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Understanding Consolidated Returns

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UNDERSTANDING CONSOLIDATED RETURNS

by

*Martin J. McMahon, Jr.**

ABSTRACT

Section 1501 allows all of the members of an affiliated group of corporations to elect to file a consolidated return. A consolidated return permits the includible members of an affiliated group of corporations to combine their incomes into a single return. The detailed rules for filing consolidated returns are found in regulations promulgated pursuant to a broad delegation of authority in section 1502 of the Internal Revenue Code. In general, the regulations reflect a “single entity” approach that attempts to treat the several members of a consolidated group in the same manner as divisions of a single corporation. This article explains the most important general principles governing consolidated returns and is intended to provide an overview of the consolidated return regulations for lawyers who are generally unfamiliar with the detailed rules. Among other topics, the article explains (1) the rules governing eligibility to file a consolidated return, (2) the computation of consolidated taxable income, including relevant limitations on the use of net operating losses, (3) intercompany

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transactions and distributions, (4) stock basis adjustments, and (5) earnings and profits calculations. It explains both the rules in the consolidated return regulations and the differences from the rules that otherwise would govern had the corporations not elected to file a consolidated return.

I.	INTRODUCTION	127
II.	OVERVIEW	128
III.	ELIGIBILITY AND INCLUDIBLE CORPORATIONS	133
	A. <i>Stock Ownership</i>	133
	B. <i>Includible Corporations</i>	135
IV.	CONSOLIDATED TAXABLE INCOME	136
V.	FORMATION OF A CORPORATE SUBSIDIARY	137
	A. <i>Generally</i>	137
	B. <i>Receipt of Other Property</i>	138
	C. <i>Assumption of Transferor's Debts</i>	139
	D. <i>Transfers to Foreign Corporations</i>	140
VI.	DIVIDEND DISTRIBUTIONS: FUNDAMENTAL RULES	141
	A. <i>Generally</i>	141
	B. <i>Dividends In Kind</i>	143
VII.	INVESTMENT ADJUSTMENTS	144
	A. <i>Stock Basis</i>	144
	B. <i>Section 357(c) Situations</i>	147
	C. <i>Unified Loss Rules</i>	147
	1. <i>Generally</i>	147
	2. <i>The Basis Redetermination Rule</i>	148
	3. <i>The Basis Reduction Rule</i>	149
	4. <i>The Attribute Reduction Rule</i>	150
	5. <i>Worthlessness</i>	152
VIII.	EARNINGS AND PROFITS	152
IX.	INTERCOMPANY TRANSACTIONS	154
	A. <i>Transactions Between Members of a Consolidated Group</i>	154
	1. <i>Generally</i>	154
	2. <i>Matching Intercompany Items Related to Deferred</i> <i>Gains and Losses</i>	155
	3. <i>Acceleration of Deferred Gains and Losses</i>	159
	B. <i>Distributions With Respect to the Stock of a Member</i>	160
	1. <i>Section 301 Distributions</i>	160
	2. <i>Intercompany Distributions of Appreciated and</i> <i>Depreciated Property</i>	160
	3. <i>Liquidation of a Subsidiary</i>	162

	C. Transactions in Which a Member Acquires Stock of Another Member.....	166
	D. Transactions in Which a Member Acquires its Own Stock	166
	E. Transactions in Which a Member Acquires Debt of Another Member.....	167
	F. Anti-Abuse Rules	168
X.	NET OPERATING LOSS CARRYOVERS	168
	A. Generally.....	168
	B. Application of Section 382 to Consolidated Groups	170
	C. Separate Return Limitation Year.....	172
	1. Generally	172
	2. Reverse Acquisition.....	173
	3. Built-In Deductions.....	175
	4. Post Acquisition Losses of an Acquired Member.....	175
XI.	FOREIGN SUBSIDIARIES	176
	A. Generally.....	176
	B. Anti-Inversion Rules	178
	C. Foreign Tax Credit.....	179
	1. Direct Credit.....	179
	2. Indirect Credit.....	180
	D. Dual Consolidated Losses	180
XII.	CONCLUSION	181

