,000 ($0.80 \times \$310,000$), so it uses \$248,000 of the NOL and has consolidated taxable income of \$62,000 ($\$310,000 - \$248,000$). The \$2,000 ($\$250,000 - \$248,000$) portion of the NOL not used in Year 2 carries over to Year 3, and its use in that year will be subject to Year 3's 80% limitation. ◀

EXAMPLE C:8-36 ▶ Assume the same facts as in Example C:8-35 except P and S file separate tax returns for Years 1 and 2. For Year 1, P cannot use any of S's loss to offset its \$400,000 taxable income. Instead, S carries all \$650,000 of its Year 1 NOL to Year 2, but it can use only \$8,000 ($0.80 \times \$10,000$) of the NOL in Year 2. S carries the remaining \$642,000 ($\$650,000 - \$8,000$) NOL to Year 3.

CARRYOVERS OF CONSOLIDATED NOLS

If the same corporations comprise the consolidated group during the carryover periods as during the year in which the NOL occurs, the treatment of the consolidated NOL is much like the treatment of an unaffiliated corporation's NOL. However, if the group's composition changes, the treatment of a consolidated NOL becomes complicated.

General Rule. The consolidated group apportions a fraction of its consolidated NOL to each member that incurred a separate loss during the year the NOL arose as follows:⁴⁰

$$\frac{\text{Separate NOL of the particular group member}}{\text{Sum of the separate NOLs of all group members having such losses}} \times \text{Consolidated NOL} = \text{Portion of consolidated NOL attributable to the particular group member}$$

³⁹ Reg. Sec. 1.1502-21(e).

⁴⁰ Reg. Sec. 1.1502-21(b)(2)(iv). The member's separate NOL is determined in a manner similar to the calculation of separate taxable income except for a series of adjustments to take into account the member's charitable contributions,

dividends-received deductions, and Sec. 1231 and capital gains and losses. The consolidated NOL apportioned to a member might be reduced under the unified loss rules of Reg. Sec. 1.1502-36, which are beyond the scope of this text.

If a corporation ceases to be a member of a consolidated group, any consolidated NOL carryover apportioned to it first must be used to offset consolidated taxable income in the year of departure. This requirement applies even when the entire NOL carryover is attributable to the departing member. Any NOL carryover apportioned to the departing member not absorbed by departure year consolidated taxable income becomes the member's separate carryover and may be used in its subsequent separate return years.⁴¹

EXAMPLE C:8-37 ►

P, S1, and S2 Corporations comprise an affiliated group that has filed consolidated tax returns on a calendar year basis for several years. At the close of business on September 30 of Year 2, P sells all its S1 stock. Therefore, S1 must file a separate tax return for the period October 1 through December 31 of Year 2. The members report the following amounts of income and loss (before any NOL deduction):

TAX STRATEGY TIP

In Example C:8-37, the group is entitled to use the consolidated NOL before S1 determines its NOL carryover. This privilege can affect the negotiated purchase price for S1.

	<u>Year 1</u>	<u>Year 2</u>
P	\$ 48,000	\$20,000
S1	(50,000)	43,000*
S2	(100,000)	10,000
Total	<u>\$(102,000)</u>	<u>\$73,000</u>

*S1 earns \$30,000 from January 1 through September 30 and \$13,000 from October 1 through December 31.

Year 2 consolidated taxable income before the NOL deduction is \$60,000 (\$20,000 + \$30,000 + \$10,000), not including S1's income for October 1 through December 31. Assuming Year 1 is 2018 or a later year, the group deducts \$48,000 ($0.80 \times \$60,000$) of the Year 1 NOL on its Year 2 tax return, making consolidated taxable income \$12,000 ($\$60,000 - \$48,000$). Of the remaining \$54,000 ($\$102,000 - \$48,000$) NOL, the group apportions \$18,000 [$\$54,000 \times (\$50,000 \div (\$50,000 + \$100,000))$] to S1 and \$36,000 [$\$54,000 \times (\$100,000 \div (\$50,000 + \$100,000))$] to S2. Of S1's carryover, \$10,400 ($0.80 \times \$13,000$) can be used in its separate tax return for October 1 through December 31 of Year 2. The remaining \$7,600 ($\$18,000 - \$10,400$) carries over to S1's Year 3 separate tax return. The consolidated group carries over S2's \$36,000 apportioned share of the Year 1 NOL to Year 3 and subsequent years. ◀

SPECIAL LOSS LIMITATIONS

The term NOL trafficking refers to attempts by one tax entity to acquire NOL deductions from another entity. For example, a profitable corporation might consider acquiring an unprofitable corporation merely to obtain a tax benefit from the acquired corporation's unused NOLs. To inhibit NOL trafficking, the tax law imposes special limitations on the use of NOLs. The Sec. 382 loss limitation rules, which were discussed in Chapter C:7 on a separate return basis, also could apply to affiliated groups filing consolidated tax returns. The separate return limitation year (SRLY) rules apply only to consolidated groups and limit the use in a consolidated return year of a member's NOL that arose in a separate return year. Specifically, the SRLY rules limit use of the NOL to the loss member's subsequent contribution to consolidated taxable income. The SRLY rules are explained in detail below, as well as special aspects of the Sec. 382 rules with respect to consolidated tax returns.

BOOK-TO TAX ACCOUNTING COMPARISON

An NOL creates a deferred tax asset on an acquiring corporation's consolidated balance sheet, thereby highlighting the economic benefit the unprofitable corporation's NOLs provides for the acquiring corporation's consolidated group. However, a valuation allowance for this deferred tax asset may be needed because of the Sec. 382 and SRLY loss limitation rules.

Separate Return Limitation Year Rules. A SRLY generally is any separate return year (i.e., a year in which a corporation filed a separate tax return or joined in a consolidated tax return of another consolidated group). However, a SRLY does not include the following:⁴²

- A separate return year of the group's parent corporation. The SRLY limitation thus does not apply to the parent corporation's NOLs, even if they arise in a separate return year.
- A separate return year of a corporation that was a member of the affiliated group for every day of the loss year (e.g., the group did not elect to file a consolidated tax return in

⁴¹ Reg. Sec. 1.1502-21(b)(2)(ii)(A).

⁴² Reg. Sec. 1.1502-1(f).

ADDITIONAL COMMENT

These two exceptions to the SRLY rules exist because, in both cases, the group has not acquired already existing NOLs.

KEY POINT

The SRLY rules limit a consolidated group's ability to acquire another corporation and use its already existing NOLs to offset the group's income.

the loss year). The SRLY limitation does not apply in this circumstance because the loss year would not have been a SRLY had the group elected to file a consolidated tax return.

An NOL incurred in a SRLY after 2017 carries over indefinitely. If the year to which the NOL carries is a consolidated return year, the NOL's deductibility is limited to the SRLY limitation for that group member:⁴³

Aggregate of consolidated taxable income 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

Minus: Any of the loss member's NOLs previously absorbed by the consolidated group

SRLY limitation (not less than zero)

The SRLY rules limit the consolidated group's use of the loss member's NOL to that member's aggregate contribution to consolidated taxable income in excess of zero. As a result, a post-2017 NOL incurred in a SRLY that is deductible on a consolidated tax return equals the lesser of (1) the SRLY limitation, (2) 80% of consolidated taxable income (computed without regard to the NOL deduction), or (3) the amount of the NOL carryover. Any NOL carryover exceeding the lesser of these three amounts carries over to subsequent tax years.⁴⁴

EXAMPLE C:8-38

P and S Corporations are calendar year corporations that formed in Year 1. P acquires 100% of S's stock at the close of business on December 31 of Year 1.⁴⁵ P and S file separate tax returns for Year 1 and begin filing a consolidated tax return for Year 2. The corporations report the following taxable incomes (losses), before any NOL deductions, for Years 1 through 5:

SELF-STUDY QUESTION

What is the consequence of having NOLs subject to the SRLY limitations?

ANSWER

The effect of having a member's NOLs tainted as SRLY NOLs is that they can be used only to offset taxable income of the loss member. This restriction could delay deduction of the NOLs and reduces the present value of the tax savings from them.

<i>Group Member</i>	<i>Taxable Income</i>				
	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>	<i>Year 5</i>
P	\$ (9,000)	\$ 17,000	\$ 6,000	\$ (5,400)	\$ 30,000
S	(20,000)	(2,000)	5,000	5,400	16,000
Consolidated taxable income without regard to NOL deduction	N/A	\$ 15,000	\$ 11,000	\$ -0-	\$ 46,000

N/A = Not applicable

Assume that all years are 2018 or later years. Under the SRLY rules, the P-S consolidated group uses the NOLs as follows:

- ▶ **Year 2:** P's Year 1 NOL offsets the group's consolidated taxable income (CTI). For P, Year 1 is not a SRLY because P is the group's parent corporation. S's only contribution to CTI by the end of Year 2 is its \$2,000 loss in Year 2. Therefore, S's SRLY limitation for Year 2 is zero because S makes no positive aggregate contribution to CTI. The limitation on the group's NOL deduction is \$12,000 ($\$15,000 \times 0.80$), which exceeds the \$9,000 of NOLs it has available (after applying the SRLY limitation). The group's resulting CTI is \$6,000 ($\$15,000 - \$9,000$).
- ▶ **Year 3:** S's SRLY limitation for Year 3 is \$3,000 [$(\$2,000) + \$5,000$]. S's \$20,000 unused NOL and the group's \$8,800 ($\$11,000 \times 0.80$) NOL deduction limitation are both more than \$3,000, so the group can deduct \$3,000 of S's Year 1 NOL. The group's resulting CTI is \$8,000 ($\$11,000 - \$3,000$), and S's remaining NOL of \$17,000 ($\$20,000 - \$3,000$) carries over to Year 4 for consideration in that year.

⁴³ Reg. Sec. 1.1502-21(c). If multiple group members have unexpired NOLs or a loss member has unexpired NOLs from multiple SRLYs, the group uses the NOLs on a first-in, first-out (FIFO) basis. The group uses NOLs from tax years ending on the same date on a pro rata basis.

⁴⁴ No authoritative guidance exists at this point on the way the 80% NOL deduction limitation applies in conjunction with the SRLY limitation. The

discussion here is based on Reg. Sec. 1.1502-21(c), which was issued before the Tax Cuts and Jobs Act of 2017 created the 80% limitation.

⁴⁵ P's acquisition of S stock might trigger both the SRLY rules and the Sec. 382 rules. To simplify the example, assume that the acquisition does not trigger the Sec. 382 rules. The SRLY-Sec. 382 overlap rules are discussed later in this chapter.

- ▶ **Year 4:** S's SRLY limitation is \$5,400 [(\$2,000) + \$5,000 + \$5,400 – \$3,000]. However, none of S's Year 1 NOL can be used; the group's NOL deduction limitation is zero because its CTI computed without regard to the NOL deduction is zero. The group's resulting Year 4 CTI is zero, and the group carries to Year 5 all \$17,000 of S's unused Year 1 NOL.
- ▶ **Year 5:** S's SRLY limitation is \$21,400 [(\$2,000) + \$5,000 + \$5,400 – \$3,000 + \$16,000], and the group's NOL deduction limitation is \$36,800 ($0.80 \times \$46,000$). However, S has only a \$17,000 NOL remaining, so the group deducts the entire \$17,000 amount. The group's resulting CTI is \$29,000 ($\$46,000 - \$17,000$) with no NOL remaining to carry over to future years. ◀

The SRLY rules generally apply separately to each corporation that has a loss carryover from a SRLY.