I. INTRODUCTION

Virtually all publicly owned United States corporations, as well as the handful of large privately owned corporations that cannot (or chose not to) make an election under subchapter S, as well as the domestic subsidiaries of foreign corporations, elect to report their income for federal tax purposes as part of a consolidated group rather than as separate entities.¹ In one form or another, the consolidated return regime dates back to 1917,² although the current regime is far more sophisticated than its early forerunners. The modern consolidated return regime is highly complex and articulated by voluminous regulations. Nevertheless, judging by the paucity of litigation in the area, one must conclude that the regime works surprisingly well. Indeed it works so well that practitioners frequently assume they know what the regulations provide without actually looking at them. That can be dangerous. This article aims to acquaint the uninitiated student or practitioner, and

1. For 2008, over 42,000 consolidated returns were filed. 30 SOI Bulletin No. 4, 339, tbl. 13 (Spring 2011).

2. See Jasper L. Cummings, *Consolidating Foreign Affiliates*, 11 FLA. TAX REV. 143, 163-195 (2011) (describing the history and evolution of the early consolidated return regulations).

perhaps even remind the seasoned practitioner who has been relying too much on memory, with the principal features of the consolidated corporate income tax return regime.

II. OVERVIEW

Election to file a consolidated return — Section 1501 of the Internal Revenue Code provides that all members of an affiliated group of corporations may elect to file a consolidated income tax return.³ A consolidated return permits the includible corporations (as defined in section 1504(b)) that are members of an affiliated group of corporations to combine their incomes, net operating losses, credits, and other items into a single return. Section 1502 authorizes the Treasury to promulgate Regulations⁴ as necessary in order “that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group . . . may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.” As amended in 2004, section 1502 specifically provides that the consolidated return Regulations may contain “rules that are different from the provisions . . . that would apply if such corporations filed separate returns.” The detailed rules for filing consolidated returns are found in Regulations promulgated pursuant to this broad delegation of authority. Broadly speaking, the Regulations reflect a “single entity” approach to dealings within the group, which attempts to treat the several members of a consolidated group in the same manner as divisions of a single corporation. However, in certain instances a separate-corporation approach applies to coordinate separate-return and consolidated-return years and to properly associate certain tax attributes with particular members of the group.

The members of an affiliated group includible in a consolidated return are identified under section 1504(a) as the common parent corporation and one or more corporations affiliated through a chain (or chains) of corporations connected by ownership of stock representing 80 percent of the voting power and value of each affiliated member.⁵ Unless otherwise excluded by statutory provision, any corporation that is connected to the

3. All references and citations sections in this article are to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

4. All references and citations in this article to Regulations are to the current Treasury Regulations under the sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

5. The value determination is made without regard to certain non-voting, non-convertible preferred stock. I.R.C. § 1504(a)(4).

common parent or another member of an affiliated group by meeting this ownership requirement is treated as an “includible corporation” and must be included on the consolidated return.⁶ Foreign subsidiaries are specifically excluded from the definition of “includible corporation” and thus are almost never included in a consolidated return.⁷

Advantages of Filing a Consolidated Return: Net Operating Losses

— The principal advantage of filing consolidated returns is the ability to combine the income and loss of each member of an affiliated group into a single taxable income.⁸ Thus, net operating losses of one member of the group can be used to offset the taxable income of another member. This ability to offset losses of one member of the group against income of another member of the group does not extend to affiliated corporations that do not file a consolidated return.