EXAMPLE C:8-39 ▶ At the close of business on December 31 of Year 1, P Corporation purchases 100% of S Corporation's stock and 100% of T Corporation's stock. S and T were unaffiliated prior to these purchases. From Year 1, S has a \$12,000 NOL carryover, and T has an \$11,000 NOL carryover. Assume the Sec. 382 limitation does not apply to these stock purchases. The P-S-T affiliated group elects to file a consolidated tax return for Year 2, and the members report the following separate taxable income for that year:

P Corporation	\$100,000
S Corporation	\$ 14,000
T Corporation	\$ 10,000

The Year 2 SRLY limitation for S's NOL is \$14,000, and the limitation for T's NOL is \$10,000. The P-S-T consolidated group can deduct all \$12,000 of S's Year 1 NOL, but it can deduct only \$10,000 of T's Year 1 NOL. As a result, the group's Year 2 consolidated taxable income is \$102,000 ($\$100,000 + \$14,000 + \$10,000 - \$12,000 - \$10,000$). The remaining \$1,000 ($\$11,000 - \$10,000$) of T's Year 1 NOL carries over to Year 3. ◀

The SRLY limitation applies to a SRLY subgroup on a joint basis rather than to each corporation separately. For NOL carryovers, a SRLY subgroup is the loss corporation and each other group member that (1) became a member of the current affiliated group at the same time as the loss corporation, (2) was affiliated with the loss corporation in another affiliated group before becoming a member of the current affiliated group, and (3) has been continuously affiliated with the loss corporation after ceasing to be a member of the former affiliated group.

EXAMPLE C:8-40 ▶ Assume the same facts as in Example C:8-39 except S owns 100% of T's stock, and P purchased 100% of S's stock at the close of business on December 31 of Year 1. S and T are a SRLY subgroup. The S-T subgroup SRLY limitation for Year 2 is \$24,000 ($\$14,000 + \$10,000$), so the P-S-T consolidated group can deduct on its Year 2 tax return all \$23,000 ($\$12,000 + \$11,000$) of S's and T's NOL carryovers from Year 1. ◀

KEY POINT

Remember that SRLYs stem from years in which a member files a separate tax return or joins in the filing of a consolidated return with a different affiliated group.

The SRLY rules also limit the use of built-in losses. A built-in loss is a loss that accrues in a separate return year but is realized in a consolidated return year. For example, S Corporation purchases land in a separate return year for \$100,000. The land's fair market value declines to \$85,000 before P purchases all of S's stock, when they start filing tax returns on a consolidated basis. If S sells the land during the five-year period beginning on the date P purchases S's stock, the SRLY rules limit the extent to which the P-S consolidated group can use the realized loss. As with NOLs, the group must compute S's SRLY limitation in determining how much of the loss it can use.⁴⁶

In a reverse acquisition, the acquired corporation's shareholders own more than 50% of the fair market value of the acquiring corporation's stock immediately after the acquisition. In such an acquisition, the SRLY limitation applies to the acquiring corporation's NOLs and does not apply to the acquired corporation's NOLs.⁴⁷ For example,

⁴⁶ Reg. Sec. 1.1502-15(a).

⁴⁷ Reg. Sec. 1.1502-1(f)(3).

suppose P Corporation acquires all of S Corporation's stock in exchange for P stock. Because P is smaller than S, persons who were S shareholders immediately before the purchase own more than 50% of the fair market value of P's stock immediately after the purchase. The form of the transaction is that P acquires S, but its substance is that S acquires P. The transaction qualifies as a reverse acquisition, so the SRLY limitation applies to P's NOLs but not to S's NOLs. That is, S is treated as if it were the parent corporation for purposes of applying the SRLY limitation. The details of this rule and other aspects of the reverse acquisition rules are beyond the scope of this textbook.

A discussion of the financial statement implications of SRLY losses appears at the end of this chapter.

Consolidated Sec. 382 Rules. The Sec. 382 rules may apply when a consolidated group acquires a corporation with an unused NOL. Section 382 inhibits NOL trafficking by limiting the acquiring corporation's use of a loss corporation's NOL to the Sec. 382 limitation, which is the value of the old loss corporation's stock multiplied by the long-term tax-exempt federal interest rate.⁴⁸ The 50 percentage point stock ownership change needed to trigger the Sec. 382 rules can occur in acquisitive transactions involving a single corporation or a group of corporations that file separate or consolidated returns. (See Chapter C:7 for a discussion of Sec. 382.) The consolidated Sec. 382 rules generally provide that the ownership change and Sec. 382 limitation are determined with respect to the entire consolidated group (or a subgroup of a consolidated group) and not separately for each corporation.⁴⁹ The details of these rules are beyond the scope of this textbook.

SRLY-Sec. 382 Overlap. A SRLY-Sec. 382 overlap occurs when an acquisition of a corporation falls under both the SRLY rules and the Sec. 382 rules (for example, a corporation in a consolidated group purchases 100% of the stock of a target corporation having an NOL carryover). Because both sets of rules inhibit NOL trafficking by restricting the use of NOLs, Treasury Regulations alleviate the burden of applying them by waiving the application of the SRLY rules in many SRLY-Sec. 382 overlap situations.⁵⁰

To qualify for the overlap rule, a corporation must become a member of a consolidated group (the SRLY event) within six months of the date of an ownership change that triggers a Sec. 382 limitation (the Sec. 382 event). Often, the SRLY event and the Sec. 382 event are simultaneous.

EXAMPLE C:8-41 ▶

P Corporation purchases 60% of S Corporation's stock on February 28 of the current year. On June 30 of the current year, P purchases the other 40% of S's stock. P has filed consolidated tax returns with its other subsidiaries for several years. The Sec. 382 event occurs on February 28, when the 50 percentage-point ownership change takes place. The SRLY event occurs on June 30, when P's ownership of S reaches the 80% threshold needed to include S in the consolidated tax return. The overlap rule applies because the Sec. 382 event occurred within six months of the SRLY event, so the SRLY rules are waived beginning with the tax year that includes June 30. Instead, only the Sec. 382 rules apply. ◀

ADDITIONAL COMMENT

In some cases, the overlap rule will not apply. In Example C:8-41, if the 40% purchase had taken place on September 30, the SRLY event would have occurred more than six months after the Sec. 382 event. Consequently, the SRLY rules and the Sec. 382 rules both would apply.

If the SRLY event precedes the Sec. 382 event by six months or less, the overlap rule applies for the first tax year beginning after the Sec. 382 event (and the SRLY rules apply for the interim period). This situation could occur, for example, if the acquiring corporation had owned 45% of the target corporation's stock for many years, purchased 40% of the target's stock in the current year, and purchased the remaining 15% of the target's stock less than six months after the 40% purchase.

Topic Review C:8-2 summarizes the rules applying to carryovers of consolidated return and separate return NOLs.

⁴⁸ The Sec. 382 limitation rules apply to the tax attributes limited by Secs. 382–384 (e.g., NOLs, capital losses, foreign tax credits, general business credits, built-in gains, and built-in losses).

⁴⁹ Reg. Sec. 1.1502-91(a)(1).

⁵⁰ Reg. Sec. 1.1502-21(g).

TOPIC REVIEW C:8-2

Rules Addressing NOL Carryovers To or From Consolidated Tax Return Years

LOSS YEAR	CARRYOVER YEAR ^a	RULE AND SPECIAL LIMITATIONS
CRY ^b	CRY	<ol style="list-style-type: none"> 1. Consolidated NOLs incurred after 2017 carry over indefinitely. No special problems arise if the group members are the same in the loss year and the year to which the loss carries. 2. The Sec. 382 limitation applies to the loss carryover if a Sec. 382 ownership change occurs.
CRY	SRY ^c	<ol style="list-style-type: none"> 1. Carryover to a member's later separate return year is possible only if part or all of the NOL is apportioned to the member. 2. The consolidated NOL carryover is used first in the consolidated return year in which the member departs. The departing member is allocated part of any remaining consolidated NOL carryover. This allocated part is available to be used in the departing member's first separate return year. The Sec. 382 loss limitation may apply to the loss carryover.
SRY	CRY	<ol style="list-style-type: none"> 1. A separate return year NOL carries over to a consolidated return year, but the SRLY rules may limit the NOL's usage. The SRLY rules do not apply to the NOLs of the parent corporation or to a corporation that is a member of the affiliated group on each day of the loss year unless a reverse acquisition occurs. 2. Section 382 loss limitation rules may apply to the loss carryover, but the SRLY rules may be waived under the overlap rule.

^aThe group's use of NOL carryovers is limited to 80% of consolidated taxable income computed without the NOL deduction.

^bConsolidated return year.

^cSeparate return year.

STOCK BASIS ADJUSTMENTS

OBJECTIVE 7

Adjust the parent's basis in stock of a consolidated subsidiary

A consolidated group member must annually adjust the basis of stock it owns in a subsidiary for the subsidiary's profits and losses, for distributions from the subsidiary, and for other items. These rules are similar to those that apply to partners of partnerships and shareholders of S corporations (see Chapters C:9 and C:11) and are intended to prevent the duplication of income or loss in consolidated taxable income.⁵¹

EXAMPLE C:8-42

P Corporation purchases all of S Corporation's stock on January 1 of the current year for \$100,000. The corporations elect to file a consolidated tax return. S recognizes a \$25,000 profit during the current year and pays no dividends to P. P sells all its S stock on December 31 of the current year for \$125,000. P increases the basis of its S stock by \$25,000. As a result, P realizes no gain or loss on the sale of its S stock [$\$125,000$ amount realized $-$ $\$125,000$ basis ($\$100,000 + \$25,000$)].⁵²

KEY POINT

Positive stock basis adjustments reduce the amount of gain or increase the amount of loss reported when a sale of the stock of a consolidated group member (other than the parent) occurs.

Had P not adjusted its basis for S's profit, it would have realized a \$25,000 gain on the stock sale ($\$125,000 - \$100,000$), and this gain would have been taxed on the current year's consolidated tax return. However, the increase in the S stock's value that led to this \$25,000 gain is attributable to the \$25,000 profit that S earned. Without the basis adjustment to the S stock, the consolidated group would have been taxed twice on the \$25,000 gain. ◀

A consolidated group may be comprised of many tiers of corporations. For example, a parent corporation may have a subsidiary corporation (a first-tier subsidiary), and the subsidiary, in turn, may have its own subsidiary (a second-tier subsidiary). The stock basis

⁵¹ Losses realized on the sale by one consolidated group member of another member's stock involve complicated rules and calculations that are beyond the scope of this text.

⁵² Example C:8-42 ignores the decrease of basis for the federal income taxes attributable to S's income, which is discussed later.

adjustments itemized below are discussed with respect to a parent corporation that owns stock of a subsidiary, but they also apply to a higher-tier subsidiary that owns stock of a lower-tier subsidiary.

The starting point for the calculation is the parent corporation's original basis in its subsidiary stock, which depends on the method used to acquire it (e.g., purchase, nontaxable corporate formation, or nontaxable reorganization). The parent makes the following adjustments to the original basis:⁵³

- ▶ Increase basis for the subsidiary's income and gain items and decrease it for the subsidiary's deduction and loss items taken into account in determining consolidated taxable income. Items whose recognition is deferred under the intercompany transaction rules do not increase or decrease basis until they are taken into account for consolidated taxable income.
- ▶ Increase basis for the subsidiary's income permanently excluded from taxation (e.g., tax-exempt bond interest and federal income tax refunds).
- ▶ Increase basis for the subsidiary's deductions that do not represent a recovery of basis or an expenditure of money as if they were tax-exempt income (for example, the dividends-received deduction). However, the parent also decreases basis for the deductions themselves, so these two adjustments usually net to zero and thus have no net effect on the parent's basis in the subsidiary.⁵⁴
- ▶ Decrease basis for the subsidiary's expenses that are not deductible and are not capital expenditures (e.g., federal income taxes, the nondeductible 50% of meals expenses, expenses related to tax-exempt income, and losses disallowed under Sec. 267).
- ▶ Decrease basis for distributions received from the subsidiary (without regard to the subsidiary's E&P or whether the E&P accumulated before or after the subsidiary became a member of the consolidated group).
- ▶ Decrease basis for the subsidiary's NOLs that arise and are used in the current year against other group members' taxable income. NOLs that carry over reduce basis in the year used. Similar rules apply to capital losses.