In addition, net operating losses of a member of the group incurred during consolidated return years of the group in which the group as a whole operates at a loss contribute to the overall net operating loss of the group, which may be carried back or forward to other consolidated return years, offsetting income of any member of the group. There are, however, limitations on carryovers of losses incurred by a corporation in separate return years before the corporation became a member of the affiliated group.⁹ Filing a consolidated return also permits the members of the affiliated group to exclude intercompany dividends from gross income in computing taxable income and to defer recognition of gain or loss on intercompany transactions. The basis of stock of one member of a consolidated group held by another member is adjusted to reflect taxable income, loss and the other items of the lower-tier member. Intercompany distributions and contributions also affect the basis of stock of a member of an affiliated group that is held by the common parent or other members, thereby increasing or decreasing gain or loss on disposition of the stock. In addition, deferred intercompany gains and losses may be taken into account in the event that a member leaves the consolidated group, even if the transaction otherwise would be accorded nonrecognition treatment as a tax-free reorganization. Filing consolidated returns requires that all members of the consolidated group use the taxable year of the common parent, but, subject to an anti-abuse rule, the individual members may use different accounting methods.¹⁰

6. I.R.C. § 1501.

7. I.R.C. § 1504(b)(3). However, section 1504(d) provides a very limited special exception to this rule.

8. Reg. § 1.1502-11(a).

9. Reg. § 1.1502-21(c).

10. Regs. §§ 1.1502-76(a), -17.

Advantages of Filing a Consolidated Return: Intercompany Transactions — The treatment of intercompany transactions within members of a consolidated group also offers significant advantages in many instances. In general, the tax consequences of intercompany transactions between members of the same consolidated group are accounted for in consolidated taxable income as transactions between divisions of a single corporation.¹¹ In the case of payment for services or a sale or exchange of property, gain or loss that is recognized by the selling member under its method of accounting is deferred until the item can be matched with the buying member's accounting of its corresponding item in the form of a deduction or a recovery of basis when the expenditure is capitalized.¹² Thus, in the case of an intercompany sale of property, the selling member defers accounting for its recognized gain or loss until the date on which the buying member sells the property outside of the consolidated group or an analogous event occurs requiring acceleration. In this manner, the gain or loss is deferred until the property is disposed of outside of the consolidated group, as would be the case with respect to an exchange of property between divisions of a single corporation. The character of the selling member's deferred gain and the buying member's recognized gain on sale outside of the group also will be determined by single entity principles. The activities of each, therefore, may affect the character of the other's gain.¹³ For example, assume that S Corporation and B Corporation are members of an affiliated group filing a consolidated return. S Corporation sells appreciated investment real estate to B Corporation. Subsequently, B Corporation develops the land as residential real estate for sale to customers in the ordinary course of B Corporation's trade or business. When B Corporation disposes of the land, S Corporation must recognize its deferred gain. Even though S Corporation held the land for investment at the time of its sale to B Corporation, both S Corporation and B Corporation's gain will be treated as ordinary income.¹⁴

In the case of a sale of depreciable property, the selling member will defer its gain or loss to the time when the buying member claims increased capital cost recovery deductions.¹⁵ For example, under the single entity approach of the Regulations, if the selling member sells depreciable property at a gain, the increased capital recovery deductions that result from the buying member's cost basis will be offset by the corresponding gain taken into account by the selling member. In this fashion, these transactions have no net effect on the overall taxable income of the group, which is the same result that would have occurred if the selling and buying members had been

11. Reg. § 1.1502-13(a)(2).

12. Reg. § 1.1502-13(c)(2).

13. Reg. § 1.1502-13(c)(1)(i).

14. Reg. § 1.1502-13(c)(7)(ii), Ex. (2).

15. Reg. § 1.1502-13(c)(7)(ii), Ex. (4).

divisions of a single corporation, rather than separate corporations filing a consolidated return. Any increased deduction or basis recovery by the buying member will be offset on the consolidated return by an equivalent recognition of deferred gain by the selling member.

Deferred gain or loss from intercompany transactions is accelerated into a year in which it becomes no longer possible to match the buying member's corresponding item with the selling member's deferred gain or loss.¹⁶ Thus, gain or loss deferred by the selling member will be accounted for if either the buying member or the selling member ceases to be a member of the consolidated group before the buying member accounts for its matching item corresponding to the selling member's deferred gain or loss.