EXAMPLE C:8-43 ▶

On January 1 of the current year, P Corporation purchases all of S Corporation's stock for \$1 million. P and S elect to file a consolidated tax return. During the current year, S reports taxable income of \$300,000 and tax-exempt bond interest of \$25,000, and S pays P a \$40,000 dividend. On January 1 of the next year, P sells the S stock for \$1.26 million. Assume that the portion of the consolidated tax liability allocable to S is \$63,000 ($\$300,000 \times 0.21$) and that S pays it. P's basis in its S stock on the sale date is \$1,222,000 ($\$1,000,000 + \$300,000 + \$25,000 - \$63,000 - \$40,000$). Thus, P realizes a \$38,000 ($\$1,260,000 - \$1,222,000$) gain on the stock sale. ▶

ADDITIONAL COMMENT

Determining the federal income tax allocable to each group member often is more complex than in Example C:8-43 because members' losses, credits, and other items affect the consolidated tax liability. The regulations specify methods for allocating the tax liability among a group's members, but the details are beyond the scope of this textbook.

TIERING UP OF STOCK BASIS ADJUSTMENTS

In adjusting the basis of its first-tier subsidiary's stock, the parent corporation also takes into account the adjustments the first-tier subsidiary makes to its basis in second-tier subsidiary stock. The adjustments are applied in order of the tiers, from the lowest to the highest.

EXAMPLE C:8-44 ▶

P Corporation owns all of S Corporation's stock, and S owns all of T Corporation's stock. The three corporations have filed on a consolidated basis for several years. At the beginning of the current year, P's basis in its S stock was \$800,000, and S's basis in its T stock was \$500,000. During the current year, S reports \$100,000 of taxable income, and T reports \$50,000 of taxable

⁵³ Reg. Sec. 1.1502-32. If the parent owns less than 100% of the subsidiary's stock, it adjusts the stock basis by its ownership percentage multiplied by the various adjustment items.

⁵⁴ Reg. Sec. 1502-32(b)(3)(ii)(B).

income. Assume that the portions of the consolidated tax liability allocable to S and T are \$21,000 ($\$100,000 \times 0.21$) and \$10,500 ($\$50,000 \times 0.21$), respectively, and that each pays its allocable portion. S increases the basis in its T stock to \$539,500 ($\$500,000 + \$50,000 - \$10,500$). P increases the basis in its S stock to \$918,500 ($\$800,000 + \$100,000 - \$21,000 + \$50,000 - \$10,500$), reflecting adjustments for both tiers below P. ◀

EXCESS LOSS ACCOUNT

If the negative basis adjustments (e.g., for losses and distributions) are sufficiently large, the parent reduces its basis in the subsidiary stock to zero. Additional negative basis adjustments create or increase an excess loss account. Creation of or change in the balance of an excess loss account does not trigger recognition of income or gain. Instead, it is treated as negative basis. Subsequent profits or other positive basis adjustments first reduce or eliminate the excess loss account before producing a positive basis in the subsidiary stock. A corporation disposing of a subsidiary's stock recognizes its excess loss account in the disposed shares as income or gain from the disposition.⁵⁵

EXAMPLE C:8-45 ► P Corporation owns all of S Corporation's stock, and the two corporations have filed on a consolidated basis for several years. P's basis in its S stock was \$900,000 at the beginning of the current year. During the current year, S incurs a \$950,000 NOL, which offsets part of P's \$2.5 million of taxable income. On January 1 of the next year, P sells its S stock for \$80,000. P first reduces its basis in the S stock to zero, and the remaining \$50,000 ($\$950,000 - \$900,000$) of the negative adjustment creates an excess loss account. When P sells the S stock, it recognizes a \$130,000 gain ($\$80,000$ amount realized $- \$0$ basis $+ \$50,000$ excess loss account). ◀

TAX PLANNING CONSIDERATIONS

OBJECTIVE 8

Compare the advantages and disadvantages of filing a consolidated tax return

Filing a consolidated tax return has several advantages and disadvantages as discussed below. Thus, the decision whether or not to file a consolidated tax return is one of an affiliated group's tax planning considerations.

ADVANTAGES OF FILING A CONSOLIDATED TAX RETURN

- The consolidated group can offset one member's operating losses against another member's operating profits. This offset usually is beneficial because it allows the losses to immediately reduce taxes. If the group members filed separate returns, the losses carry over as an NOL. However, discounting decreases the present value of the tax savings from an NOL that carries over.
- The group can offset one member's net capital loss against another member's net capital gain. Again, this offset allows the net loss to immediately reduce taxes, and it reduces the chance that the losses will expire unused.
- The group computes various credit and deduction limitations on a consolidated basis (e.g., charitable contributions). If the group members filed separate tax returns, some members' credits or deductions might be only partially used due to the limitations, while other members' credits or deductions fall short of the limitations. By filing a consolidated tax return, group members with "excess" credits or deductions can take advantage of other members' "excess" limitations.
- In the consolidated tax return, the group eliminates dividends paid from one group member to another group member. However, the recipient member would be eligible for a 100% dividends-received deduction if they filed separate tax returns.
- The group defers gains and profits on intercompany transactions, which reduces the present value of the taxes on these items (assuming tax rates do not increase).

⁵⁵ Reg. Sec. 1.1502-19.

- ▶ The parent corporation (and upper tier corporations) increase their bases in subsidiary (and lower tier corporation) stock investments for the subsidiary's (and lower tier corporations') taxable income, much like pass-through entities, thereby eliminating multiple taxation at the higher tier levels.

DISADVANTAGES OF FILING A CONSOLIDATED TAX RETURN

- ▶ The group must continue to file consolidated tax returns for all subsequent tax years until the affiliated group terminates or the IRS grants permission for the group to discontinue filing on a consolidated basis. By filing a consolidated tax return, the group forfeits the flexibility to choose between filing on a separate or consolidated basis in future years.
- ▶ Offsetting one member's losses against other members' profits or gains reduces the limitations on various deductions and credits (e.g., charitable contributions), which may reduce the amounts of such items currently allowed on a consolidated basis compared to those allowed on a separate return basis.
- ▶ All group members must use the same taxable year.
- ▶ The group defers losses and deductions on intercompany transactions, which reduces the present value of the tax savings on these items (assuming tax rates do not increase).
- ▶ The group may incur additional administrative costs to maintain the records necessary to account for intercompany transactions and the special loss limitations, although it may realize some savings by filing a single tax return.

No general rule can be applied to determine whether an affiliated group should elect to file a consolidated tax return. Each group should examine the long- and short-term advantages and disadvantages of filing a consolidated tax return instead of separate tax returns before making this decision.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 9

Comply with the procedures for making a consolidated return election

ADDITIONAL COMMENT

On Form 1120, Item A (Page 1) includes a box to be checked if a consolidated tax return is filed. In addition, Question 3 in Schedule K (Page 4) asks whether a corporation is a subsidiary in an affiliated group.

THE BASIC ELECTION AND RETURN

As discussed earlier in this chapter, an affiliated group elects to file its tax return on a consolidated basis by filing a corporate tax return (Form 1120) that includes the income, expenses, etc. of all its members. The group must make the election no later than the due date for the common parent's tax return including any permitted extensions.⁵⁶ Each corporation that is a member of the affiliated group during the initial consolidated return year must consent to the election. The parent corporation consents by joining in the consolidated tax return. Each subsidiary corporation consents to the election by filing Form 1122 (Authorization and Consent of Subsidiary Corporation to Be Included in a Consolidated Income Tax Return) as part of the initial consolidated tax return. Only newly acquired subsidiary corporations file Form 1122 with subsequent consolidated tax returns.

Each year's consolidated tax return also must include Form 851 (Affiliations Schedule). This form includes names, addresses, and identification numbers of the corporations in the consolidated group; the corporations' tax prepayments; the ownership of their stock at the beginning of the tax year; and all stock ownership changes occurring during the tax year. Treasury Regulations require the group to file supporting statements with its consolidated tax return. These statements show in columnar form a reconciliation of the members' taxable incomes with consolidated taxable income, and they also

⁵⁶ Reg. Sec. 1.1502-75(a)(1).

ADDITIONAL COMMENT

If a corporation or consolidated group has a June 30 year end, the filing deadline is the fifteenth day of the third month after the end of its taxable year (i.e., September 15) until tax years beginning after 2025. For corporations and consolidated groups with taxable years ending on June 30, the extension for filing the tax return is seven months, until 2026.

show the details of each member's gross income and deductions so the IRS can readily audit them.⁵⁷ An example of such a reconciliation appears in the consolidated tax return included in Appendix B.

The due date for a consolidated tax return is the fifteenth day of the fourth month after the end of the consolidated group's tax year. The group can obtain a six-month extension for filing the tax return if the parent corporation files Form 7004 (Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns). The IRS will not assess a late payment penalty if the group pays at least 90% of its total tax liability by the unextended due date and pays the balance by the extended due date. Special rules apply for corporations having a June 30 year end. See the adjoining Additional Comment for details. If a subsidiary corporation enters or departs the consolidated group, the due date for its separate tax return for the part of the year it was not affiliated with the group depends on the date the group files its consolidated tax return.⁵⁸

Appendix B presents a sample Form 1120 for reporting the current year's results for the Alpha affiliated group described in Example C:8-46. The Form 1120 involves the three intercompany transactions mentioned in the example, and a worksheet that summarizes the income and expense items for the five corporations illustrates the reporting of the intercompany transactions and presents the details of the consolidated taxable income calculation.

EXAMPLE C:8-46 ►

Alpha Manufacturing Corporation owns 100% of Beta, Charlie, Delta, and Echo Corporations' stock. The affiliated group has filed consolidated tax returns for several years using the calendar year as its tax year. The five corporations' separate taxable income components are reported on the supporting schedule of the group's consolidated tax return contained in Appendix B. This return illustrates the following three common transactions involving members of a consolidated group:

ADDITIONAL COMMENT

If an affiliated group is considering making a consolidated return election, a properly executed Form 1122 should be obtained before any corporation is sold during the election year. After the sale, the consent form may be difficult to obtain.

- The sale of inventory from Alpha to Beta, the profit from which is deferred for consolidated taxable income. Beta sells additional inventory to outsiders.
- Intragroup dividends paid from Beta and Echo to Alpha
- Payment of interest from Delta to Alpha ◀

ADDITIONAL COMMENT

The treatment for state income tax purposes of corporations affiliated for federal income tax purposes varies. Many states allow such corporations to file on a separate or consolidated basis, but several other states require combined unitary reporting, which is somewhat similar to consolidated reporting. The corporations comprising a consolidated or unitary reporting group for state income tax purposes often differs from those comprising an affiliated group for federal income tax purposes (e.g., 50% rather than 80% minimum ownership).

Students should review this sample return to see how the group reports the transactions and how it transfers the numbers from the consolidated taxable income schedule to the consolidated group's Form 1120. Although not displayed in Appendix B, the consolidated return should include a Schedule M-3 if applicable (see Chapter C:3).

PARENT CORPORATION AS AGENT FOR THE CONSOLIDATED GROUP

A consolidated group's parent corporation generally acts as the sole agent for all matters relating to the group's consolidated tax liability.⁵⁹ This agency role means that a subsidiary corporation cannot act in its own behalf with respect to a consolidated return year except to the extent that Treasury Regulations prohibit the parent from acting in the subsidiary's behalf. For example, the parent, not the subsidiary, makes or changes any election used in computing the subsidiary's separate taxable income, corresponds with the IRS regarding a tax liability determination, files any requests for extensions of time in which to file a tax return, files a claim for a refund or credit relating to a consolidated return year, or elects to deduct or credit foreign tax payments.

⁵⁷ Reg. Sec. 1.1502-75(j).

⁵⁸ Reg. Sec. 1.1502-76(c). The details of these rules are beyond the scope of this text.

⁵⁹ Reg. Sec. 1.1502-77(a).

SEPARATE ENTITY TREATMENT OF INTERCOMPANY TRANSACTIONS

The consolidated group's common parent can request consent from the IRS to treat the group's intercompany transactions on a separate entity basis, where the transactions are treated as if the group members involved were not members of the same consolidated group. When deciding whether to grant such consent, the IRS considers whether such treatment reduces the group's tax compliance burden and whether it has more than a 5% effect on the group's consolidated taxable income or consolidated tax liability. The group can make the request for all its intercompany transactions (other than those involving group members' stock or obligations) or only one or more classes of intercompany transactions. The group applies such separate entity treatment for the consolidated return year for which the IRS grants consent and subsequent tax years. The group's common parent can revoke such separate entity treatment if the IRS consents to it, and the IRS can revoke the group's use of such treatment.⁶⁰

TAX STRATEGY TIP

Because of the several liability rule, the purchaser of a consolidated group's subsidiary should consider obtaining an agreement under which the purchaser will be reimbursed for any additional taxes, interest, and penalties the IRS assesses the subsidiary that are attributable to other group members.

LIABILITY FOR TAXES DUE

The parent corporation and every other corporation that was a group member for any part of the consolidated return year are liable for that year's consolidated tax liability.⁶¹ Thus, the IRS may collect the entire consolidated tax liability from one group member if the other group members are unable to pay their allocable portion of the tax. The IRS can ignore any agreements among the group members to limit their share of the tax liability. A corporation that is a member of a consolidated group for even a few days during a tax year can be liable for the entire year's consolidated tax liability and related deficiencies.

An exception to this several liability rule occurs when a subsidiary corporation departs the consolidated group because its stock is sold or exchanged before the IRS assesses a deficiency against the group. The IRS can opt to assess a former subsidiary for only its allocable portion of the total deficiency if the IRS believes that the assessment and collection of the balance of the deficiency from the other group members will not be jeopardized.

FINANCIAL STATEMENT IMPLICATIONS

OBJECTIVE 10

Explain the financial statement implications of various consolidated transactions

INTERCOMPANY TRANSACTIONS

Intercompany transactions can raise deferred tax issues depending on the type of transaction and whether the affiliated group files consolidated tax returns or separate tax returns. The following discussion assumes a 100%-owned domestic subsidiary to avoid the complications of accounting for noncontrolling interests and for foreign subsidiaries. It also addresses just two types of intercompany transactions: (1) distributed and undistributed subsidiary profits and (2) intercompany sales of property.

For a parent with a 100%-owned domestic subsidiary, intercompany dividends and undistributed subsidiary earnings cause no temporary differences. If the group files a consolidated tax return, the intercompany dividend is eliminated for both tax and consolidated financial statement purposes. If the group files separate tax returns, the parent takes a 100% dividends-received deduction because it owns at least 80% of the subsidiary's stock. Therefore, in either case, no book-tax difference occurs that would create a temporary difference. Undistributed subsidiary earnings are included in consolidated financial statements, but a parent filing a separate tax return would not include these earnings in its income until the subsidiary distributes them as dividends. However, when ultimately distributed, the parent can take the 100% dividends-received deduction, thereby offsetting the dividend income. Consequently, undistributed subsidiary earnings also present no deferred tax issues (within the assumed parameters of this discussion).

⁶⁰ Reg. Sec. 1.1502-13(e)(3) and Rev. Proc. 2009-31, 2009-27 I.R.B. 107.

⁶¹ Reg. Sec. 1.1502-6(a).

ADDITIONAL COMMENT

Although a consolidated group defers income or loss on intercompany sales for both tax and financial statement purposes, the amount of income or loss deferred may differ.

ADDITIONAL COMMENT

The prohibition on recognizing a deferred tax asset applies only to intra-entity inventory transfers. See the text after Example C:8-47 for a discussion of non-inventory assets.

Intercompany sales, however, do raise deferred tax issues in certain cases. If the group files a consolidated tax return, the group defers income or loss on intercompany sales of inventory and other property for both tax and consolidated financial statement purposes. Thus, temporary differences and deferred tax issues do not arise. On the other hand, if the group members each file a separate tax return, the selling member recognizes income or loss for tax purposes but not for consolidated financial statement purposes, thereby creating a temporary difference. Accounting Standards Codification (ASC) 810 requires the group to defer recognizing income taxes on intercompany profits on assets remaining within the group,⁶² but ASC 740 prohibits “recognition of a deferred tax asset for the difference between the tax basis of inventory in the buyer’s tax jurisdiction and the carrying value as reported in the consolidated financial statements as a result of an intra-entity transfer of inventory from one tax-paying component to another tax-paying component of the same consolidated group.”⁶³ Thus, even though the buyer’s tax basis (the intercompany purchase price) may exceed the financial statement basis (e.g., the original cost), the group does not recognize a deferred tax asset. Instead, the group recognizes a prepaid asset for the seller’s tax on the intercompany profit.

EXAMPLE C:8-47 ►

P Corporation forms S Corporation on January 2 of the current year as a 100%-owned subsidiary. P and S have no temporary or permanent differences aside from those that might arise on intercompany transactions. For the current year, P and S report the following transactions:

	<u>P Corp.</u>	<u>S Corp.</u>
Net income before intercompany transactions and income taxes	\$900,000	\$360,000
Profit on sale of inventory from P to S	150,000	
Profit on partial sale of same inventory from S to third parties		18,000
Dividend from S to P	120,000	

The \$150,000 profit to P is the difference between the inventory’s \$180,000 cost to P and its \$330,000 selling price to S. S, in turn, sells 30% of this inventory to third parties for \$117,000. This portion of the inventory had a \$99,000 ($\$330,000 \times 0.30$) tax basis to S, thereby generating the \$18,000 profit.

If P and S file a consolidated tax return for the current year, the \$120,000 intercompany dividend and the \$105,000 ($\$150,000 \times 0.70$) profit in the remaining inventory will be eliminated in both the consolidated financial statements and the consolidated tax return, leaving no temporary differences. Thus, consolidated taxable income (as well as net income before federal income taxes) will equal \$1,323,000 ($\$900,000 + \$360,000 + (\$150,000 - \$105,000) + \$18,000$), and the federal income tax liability will be \$277,830 ($\$1,323,000 \times 0.21$). Accordingly, the group makes the following book journal entry:

Federal income tax expense	277,830	
Federal income taxes payable		277,830

If instead, P and S file separate tax returns, P will claim a \$120,000 dividends-received deduction. P, however, will eliminate the \$105,000 inventory profit deferred for consolidated financial statement purposes but not for tax purposes. Thus, P’s separate taxable income will be \$1,050,000 ($\$900,000 + \$150,000 + \$120,000 - \$120,000$), and S’s separate taxable income will be \$378,000 ($\$360,000 + \$18,000$). The tax liabilities will be \$220,500 ($\$1,050,000 \times 0.21$) for P and \$79,380 ($\$378,000 \times 0.21$) for S, resulting in a total of \$299,880. At the same time, the group’s consolidated net income before federal income taxes remains at \$1,323,000, which is \$105,000 ($\$1,050,000 + \$378,000 - \$1,323,000$) less than the group’s total taxable income. The group records as prepaid taxes the \$22,050 ($\$105,000 \times 0.21$) tax that P pays on the eliminated intercompany inventory profit, so the group’s federal income tax expense is \$277,830 ($\$299,880 - \$22,050$). This \$277,830 also equals 21% of the group’s \$1,323,000 consolidated net income before federal income taxes. Accordingly, the group makes the following book journal entry:

Federal income tax expense	277,830	
Prepaid taxes	22,050	
Federal income taxes payable		299,880

⁶² Accounting Standards Codification (ASC) 810-10-45-8.

⁶³ Accounting Standards Codification (ASC) 740-10-25-3 and 740-10-25-20.

Next year, P and S earn the same income before intercompany transactions (\$900,000 and \$360,000, respectively) and file separate tax returns. However, they have no intercompany transactions next year, and S sells the remaining inventory to third parties for a \$42,000 profit. Thus, P's taxable income is \$900,000, and S's taxable income is \$402,000 (\$360,000 + \$42,000). In addition, P's tax liability is \$189,000 ($\$900,000 \times 0.21$), and S's tax liability is \$84,420 ($\$402,000 \times 0.21$), for a total of \$273,420. At the same time, the group's consolidated net income after recognizing the \$105,000 deferred profit but before federal income taxes is \$1,407,000 ($\$900,000 + \$402,000 + \$105,000$). The group now charges to federal income tax expense the \$22,050 it previously recorded as prepaid taxes in the year the intercompany sale occurred, so the group's federal income tax expense is \$295,470 ($\$273,420 + \$22,050$). This \$295,470 also equals 21% of the group's \$1,407,000 consolidated net income before federal income taxes. Accordingly, the group makes the following book journal entry:

Federal income tax expense	295,470	
Prepaid taxes		22,050
Federal income taxes payable		273,420

The financial accounting treatment discussed above applies to intercompany sales of *inventory*, but a recent change in GAAP makes this treatment inapplicable to intercompany sales of other property.⁶⁴ For such a transaction, the group recognizes current and deferred income taxes on the sale's intercompany profit or loss, even though the group defers recognizing the profit or loss for consolidated financial statement purposes.

EXAMPLE C:8-48 ▶ Assume the same facts as in Example C:8-47, except the property is marketable securities. Because the property is not inventory, the group recognizes current and deferred income taxes on the intercompany profit. If P and S file separate tax returns, the federal income taxes payable for the current and next years are \$299,880 and \$273,420, respectively, for the same reasons as in Example C:8-47. S's \$231,000 ($\$330,000 \times 0.70$) adjusted basis in the remaining securities exceeds its \$126,000 ($\$180,000 \times 0.70$) remaining book value, so the group debits deferred tax assets rather than prepaid taxes for \$22,050 ($(\$231,000 - \$126,000) \times 0.21$). Similarly, the group credits deferred tax assets rather than prepaid taxes for \$22,050 for the next year. Federal income tax expense is \$277,830 and \$295,470 for current and next years, respectively.⁶⁵ ◀

SRLY LOSSES

A net operating loss (NOL) from a separate return limitation year (SRLY) will create a deferred tax asset, possibly subject to a valuation allowance.

EXAMPLE C:8-49 ▶ Parent Corporation acquires 100% of Subsidiary Corporation at the beginning of the current year, when Subsidiary has a \$200,000 NOL that arose before 2018. Parent and Subsidiary elect to file a consolidated tax return for the current year. Assuming Parent's acquisition of Subsidiary is not a Sec. 382 ownership change, the SRLY limitation restricts the Parent-Subsidiary group's use of Subsidiary's NOL. Accordingly, management estimates that the group will be able to use only \$150,000 of the NOL before it expires. The group's tax rate is 21%. The deferred tax asset is \$42,000 ($\$200,000 \times 0.21$), and the valuation allowance is \$10,500 ($\$50,000 \times 0.21$).

ADDITIONAL COMMENT

NOLs arising in 2018 and later years carry over indefinitely, and their deductibility is limited to 80% of taxable income computed without regard to the NOL deduction. NOLs arising before 2018 carry over for 20 years (to the extent not carried back two years), and their deductibility is limited to 100% of taxable income computed without regard to the NOL deduction.

If Parent's acquisition of Subsidiary qualifies as a Sec. 382 ownership change, the SRLY limitation does not apply because of the overlap rule. However, the Sec. 382 limitation applies to restrict the group's use of Subsidiary's NOL. Assuming management estimates that the group will be able to use only \$140,000 of the NOL before it expires, the deferred tax asset is \$42,000 ($\$200,000 \times 0.21$), and the valuation allowance is \$12,600 ($\$60,000 \times 0.21$).

If Parent and Subsidiary file separate tax returns, Subsidiary's use of its own NOL is restricted. If Parent's acquisition of Subsidiary does not qualify as a Sec. 382 ownership change, Subsidiary can use the \$200,000 NOL only to offset the taxable income on its separate tax return, which restricts Subsidiary's use of its own NOL in much the same way as the SRLY limitation restricts it on a consolidated tax return. If the acquisition qualifies as a Sec. 382 ownership change, Subsidiary's use of its own NOL is limited to the same Sec. 382 limitation that applies had the corporations file a consolidated tax return. ◀

See Chapter C:3 for a general discussion of financial implications of federal income taxes.