Distributions — Distributions from one member of an affiliated group to another are also treated under the single entity principle. Distributions are not included in the income of the recipient, but only so long as there is a matching reduction in the basis of the stock of the distributing member held by the recipient member under the investment adjustment rules of Treasury Regulation section 1.1502-32.¹⁷ Gain recognized by the distributing member under section 311(b) is deferred under the matching principle until the property is sold outside the group, the property is depreciated by the distributee member, or either the distributing or distributee corporation leaves the group.¹⁸

Aggregate versus Entity Theory — Even though the federal tax liability of an affiliated group filing a consolidated return is based on the combined taxable incomes of the members of the affiliated group, the separate tax identity of each member of the group is respected through maintenance of individual earnings and profits accounts and basis adjustments with respect to the stock of each member.¹⁹ As a result, while accounting for certain intercompany transactions is deferred for purposes of computing taxable income of the group under the consolidated return rules, those transactions will affect the earnings and profits and stock basis of the component members. Accounting for the separate tax identity of each member is required to determine tax consequences in the event that an includible corporation enters or leaves the affiliated group.

Investment Adjustment Accounts — The Regulations require a series of “investment adjustments” to the basis of stock of subsidiaries held by

16. Reg. § 1.1502-13(d).

17. Reg. § 1.1502-13(f)(2)(ii).

18. Reg. § 1.1502-13(f)(2).

19. Regs. §§ 1.1502-19, -31, -32, and -33.

other members of an affiliated group.²⁰ These adjustments are intended to eliminate potential double tax consequences as the separate taxable income or loss of each member of the consolidated group is reflected on the consolidated return.²¹ Investment adjustments begin with the stock of the lowest-tier subsidiary in a chain and work their way up to stock of includible corporations held by the common parent.²² Positive adjustments increase the basis of the stock of a subsidiary member of the group held by another member, and negative adjustments decrease basis.²³ Adjustments are made for the net amount of the subsidiary's taxable income or loss, expired loss carryover, tax-exempt income, non-deductible non-capital expenses (e.g. fines and disallowed losses), and distributions with respect to the stock of the subsidiary. Losses of a subsidiary and/or distributions may exceed the upper-tier corporation's basis in the stock of the subsidiary. In that case, the Regulations provide for the creation of an "excess loss account", which is the equivalent of a negative basis in the subsidiary's stock.²⁴ The amount of an excess loss account attributable to the stock of an includible subsidiary is recognized as income (1) on a sale of the stock, (2) whenever either the subsidiary or the includible corporation holding the stock ceases to be a member of the consolidated group, or (3) if the subsidiary's stock becomes worthless (as defined in the Regulations).²⁵ The gain is generally treated as gain from the disposition of stock, and is thus capital gain. However, to the extent that the subsidiary is insolvent (or deemed to be insolvent), gain is ordinary except to the extent that the excess loss account is attributable to distributions.²⁶

Elections —In the first year that a group files a consolidated return, each member of the affiliated group for any part of that year must consent to filing the return; generally that consent must be demonstrated by the member filing a Form 1122 with the first return.²⁷ The common parent consents to the return by filing the return. After the first year, each member is deemed to consent to the return, even if it joins the group after that first year.²⁸

An election to file a consolidated return may not be revoked without the consent of the Commissioner. Permission to discontinue filing a

20. Reg. § 1.1502-32.

21. Reg. § 1.1502-32(a)(1).

22. Reg. § 1.1502-32(a)(3)(iii).

23. Reg. § 1.1502-32(b)(2).

24. Reg. § 1.1502-32(a)(3)(ii). Reg. § 1.1502-19(a)(2)(B)(ii) refers to the amount of an excess loss account as "basis that is negative in amount."

25. Reg. § 1.1502-19(a)(1), (b).

26. Reg. § 1.1502-19(b)(4).

27. Reg. § 1.1502-75(a)(1), (b)(2).

28. Reg. § 1.1502-75(a)(2).

consolidated return will be granted only on a showing of good cause.²⁹ The Regulations describe “good cause” as including a change in the Code, Regulations, or other law which has a “substantial adverse effect” on the tax liability of an affiliated group relative to the aggregate tax liability of the members of the group filing separate returns.³⁰ The Commissioner has additional authority to grant blanket permission to discontinue filing consolidated returns to all groups, or to a class of groups, in the event of a change in the law of the type that will have a “substantial adverse effect on the filing of consolidated returns.”³¹ The election to file a consolidated return will, therefore, affect the tax liability of an affiliated group for the current and future tax years, and a proposal to file a consolidated return must be carefully analyzed.