⁶⁴ Accounting Standards Update 2016-16. This change generally is applicable to annual reporting periods beginning after December 15, 2017, but earlier adoption is allowed.

⁶⁵ Federal income tax expense is the same in Examples C:8-47 and C:8-48 because P and S are in the same taxing jurisdiction, i.e., federal government. If P and S were in different taxing jurisdictions, e.g., different countries, income tax expense could differ when the intercompany transaction involves inventory versus other property.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

- C:8-1** What minimum level of stock ownership does the IRC require for a corporation to be included in an affiliated group?
- C:8-2** Which of the following entities are includible in an affiliated group (if the 80% stock ownership requirements are met)?
- Domestic C corporation.
 - Foreign corporation.
 - Life insurance company taxed under Sec. 801.
 - Limited liability company.
- C:8-3** Pamela (an individual) owns 100% of P Corporation's stock and 100% of R Corporation's stock. P owns 100% of S Corporation's stock and 49% of T Corporation's stock. S owns the remaining 51% of T's stock. All the corporations are includible corporations and have only one class of stock.
- Which entities comprise an affiliated group?
 - Which entities comprise a controlled group?
 - How would your answer to Part a change if S were instead a foreign corporation?
- C:8-4** P Corporation purchases all of S Corporation's stock in the current year. Both corporations are includible corporations. S is P's only subsidiary. Explain their federal income tax return filing alternatives.
- C:8-5** How do the stock ownership requirements for an affiliated group of corporations differ from those for a controlled group?
- C:8-6** P Corporation owns 100% of the stock of S1 and S2 Corporations. S1 owns 51% of S3 Corporation's stock, and unrelated persons own the remaining 49%. S2 is a foreign corporation. Explain why the corporations included in a consolidated tax return can differ from the corporations included in a set of consolidated financial statements.
- C:8-7** Explain why the consolidated return Treasury Regulations are legislative regulations.
- C:8-8** P Corporation has owned all the stock of S and T Corporations for several years. P sells all of T's stock to Z Corporation during the current year.
- Does P's sale of T's stock cause the affiliated group to cease to exist?
 - Is T required to file a consolidated tax return with Z?
 - If P purchases all of T's stock from Z three years after it sells T's stock to Z, is T required to file a consolidated tax return with P and S?
 - How would your answers change if P did not own any of S's stock?
- C:8-9** P Corporation owns all the stock of S and T Corporations, and the three corporations elected to file a consolidated tax return for the prior year. What circumstances would allow the corporations to file separate tax returns for the current year?
- C:8-10** Define the following terms:
- Intercompany transaction.
 - Intercompany item.
 - Corresponding item.
 - Recomputed corresponding item.
 - Matching rule.
 - Acceleration rule.
- C:8-11** P and S1 Corporations have filed consolidated tax returns for several years. S1 acquires all of S2 Corporation's stock at the close of business on June 15 of the current year. Which of the following current year transactions are intercompany transactions?
- S1 sells machinery (Sec. 1245 property) to S2 on September 1.
 - P sells inventory to S1 throughout the year.
 - S2 performs services for S1 throughout the year.
 - P sells inventory to the S1-S2 Partnership on July 23. S1 and S2 are equal partners in the partnership.
- C:8-12** P, S1, and S2 Corporations comprise a consolidated group. The group members use the accrual method of accounting. For each of the following intercompany transactions that occur during the current year, determine the intercompany item, corresponding item, and recomputed corresponding item.
- P lends S1 money, and P charges interest at a 10% annual rate. The money and interest remain unpaid at the end of the tax year.
 - S1 sells inventory to P. At year end, P holds the entire inventory purchased from S1.
 - P sells land (Sec. 1231 property) to S2. S2 holds the land (Sec. 1231 property) at year-end.
 - S1 provides engineering services that are capitalized as part of the cost of S2's new factory building.
- C:8-13** One consolidated group member lends money to another member of its group. Both corporations use the accrual method of accounting. Explain how the lending group member reports its interest income and how the borrowing group member reports its interest expense for consolidated tax return purposes. Discuss how this treatment compares to the consolidated financial accounting treatment of the transaction.

- C:8-14** Brooklyn and Bronx Corporations become an affiliated group at the beginning of the current year. Will the corporations obtain a greater charitable contribution deduction for the current year by filing a consolidated tax return or separate tax returns?
- C:8-15** An affiliated group elects to file a consolidated tax return. 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.
- C:8-16** Indicate the tax treatment for each of the following dividends received by a corporation that is a member of an affiliated group filing a consolidated tax return:
- Dividend received from a corporation that is 5%-owned by the group member.
 - Dividend received from a corporation that is 100%-owned by the group member.
 - Dividend received from a foreign corporation that is 80%-owned by the group's parent corporation.
 - Dividend received from a life insurance company that is 100%-owned by the group's parent corporation.
 - Dividend received from a corporation that is 50%-owned by the group member and 50%-owned by the group's parent corporation.
- C:8-17** P, S, and T Corporations comprise a consolidated group. In the current year, P has a profit, while S and T both incur a loss. The net of P's profit with S's and T's losses result in a consolidated NOL. In what years can P, S, and/or T deduct the consolidated NOL?
- C:8-18** Define the term SRLY and explain its significance and application to a consolidated tax return.
- C:8-19** What is the SRLY-Sec. 382 overlap rule? Explain its significance and application to a consolidated tax return.
- C:8-20** P Corporation owns 100% of S Corporation's stock, and the corporations file a consolidated tax return.
- Explain why P must increase the basis in its S stock by S's taxable income and decrease the basis by the dividends S pays to P.
 - Suppose S owns 100% of T Corporation's stock. Explain the basis adjustments that P and S must make.
- C:8-21** P Corporation owns 100% of the stock of S1 and S2 Corporations. The corporations currently are filing separate tax returns. P and S1 are profitable. S2 is a start-up company that has reported losses for its first two years of operations. S1 eventually will be purchasing cosmetics from S2 and reselling them to retailers. What are the advantages and disadvantages of the three corporations filing a consolidated tax return?
- C:8-22** The president of your CPA firm's largest client, a medium-size manufacturing company, advises you that the firm is about to acquire its largest supplier. Both companies have been profitable for the past ten years. The president wants to know what tax return filing options are available for the two companies and the advantages and disadvantages of the options. What factors are likely to be most important for this decision? What additional information do you need to give the president an informed answer?
- C:8-23** During what time period can an affiliated group elect to file a consolidated tax return? How does it make the election? During what time period can it request to terminate its consolidation?
- C:8-24** For which of the following tax-related matters can an affiliated group's parent corporation act as the group's agent?
- Consent by a subsidiary corporation to the filing of a consolidated tax return.
 - Changing a subsidiary corporation's accounting method.
 - Corresponding with the IRS during its audit regarding a subsidiary corporation's transaction that affects the group's consolidated taxable income.
 - Requesting an extension of time to file a consolidated tax return.

ISSUE IDENTIFICATION QUESTIONS

- C:8-25** Mark owns all the stock of Red and Green Corporations. In each of the past five years, Red has reported approximately \$125,000 of taxable income, and Green has reported NOLs of about \$30,000. One-third of Red's profits come from sales to Green, and their intercompany sales have been increasing in recent years. What tax issues should Mark consider with respect to Red and Green?
- C:8-26** Alpha and Baker Corporations, accrual method of accounting corporations that use the calendar year as their tax year, have filed consolidated tax returns for several years. Baker, a 100%-owned subsidiary of Alpha, transfers a patent, equipment, and working capital to newly created Charter Corporation in exchange for 100% of its stock. In the current year, Charter will begin to produce parts for the automotive industry. Charter incurs organizational expenditures of \$12,000 and start-up expenditures of \$60,000. What

tax issues should Charter consider with respect to the selection of its overall accounting method, inventory method, and tax year, deducting its organizational and start-up expenditures, and the type of income tax return to file?

- C:8-27** Wildcat and Badger Corporations have filed consolidated tax returns for several years. Early in the current year, Wildcat purchases Hawkeye Corporation, a start-up business that incurred net operating losses in each of its first three years prior to the purchase. Hawkeye's losses total \$260,000. Can the Wildcat-Badger-Hawkeye group deduct the losses on its consolidated tax return? The group expects annual profits to be \$300,000, with Hawkeye's contribution to the total being \$50,000. What tax issues should the three corporations consider when determining how they can deduct the NOLs?

PROBLEMS

- C:8-28** *Affiliated Group Definition.* In each of the following cases, determine the corporations that comprise an affiliated group. All corporations are includible corporations and have one class of stock.
- B Corporation owns 100% of C Corporation's stock and 90% of D Corporation's stock. Unrelated persons own 10% of D's stock.
 - B Corporation owns 100% of C Corporation's stock and 90% of D Corporation's stock. C owns 80% of E Corporation's stock, and D owns 75% of F Corporation's stock. Unrelated persons own the remainder of D's, E's, and F's stock.
 - B Corporation owns 80% of C Corporation's stock and 40% of D Corporation's stock. C owns 41% of D's stock. Unrelated individuals own the remainder of C's and D's stock.
 - Luciano, an individual, owns all the stock of M and N Corporations.
 - Viviana, an individual, owns all the stock of W and X Corporations. W owns all of Y Corporation's stock, and X owns all of Z Corporation's stock.
- C:8-29** *Affiliated Group Definition.* In each of the following cases, determine the corporations that comprise an affiliated group. All corporations are includible corporations and have one class of stock unless otherwise indicated.
- P Corporation owns all the stock of S and T Corporations. T owns all of U Corporation's stock. T and U are Belgian corporations.
 - Assume the same facts as in Part a except U is a domestic corporation.
 - Omar, an individual, owns 100% of P Corporation's stock and 30% of S Corporation's stock. P owns 70% of S's stock.
 - G is a German corporation. G owns all of P Corporation's stock. P owns all of S Corporation's stock.
 - P Corporation owns all of S Corporation's stock. P and S each own 50% of T, a domestic limited liability company.
- C:8-30** *Stock Ownership Requirement.* Pierre Corporation's management is negotiating with Salem Corporation's management to purchase some of Salem's stock. Salem's outstanding shares are as follows:

<u>Type of Stock</u>	<u>Votes per Share</u>	<u>Shares Outstanding</u>	<u>FMV per Share</u>
Common stock	4	60,000	\$40
Preferred stock	1	10,000	75

Pierre's management wants to acquire enough Salem stock to allow Pierre and Salem to file a consolidated tax return. Pierre and Salem are includible corporations.

- If Pierre acquires all of Salem's common stock and none of Salem's preferred stock, will they be eligible to file a consolidated tax return?
- What minimum amount of Salem's common stock and/or preferred stock must Pierre acquire for the two corporations to be eligible to file a consolidated tax return?
- Suppose that Salem also has 10,000 shares of nonvoting preferred stock outstanding. Each share's FMV is \$90. The stock is nonparticipating, has redemption and liquidation rights limited to its issue price, and is not convertible. If Pierre acquires all of Salem's common and voting preferred stock, what minimum amount of Salem nonvoting preferred stock must Pierre acquire for the two corporations to be eligible to file a consolidated tax return?

- C:8-31** *Affiliated Group Termination.* P Corporation owns all of S Corporation's stock. P and S have filed consolidated tax returns for several years. Determine whether the affiliated group terminates in each of the following circumstances. Assume that all corporations use the calendar year as their tax year.
- On February 1 of the current year, P purchases all of T Corporation's stock.
 - On March 1 of the current year, P purchases all of T Corporation's stock. On October 1 of the current year, P sells all of S's stock.
 - On April 1 of the current year, P sells all of S's stock. On September 1 of the current year, P purchases all of T Corporation's stock.
 - On May 1 of the current year, P sells all of S's stock. On January 1 of the next year, P purchases all of T Corporation's stock.
 - On June 1, R Corporation purchases all of P's stock. R had no subsidiaries prior to June 1.
 - On July 1, R Corporation purchases all of P's stock. On July 1, R has several wholly owned subsidiaries with which it has filed consolidated tax returns for several years.
- C:8-32** *Consolidated Taxable Income.* Assume the same facts as in Problem C:8-31. What tax returns must the corporations file for the current year?
- C:8-33** *Consolidated Taxable Income.* P Corporation owns all the stock of S1 and S2 Corporations. The corporations have filed calendar year, consolidated tax returns for several years. On September 15 of the current year, P sells all of S1's stock to Michelle, an unrelated individual. What effect does P's sale of S1's stock have on the P-S1-S2 group's current year consolidated taxable income?
- C:8-34** *Consolidated Return Election.* P Corporation uses the calendar year as its tax year and the accrual method as its overall accounting method. S Corporation uses a fiscal year ending June 30 as its tax year and the cash method as its overall accounting method. On July 31, 2019, P acquires all of S's stock, and the P-S affiliated group elects to file a consolidated tax return for 2019.
- What tax year must the group use in filing its consolidated tax return?
 - What overall accounting method(s) can P and S Corporations use?
 - What tax returns must the corporations file?
- C:8-35** *Consolidated Taxable Income.* P Corporation acquires all the stock of S Corporation on October 15 of the current year, which is the 288th day of the year (and not a leap year). Neither corporation is affiliated with another corporation prior to the acquisition. P and S use the accrual method of accounting, and each uses the calendar year as its taxable year. P's and S's income for the current year, which includes no extraordinary items, are \$876,000 and \$292,000, respectively. For each of the following circumstances, what tax returns must the corporations file for the current year, and what amount of income must each of those returns include?
- P and S elect to file a consolidated tax return and also elect to ratably allocate the entering subsidiary's income.
 - P and S do not elect to file a consolidated tax return.
- C:8-36** *Intercompany Transactions.* P, S1, and S2 Corporations have filed consolidated tax returns for several years. In the current year (Year 1), S1 sells land to S2 for \$275,000. S1 purchased the land for \$120,000 several years ago and has held it for possible expansion. S2 constructs a new plant facility on the land. In Year 3, S2 sells the land and the plant facility to a third party for cash, with \$400,000 of the sales price attributable to the land.
- What are the intercompany item, the corresponding item, and the recomputed corresponding item for this intercompany transaction?
 - In what year(s) are S1's gain or loss and S2's gain or loss included in consolidated taxable income?
- C:8-37** *Intercompany Transactions.* P Corporation owns all the stock of S and B Corporations. The three corporations have filed consolidated tax returns on a calendar year basis for several years. S owns property it had purchased for \$40,000 several years ago. On August 1 of Year 1, S sells the property to B for \$55,000. On February 1 of Year 3, B sells the property to an unrelated third party for \$60,000.
- What are the intercompany item, the corresponding item, and the recomputed corresponding item for this intercompany transaction?
 - In what year(s) are S's and B's gains or losses included in consolidated taxable income?

- c. Suppose B sells the property to the third party for \$53,000 instead of \$60,000. How would your answers to Part b change?
- d. Suppose P sells all of its B stock to an unrelated third party on October 1 of Year 2. How would your answers to Part b change?

- C:8-38** *Intercompany Transactions.* P Corporation owns all the stock of S1 and S2 Corporations, and the three corporations have filed consolidated tax returns on a calendar year basis for several years. P owns 2,400 shares of publicly traded stock it purchased several years ago for \$30 per share. P sells all the stock to S1 for \$45 per share on January 25 of the current year (Year 1). S1 sells 1,400 shares of the stock to a third party for \$48 per share on December 6 of Year 1, and S1 sells the other 1,000 shares to another third party for \$52 per share on March 18 of Year 2.
- What are the intercompany item, the corresponding items, and the recomputed corresponding items for this intercompany transaction?
 - In what year(s) are P's gain or loss and S1's gain or loss included in consolidated taxable income?
 - Suppose P sells all of S1's stock to a third party on December 30 of Year 1. How would your answer to Part b change?
 - Suppose S1 sells the 1,000 shares on March 18 of Year 2, for \$44 per share instead of \$52 per share. How would your answers to Parts a and b change?
- C:8-39** *Intercompany Transactions.* P and S Corporations have filed consolidated tax returns for several years. In Year 1, P purchased land as an investment for \$20,000. In Year 3, P sold the land to S for \$60,000. S used the land for four years as additional parking space for its employees and made no improvements to the land. In Year 7, S sells the land to Z Corporation, an unrelated party, for \$180,000. The sale's terms require Z to pay S \$36,000 in each of Years 7 through 11. The terms also require Z to pay S interest at a rate acceptable to the IRS. Z pays all the required amounts.
- What are the intercompany item, the corresponding items, and the recomputed corresponding items?
 - In what year(s) does the consolidated group include P's gain or loss and S's gain or loss in its taxable income?
 - How does the consolidated group report the interest income?
- C:8-40** *Intercompany Transactions.* P owns all the stock of S1 and S2 Corporations. The corporations have filed consolidated tax returns for several years. In the current year (Year 1), S1 sells land to P for \$100,000. S1 purchased the land several years earlier for \$35,000. P sells the land to an unrelated third party in Year 3 for \$115,000. The sale's terms require the third party to pay P \$50,000 in Year 3, \$40,000 in Year 4, and \$25,000 in Year 5, plus interest at a rate acceptable to the IRS. The third party pays all the required amounts.
- In what year(s) does the consolidated group include S1's gain or loss and P's gain or loss in its taxable income?
 - Suppose P sells all of S1's stock on December 31 of Year 4. How would this sale change your answer to Part a?
 - Suppose S1 sold the land to P in Year 1 for \$120,000 instead of \$100,000. How would this sale change your answer to Part a?
- C:8-41** *Intercompany Transactions.* P Corporation owns all of S Corporation's stock. Both corporations use the accrual method of accounting, and they file a consolidated tax return. S provides cleaning services to P. In so doing, S charges P \$6,000 for the services and incurs \$5,000 of expenses to provide them. How does this transaction affect the group's consolidated taxable income?
- C:8-42** *Intercompany Transactions.* P and S Corporations have filed consolidated tax returns on a calendar year basis for several years. Both corporations use the accrual method of accounting. On August 1 of the current year (Year 1), P loans S \$250,000 on a one-year note. P charges interest at a 12% simple rate. S repays the loan plus interest on July 31 of Year 2. How does this intercompany transaction affect the group's consolidated taxable income?
- C:8-43** *Intercompany Transactions.* P and S Corporations have filed consolidated tax returns on a calendar year basis for several years. Both corporations use the accrual method of accounting. On January 1 of the current year, S begins renting a warehouse to P for \$10,000 per month. P pays S \$10,000 on the first day of each month of the current year. How does this transaction affect the group's consolidated taxable income?
- C:8-44** *Intercompany Transactions.* S and B corporations are members of an affiliated group that has filed consolidated tax returns for several years. S drills a water well for B in Year

1 and charges B \$5,000 for the service. S incurs \$4,400 of expenses when drilling the well. B capitalizes the \$5,000 cost of its well and amortizes it over the five-year period Years 2 through 6. S and B both use the accrual method of accounting.

- What are the intercompany item, the corresponding items, and the recomputed corresponding items for this intercompany transaction?
- In what year(s) are S's profit or loss and B's deductions taken into account for consolidated taxable income?

C:8-45 *Intercompany Transactions.* P and S Corporations have filed consolidated tax returns for several years. In the current year (Year 1), P began selling inventory items to S. P and S use the first-in, first-out (FIFO) inventory method. P's profits on its Year 1 inventory sales to S are \$75,000. S's sales to third parties during Year 1 include inventory items that P sells to S during Year 1 for a \$40,000 profit; S sells these inventory items to third parties for a \$25,000 profit. S's inventory at the end of Year 1 includes items that P sells to S for a \$35,000 profit. S is deemed to sell these to third parties during Year 2 due to its use of the FIFO method and realizes a \$22,000 profit on their sale. P's profits on its Year 2 inventory sales to S are \$240,000. S's sales to third parties during Year 2 include items that P sells to S during Year 2 for a \$160,000 profit. S sells these inventory items to third parties for a \$105,000 profit. S's inventory at the end of Year 2 includes items that P sells to S for an \$80,000 profit. The group's consolidated taxable income (before taking into account any adjustments for profits on intercompany inventory sales) is \$100,000 in Year 1 and \$367,000 in Year 2. For simplicity, assume P and S have no other transactions in these two years. What is the group's consolidated taxable income for Years 1 and 2?

C:8-46 *Intercompany Transactions.* P and S Corporations have filed consolidated tax returns for several years. The group had no intercompany inventory sales before the current year (Year 1). P and S use the first-in, first-out (FIFO) inventory method. During Year 1, S sells 50,000 widgets to P, earning \$8 per unit profit on the sale. Also during Year 1, P sells 37,500 of these widgets to third parties for an additional \$6 per unit profit. Thus, P's inventory at the end of Year 1 includes 12,500 of unsold widgets. During Year 2, S sells 80,000 widgets to P, earning \$9 per unit profit on the sale. Also during Year 2, P sells to third parties 65,000 of these widgets and also sells the 12,500 widgets from beginning inventory, all for an additional \$6 per unit profit. Thus, P's inventory at the end of Year 2 includes 15,000 widgets P purchased from S in Year 2. No intercompany inventory sales occur in Year 3. However, during Year 3, P sells all widgets in beginning inventory for an additional \$7 per unit profit. In addition to these intercompany transactions, P incurs a \$40,000 loss and S earns \$500,000 of profit in each year from other business activities. What is the group's consolidated taxable income for each of Years 1, 2, and 3?

C:8-47 *Charitable Contribution Deduction.* Topeka and Wichita Corporations have filed consolidated tax returns for several years. Topeka and Wichita report current year taxable incomes (without regard to any dividend income received, charitable contribution deduction, or dividends-received deduction) of \$200,000 and \$150,000, respectively. The \$200,000 includes \$30,000 profit on inventory that Topeka sold to Wichita on December 29 of the current year. Wichita sold none of the inventory before the end of the year. Topeka and Wichita received dividends of \$10,000 and \$4,000, respectively, during the current year that qualify for the 50% dividends-received deduction. Wichita's and Topeka's cash contributions to public charities during the current year are \$45,000 and \$5,000, respectively.

- What is the Topeka-Wichita group's consolidated taxable income?
- What is the amount of the charitable contribution carryover? How long can it be carried over?
- What is the Topeka-Wichita group's regular tax liability?

C:8-48 *Sec. 1231 Gains and Losses and Capital Gains and Losses.* Mobile, Newark, and Omaha Corporations comprise an affiliated group that has filed separate tax returns prior to the current year. The corporations report the following amounts for the current year:

<u>Transaction</u>	<u>Mobile</u>	<u>Newark</u>	<u>Omaha</u>	<u>Total</u>
Sec. 1231 gains	\$ 18,000	\$ 9,000	\$ -0-	\$ 27,000
Sec. 1231 losses	12,000	14,000	-0-	26,000
Short-term capital gains	3,500	-0-	-0-	3,500
Short-term capital losses	(2,000)	-0-	(6,200)	(8,200)
Long-term capital gains	-0-	8,100	5,500	13,600
Long-term capital losses	(2,400)	(7,300)	-0-	(9,700)
Other separate taxable income	300,000	200,000	100,000	600,000

The corporations have no intercompany transactions, no capital loss carryovers, and no nonrecaptured net Sec. 1231 losses.

- Determine each corporation's current year taxable income if they file separate tax returns for the current year.
- Determine the group's current year taxable income if the corporations elect to file a consolidated tax return.

C:8-49 *Capital Gains and Losses.* Alpha and Beta Corporations comprise an affiliated group that has filed separate tax returns prior to the current year. The corporations report the following amounts for the current year:

<u>Transaction</u>	<u>Alpha</u>	<u>Beta</u>	<u>Total</u>
Long-term capital gains	\$ 20,000	\$ 15,000	\$ 35,000
Long-term capital losses	(11,900)	(17,000)	(28,900)
Other separate taxable income	80,000	70,000	150,000

Alpha's long-term capital gains include a \$4,400 gain on land it sold to Beta during the current year. Beta had not sold the land by the end of the current year. The corporations have no other intercompany transactions and no capital loss carryovers.

- Determine each corporation's current year taxable income if they file separate tax returns for the current year.
- Determine the group's current year taxable income if the corporations elect to file a consolidated tax return.

C:8-50 *Dividends-Received Deduction.* P, S, and T Corporations have filed consolidated tax returns for several years. P, S, and T report taxable incomes or losses (without regard to any dividends received and dividends-received deductions) of \$200,000, \$(70,000), and \$175,000, respectively, for the current year. P and S received cash dividends this year as follows:

<u>Shareholder</u>	<u>Distributing Corporation</u>	<u>Amount</u>
P Corporation	T Corporation	\$125,000
P Corporation	100%-owned nonconsolidated U.S.-based life insurance company	15,000
S Corporation	25%-owned domestic corporation	40,000
P Corporation	51%-owned foreign corporation	10,000

- What amount of dividend income does the group include in its consolidated taxable income?
- What is the amount of the consolidated dividends-received deduction?
- What is the amount of consolidated taxable income and consolidated regular tax liability?

C:8-51 *Tax Liability and NOLs.* Miami and Tampa Corporations comprise an affiliated group that has filed separate tax returns prior to the current year. In each case for the current year, determine each corporation's tax liability if they file separate tax returns, and determine the group's consolidated tax liability if they elect to file a consolidated tax return. Assume that, if the group elects to file a consolidated tax return, its consolidated taxable income equals the sum of Miami's and Tampa's separate taxable incomes.

- Miami's separate taxable income is \$50,000, and Tampa's separate taxable income is \$30,000.
- Miami's separate taxable income is \$70,000, and Tampa's separate taxable income is \$(15,000), i.e., a loss.

C:8-52 *General Business Credit.* Peoria and Salem Corporations have filed consolidated tax returns for several years. For the current year, consolidated taxable income is \$300,000. The consolidated general business credit (computed without regard to the overall limitation) is \$51,000.

- What is the group's federal tax liability?
- Are any credit carryovers created in the current year? How are they used?

C:8-53 *Consolidated NOL Carryovers.* P and S Corporations form in Year 1, with S as P's wholly-owned subsidiary. The corporations immediately elect to file consolidated tax returns. The group reports the following results:

<u>Group Member</u>	<u>Taxable Income</u>			
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
P	\$9,000	\$20,000	\$21,000	\$25,000
S	(7,800)	(30,000)	(16,000)	2,000
Consolidated taxable income (before NOL deduction)	<u>\$1,200</u>	<u>\$(10,000)</u>	<u>\$ 5,000</u>	<u>\$27,000</u>

In what year(s) can the group deduct the Year 2 consolidated NOL? Assume that Year 2 is 2018 or a later year.

- C:8-54** *Consolidated NOL Carryover.* P Corporation owns all the stock of S1 and S2 Corporations. The corporations have filed consolidated tax returns since their creation in Year 1. At the close of business on July 10 of Year 2, P sells all of its S2 stock. The group reports the following results:

<u>Group Member</u>	<u>Taxable Income</u>	
	<u>Year 1</u>	<u>Year 2</u>
P	\$(18,000)	\$32,000
S1	(24,000)	(8,000)
S2	(28,000)	30,000 ^a
Consolidated taxable income (before NOL deduction)	<u>\$(70,000)</u>	<u>\$38,000^b</u>

^a\$14,000 is attributable to January 1 through July 10 of Year 2, and \$16,000 is attributable to July 11 through December 31 of Year 2.

^b\$32,000 + (\$8,000) + \$14,000

In what year(s) can the corporations deduct the Year 1 consolidated NOL? Assume that Year 1 is 2018 or a later year.

- C:8-55** *Separate Return and Consolidated NOL Carryovers.* P Corporation acquires all of S Corporation's stock on January 1 of Year 2. In Year 1, the corporations were unrelated entities that filed separate returns. P and S report the following results:

<u>Group Member</u>	<u>Taxable Income</u>		
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
P	\$40,000	\$(30,000)	\$21,000
S	(29,000)	20,000	6,000
Consolidated taxable income (before NOL deduction)	<u>N/A</u>	<u>\$(10,000)</u>	<u>\$27,000</u>

N/A = Not applicable

Ignore the Sec. 382 loss limitation that might apply to P's acquisition of S. Assume that Year 1 is 2018 or a later year.

- What are the Year 2 tax consequences if P and S file a consolidated tax return? What are the Year 2 tax consequences if P and S instead file separate tax returns?
- What are the Year 3 tax consequences if P and S file consolidated returns for Years 2 and 3?

- C:8-56** *Consolidated NOL Carryovers and Intercompany Transactions.* P Corporation owns all the stock of S1 and S2 Corporations, and the group has filed consolidated tax returns on a calendar year basis for several years. In the current year (Year 1), S2 sells to S1 for \$90,000 land S2 had purchased for \$75,000. On December 31 of Year 2, S1 sells the land to a third party for \$91,000. On January 18 of Year 3, P sells all of its S2 stock to a third party for a sales price equal to P's basis in the S2 stock. The consolidated group members report the following amounts of taxable income and loss (before deducting any NOLs or applying the matching and acceleration rules):

<u>Group Member</u>	<u>Taxable Income (Loss)</u>	
	<u>Year 2</u>	<u>Year 3</u>
P	\$165,000	\$(30,000)
S1	(120,000)	(20,000)
S2	(140,000)	7,000 ^a
Consolidated taxable income or loss before deducting any NOLs or applying the matching and acceleration rules	<u>\$ (95,000)</u>	<u>\$(43,000)</u>

^a Pertains to January 1 through January 18 of Year 3.

Assume that Year 2 is 2018 or a later year.

- Determine the amount of NOL available for S2's Year 3 separate tax return.
- Assume the same facts as in Part a except S1's land sale to a third party for \$91,000 occurred on January 1 of Year 3. Determine the amount of NOL available for S2's Year 3 separate tax return.

C:8-57 *SRLY Limitation.* P Corporation acquires all of S Corporation's stock at the close of business on December 31 of Year 1. The corporations, which file on the calendar year, begin filing a consolidated tax return for Year 2. The corporations report the following taxable incomes (losses), before any NOL deduction, for Years 1 through 5:

<u>Group Member</u>	<u>Taxable Income Before NOL deduction</u>				
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
P	\$100,000	\$125,000	\$71,000	\$(8,000)	\$100,000
S	(63,000)	(15,000)	18,000	25,000	40,000
Consolidated taxable income (before NOL deduction)	<u>N/A</u>	<u>\$110,000</u>	<u>\$ 89,000</u>	<u>\$17,000</u>	<u>\$140,000</u>

N/A = Not applicable

P and S have no NOLs before Year 1. Ignore the Sec. 382 loss limitation that might apply to P's acquisition of S, assume that the acquisition does not qualify as a reverse acquisition, and assume that Year 1 is 2018 or a later year. What is consolidated taxable income for each of Years 2 through 5?

C:8-58 *SRLY Limitation.* Bart, P's sole shareholder, creates P on January 1 of Year 1. P purchases all of S1's and S2's stock on September 1 of Year 1, after both corporations are in operation for about six months. P, S1, and S2 Corporations comprise the P-S1-S2 affiliated group and file separate tax returns for Year 1. The P-S1-S2 affiliated group then elects to file consolidated tax returns starting in Year 2. The group reports the following results:

<u>Group Member</u>	<u>Taxable Income</u>		
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
P	\$(8,000)	\$50,000	\$10,000
S1	(24,000)	20,000	(18,000)
S2	(16,000)	(10,000)	15,000
Consolidated taxable income (before NOL deduction)	<u>N/A</u>	<u>\$60,000</u>	<u>\$ 7,000</u>

Ignore the Sec. 382 loss limitation that might apply to the acquisitions of S1 and S2, assume that P's purchase of S1 and S2 does not qualify as a reverse acquisition, and assume that Year 1 is 2018 or a later year.

- What is Year 2 consolidated taxable income?
- What is Year 3 consolidated taxable income?
- What NOL carryovers are available in Year 4?
- How would your answer to Parts a through c change if Bart instead created P, S1, and S2 as an affiliated group on January 1 of Year 1?

- C:8-59** *SRLY and Sec. 382 Loss Limitations.* P Corporation owns 100% of S Corporation's stock, and they have filed consolidated tax returns for several years. P also has owned 49% of T Corporation's stock for 10 years. On December 31 of the current year (Year 1), P purchases the other 51% of T's stock for \$510,000 cash. T has \$160,000 of NOLs it is carrying over on that date. In Year 2, the corporations report taxable profits as follows: P, \$400,000; S, \$250,000; and T, \$90,000. Assume that the long-term tax-exempt federal interest rate is 5% and that Year 1 is 2018 or a later year.
- Determine the amount of T's NOLs the group can deduct for its Year 2 consolidated taxable income.
 - Assume the same facts as in Part a except P purchases 45% of T's stock for \$450,000 on December 31 of Year 1. Determine the amount of T's NOLs the group can deduct for its Year 2 consolidated taxable income.
- C:8-60** *Stock Basis Adjustments.* P Corporation purchases 100% of S Corporation's stock for \$2 million on January 1 of the current year. The corporations elect to file a consolidated tax return. During the current year, S reports \$350,000 of taxable income and \$30,000 of tax-exempt interest income, and it distributes a \$100,000 dividend to P. Each corporation pays its portion of the consolidated tax liability. The corporate tax rate is 21%. What is P's basis for its S stock at the end of the current year?
- C:8-61** *Stock Basis Adjustments.* P Corporation owns 100% of S Corporation's stock, and S owns 100% of T Corporation's stock. The three corporations have filed consolidated tax returns for several years. On January 1 of the current year, P's basis for its S stock is \$5 million, and S's basis for its T stock is \$3 million. The corporations' taxable incomes for the current year are \$500,000 for P, \$350,000 for S, and \$250,000 for T. S and T pay no dividends during the year. Each corporation pays its portion of the consolidated tax liability. The corporate tax rate is 21%.
- Determine P's basis for its S stock and S's basis for its T stock at the end of the current year.
 - Assume the same facts as in Part a except S pays an \$80,000 dividend to P and T pays a \$90,000 dividend to S. Determine P's basis for its S stock and S's basis for its T stock at the end of the current year.
- C:8-62** *Financial Statement Implications.* P and S Corporations comprise an affiliated group that files separate tax returns. P and S had no intercompany inventory sales before the current year (Year 1). P and S use the first-in, first-out (FIFO) inventory method. During Year 1, S sells 40,000 widgets to P, earning \$7 per unit profit on the sale. P's inventory at the end of Year 1 includes 10,000 of these widgets. During Year 2, S sells 75,000 widgets to P, earning \$7.50 per unit profit on the sale. P's inventory at the end of Year 2 includes 12,000 of these widgets. During Year 3, no intercompany inventory sales occur, and P sells all widgets in beginning inventory. P's and S's taxable income each year (including any profits from intercompany inventory sales) is \$380,000 and \$300,000, respectively. The corporate tax rate is 21%.
- Prepare the journal entries to record federal income tax expense for each of Years 1, 2, and 3.
 - Assume that, instead of units of inventory, S sells to P shares of marketable securities, with the same profits as in Part a. Again, prepare the journal entries to record federal income tax expense for each of Years 1, 2, and 3.
- C:8-63** *Financial Statement Implications.* P Corporation acquires all of S Corporation's stock at the beginning of the current year in a transaction that qualifies as a Sec. 382 ownership change. P and S elect to file a consolidated tax return for the current year. At the time of the acquisition, S has \$900,000 of pre-2018 NOLs it has not deducted. Management estimates that, because of the Sec. 382 limitation, the group will be able to use only \$300,000 of the NOLs before they expire. The corporate tax rate is 21%. Determine the amount of deferred tax asset and valuation allowance the group records for S's NOL.

COMPREHENSIVE PROBLEMS

- C:8-64** P and S Corporations have filed consolidated tax returns for ten years. P and S use the accrual method of accounting, and they use the calendar year as their tax year. P and S report separate return taxable income (before any consolidation adjustments and eliminations, the NOL deduction, the charitable contributions deduction, and the dividends-received deduction) for the current year of \$200,000 and \$250,000, respectively. These amounts include the following current year transactions and events:

- P sells land to a third party for \$80,000. P purchased the land from S two years ago for \$70,000. S had purchased the land five years ago for \$48,000.
- P's separate taxable income includes a \$12,000 dividend S paid to P.
- P sold inventory to S in the previous year for which the deferred profit at the beginning of the current year is \$5,000. S sells this inventory outside the consolidated group in the current year. P sells additional inventory to S in the current year, realizing a \$100,000 profit. The intercompany profit on this unsold inventory is \$8,000.
- The P-S group has a \$20,000 consolidated NOL carryover available from the previous year. The NOL is wholly attributable to S.
- P receives \$10,000 of dividends from corporations in which it owns less than 1% of the stock.
- P and S contribute cash to charities of \$17,000 and \$11,000, respectively.
- P lends S \$150,000 early in the current year. S repays the loan later in the year. In addition, S pays P \$6,000 interest at the time of repayment.
- S earns \$1,600 of tax-exempt interest income, which is not included in S's \$250,000 separate return taxable income.

Determine the P-S group's consolidated taxable income and consolidated tax liability for the current year. What is P's basis for the S stock at the end of the current year? Assume that P's basis for the S stock was \$1.4 million at the beginning of the current year.

- C:8-65** Using the facts from Problem C:8-67 below, calculate the tax liabilities of Flying Gator and T Corporations for 2018. How much larger (or smaller) would be the total of the two separate return tax liabilities if they were to file separate tax returns than the affiliated group's consolidated return tax liability? What taxes are due (or refund available) if Flying Gator made \$90,000 of estimated tax payments and T Corporation made \$10,000 of estimated tax payments?

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

- C:8-66** Sandra and John, who are unrelated, each own 50% of Alpha Corporation's stock and 50% of Beta Corporation's stock. For five years, Alpha has conducted manufacturing activities and sold machine parts primarily in the eastern United States. Alpha has reported \$75,000 of operating profits in each of the last two years. Alpha's annual operating profits are expected to grow to \$150,000 during the next five years. Alpha has \$100,000 of NOLs it is carrying over. Alpha sells 25% of its product to Beta. Beta has been working to establish a market niche for reselling Alpha products in the southwestern United States. In the start-up phase of establishing the market, Beta incurred \$200,000 of NOLs. Under the sales arrangement with Alpha, probably the best that Beta can hope to achieve in the short-run is reach a break-even point.

Required: What suggestions can you offer Sandra and John about the short-term possibility of using Alpha's and Beta's NOLs against the profits that Alpha expects to earn and about minimizing their overall tax liabilities if both businesses become profitable? Sandra has specifically asked about merging the two companies into a single entity so the losses of one entity can offset the profits of the other and delay the need to pay income taxes to the federal government. Sandra indicates that the two companies were created for business reasons and not tax avoidance reasons. The operating situation has changed and, according to Sandra, now may be the time to combine the entities into one. However, John is not sure that bringing the two businesses together is a good idea.

- C:8-67** River Corporation owns all 900,000 shares of Lake Corporation's common stock. Lake also has 250,000 shares of preferred stock, which are owned by unrelated persons. Each share of common stock is worth \$38 and has two votes, and each share of preferred stock is worth \$26 and has one vote. River has filed consolidated tax returns with Lake for many years.

Lake would like to provide stronger performance incentives for its management and is considering a plan under which it would compensate its management in part with newly-issued shares of its common stock. There is concern, however, that the resulting dilution in River's ownership would preclude Lake from continuing to file a consolidated tax return with River. Determine and advise management as to the maximum number of common shares Lake can issue to its management that would allow it to continue to file a consolidated tax return with River.

C:8-68

TAX FORM/RETURN PREPARATION PROBLEM

Flying Gator Corporation and its 100%-owned subsidiary, T Corporation, have filed consolidated tax returns for many years. Both corporations use the hybrid method of accounting and the calendar year as their tax year. During 2018 (which is the current year for this problem), they report the operating results as listed in Table C:8-2. Note the following additional information:

- Flying Gator and T Corporations are the only members of their controlled group.
- Flying Gator's address is 2101 W. University Ave., Gainesburg, FL 32611. Its employer identification number is 38-2345678. Flying Gator was incorporated on June 11, 2006. Its total assets are \$430,000.
- A \$50,000 consolidated NOL carryover from the preceding year is available. The NOL is wholly attributable to Flying Gator.
- Flying Gator and T use the first-in, first-out (FIFO) inventory method. T began selling inventory to Flying Gator in the preceding year, which resulted in a \$40,700 deferred intercompany profit at the end of the preceding year. Flying Gator is deemed to realize this profit in the current year because it uses the FIFO method. During the current year, T sells additional inventory to Flying Gator, realizing a \$300,000 profit. At the end of the current year, Flying Gator holds inventory responsible for \$45,100 of this profit.
- Flying Gator receives all its dividends from T. T receives all its dividends from a 60%-owned domestic corporation. All distributions are from E&P.
- Flying Gator receives all its interest income from T. T pays Flying Gator the interest on March 31 of the current year on a loan that was outstanding from October 1 of the preceding year through March 31 of the current year. Flying Gator and T did not accrue any interest at the end of the preceding year because they use the hybrid method of accounting. T pays \$5,000 of its interest expense to a third party.

▼ **TABLE C:8-2****Current Year Operating Results for Flying Gator and T Corporations (Problems C:8-65 and C:8-68)**

Income or Deductions	Flying Gator	T	Total
Gross receipts	\$2,500,000	\$1,250,000	\$3,750,000
Cost of goods sold	(1,500,000)	(700,000)	(2,200,000)
Gross profit	\$1,000,000	\$ 550,000	\$1,550,000
Dividends	100,000	50,000	150,000
Interest	15,000		15,000
Sec. 1231 gain		20,000	20,000
Sec. 1245 gain		25,000	25,000
Long-term capital gain (loss)	(5,000)	6,000	1,000
Short-term capital gain (loss)		(3,000)	(3,000)
Total income	\$1,110,000	\$ 648,000	\$1,758,000
Salaries and wages	175,000	200,000	375,000
Repairs	25,000	40,000	65,000
Bad debts	10,000	5,000	15,000
Taxes	18,000	24,000	42,000
Interest	30,000	20,000	50,000
Charitable contributions	22,000	48,000	70,000
Depreciation (other than that included in cost of goods sold)	85,000	40,000	125,000
Other expenses	160,000	260,000	420,000
Total deductions	\$ 525,000	\$ 637,000	\$1,162,000
Separate return taxable income (before the NOL deduction and DRD)	\$ 585,000	\$ 11,000	\$ 596,000

- Officer's salaries are \$80,000 for Flying Gator and \$65,000 for T. These amounts are included in salaries and wages in Table C:8-2.
- Flying Gator's capital losses include a \$9,000 long-term loss on a sale of land to T in the current year. T holds the land at year-end.
- The corporations have no nonrecaptured net Sec. 1231 losses from prior tax years.
- Estimated tax payments for the current year are \$100,000.

Determine the consolidated group's 2018 tax liability. Prepare the first page of the consolidated group's current year corporate income tax return (Form 1120). Hint: Prepare a spreadsheet similar to the one included in Appendix B to arrive at consolidated taxable income.

CASE STUDY PROBLEM

C:8-69 Carol owns all the stock of P Corporation and J Corporation. P operates six automotive service franchises in a metropolitan area. The service franchises have been a huge success in their first three years of operation, and P's annual taxable income exceeds \$600,000. J owns the real estate associated with the six service franchises and leases it to P. J reports large interest and MACRS depreciation deductions because of a highly leveraged, capital intensive operation. As a result, J has reported NOLs in its first three years of operation. P and J file separate tax returns.

Carol sees the idea for the automotive service franchise chain starting to really develop and expects to add six more locations in each of the next two years. Because of the rapid expansion that is planned, she feels that she has outgrown her father's accountant and needs to have new ideas to help her save tax dollars so she can reinvest more money in the business.

Required: The tax partner that you are assigned to requests that you prepare a memorandum outlining your thoughts about Carol's tax problems and suggested solutions to those problems in preparation for his meeting next week with Carol.

TAX RESEARCH PROBLEMS

C:8-70 Angela owns all the stock of A, B, and P Corporations. P has owned all the stock of S1 Corporation for six years. The P-S1 affiliated group has filed a consolidated tax return in each of these six years using the calendar year as its tax year. On July 10 of the current year (a nonleap year), Angela sells her entire stock investment in A, which uses the calendar year as its tax year. No change takes place in Angela's ownership of B's and P's stock during the tax year. At the close of business on November 25 of this year, S1 purchases 90% of the common stock and 80% of the nonconvertible, nonvoting preferred stock (measured by value) of S2 Corporation. All the corporations are includible corporations. Which corporations are included in the affiliated group? In the controlled group? What income is included in the various tax returns? How is the allocation of the income between tax years made if the books are not closed on the sale or acquisition dates?

A partial list of resources includes:

- IRC Sec. 1504
- IRC Sec. 1563
- Reg. Sec. 1.1502-76

C:8-71 P, R, and T Corporations have filed a consolidated tax return for a number of years using the calendar year as its tax year. Current plans call for P to purchase all of X Corporation's stock at the close of business on June 30 of the current year from three individuals. X was created seven years ago and always has been an S corporation using the calendar year as its tax year. The chief financial officer of P comes to your office and makes a number of inquiries about the tax consequences of the acquisition including: Can X retain its S election? If so, does it file a federal income tax return separate from the consolidated group? Does X have to be included in the P-R-T group's consolidated tax return? Assuming the acquisition takes place as planned, what tax returns are required of the consolidated group and X? What income is included in the pre-affiliation tax return of X (if required) and the consolidated group's post-acquisition consolidated tax return? Prepare a brief memo for the chief financial officer outlining the answers to these questions and any other questions you feel are relevant.

A partial list of resources includes:

- IRC Sec. 1361(b)
- IRC Sec. 1362(d)(2)
- Reg. Sec. 1.1502-76

C:8-72 Anna, one of your firm's clients, is a physician who owns and operates her practice through a professional service corporation (PSC). She sees opportunities to grow the PSC, allowing her to serve more patients and generate more profits. Anna, however, cannot invest more funds in her practice because she is still paying off her medical school loans. She also is concerned that this growth would require her to spend more time managing her practice's business aspects and less time with patients.

Anna was discussing her situation with a friend, whose medical practice is in the same city. He told Anna that she should look into a practice management company (PMCo). He explained that the PSC would continue to perform the medical activities, but the PMCo would charge the PSC a fee for overseeing the practice's business aspects. The fee would be based on the practice's profits. This structure would allow the PMCo to invest funds to grow the business and would satisfy a state law requiring all PSC shareholders to be physicians. He mentioned that, although Anna would remain as the legal owner of the PSC's stock, the PMCo probably would prohibit her from using that ownership to exercise control over the PSC, thereby prohibiting her from selling the PSC's stock without the PMCo's consent and prohibiting the PSC from paying her a dividend without the PMCo's consent.

Anna wants to explore this opportunity and has asked a tax partner in your firm what the tax ramifications would be. The partner has asked you to determine whether Anna's PSC and the PMCo would have to file a consolidated federal income tax return. Prepare a brief memo for the partner answering this question.

A partial list of resources includes:

- IRC Sec. 1504
- Rev. Rul. 84-79
- *PLR 201451009*