III. ELIGIBILITY AND INCLUDIBLE CORPORATIONS

A. *Stock Ownership*

An affiliated group consists of the common parent and one or more chains of corporations connected through stock ownership with the common parent.³² The common parent must own stock of at least one other corporation that represents at least 80 percent of the total voting power of the stock of that corporation and has value equal to at least 80 percent of the total value of the stock of that corporation.³³ In addition, each includible corporation must be connected to the common parent or to one or more corporations owned by the common parent with the requisite 80 percent of voting power and value. Thus, a single chain of connected corporations or parallel brother-sister corporations connected to a common parent corporation can qualify as an affiliated group. All shares of stock within a class are treated as having the same value. Control premiums, minority discounts and blockage discounts are not taken into account.³⁴

Generally, voting power relates to the right to elect members of the board of directors, although other factors may be considered for complicated voting arrangements. In *Alumax Inc. v. Commissioner*,³⁵ the court was required to interpret the 80 percent voting power requirement of section

29. Reg. § 1.1502-75(c).

30. Reg. § 1.1502-75(c)(1)(ii).

31. Reg. § 1.1502-75(c)(2). The IRS typically allows consolidated groups the option to cease filing consolidated returns when it promulgates any significant change to the overall consolidated return regime.

32. I.R.C. § 1504(a)(1).

33. I.R.C. § 1504(a)(1), (2).

34. Reg. § 1.1504-4(b)(2)(iv).

35. 109 T.C. 133 (1997), *aff'd*, 165 F.3d 822 (11th Cir. 1999).

1502(a)(2) in the face of a complicated voting arrangement. Alumax had two classes of stock outstanding. The class C stock, which was owned by an affiliated group claiming control, was entitled to elect four of six voting members of the Alumax Board. The class B stock was entitled to elect two of six voting members. The class B and class C directors, in the aggregate and not voting by class, elected one of two special non-voting directors. By agreement between the two classes of stockholders, the class B directors were permitted to name this special director. The other special non-voting director was the CEO of Alumax. Each of the two class B directors had one vote. Each of the four class C directors had two votes. However, a majority of the directors of each of the two classes was required to approve certain corporate actions. Likewise, with respect to shareholder votes, each share of class C stock had four votes while each share of class B stock had one vote. A majority vote of each class of stock was required with respect to a number of restricted stockholder matters. The court rejected the taxpayer's assertion that a mechanical application of these voting formulae represented 80 percent voting control. The court held that the impact of various restrictions on the actions of elected directors must be taken into account in assessing the existence of voting power under section 1502(a)(2). Accordingly, the control test was not met and Alumax was not part of the affiliated group.

Certain stock that possesses more "debt-like" features than equity features is not included for purposes of determining whether the voting power and value tests of section 1504(a)(2) are satisfied. Section 1504(a)(4) provides that "stock" does not include non-voting stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, if its liquidation and redemption rights do not exceed its issue price (except for a reasonable liquidation or redemption premium), and it is not convertible into another class of stock. In addition, section 1504(a)(5) authorizes Regulations that treat certain convertible instruments as not constituting stock.

The Regulations provide in general that options will not be treated as stock, or as deemed exercised, unless it can be reasonably anticipated that the issue or transfer of the underlying stock will result in a substantial federal income tax saving, and it is reasonably certain that the option will be exercised.³⁶ The Regulations broadly define options as including any instrument that provides for the transfer of stock.³⁷ This definition, therefore, includes convertible stock. The inquiry is undertaken at the time of issue or transfer of an option, the "measurement date," with some exceptions.³⁸ If an

36. Reg. § 1.1504-4(b)(1), (2)(i).

37. Reg. § 1.1504-4(d)(1).

38. Reg. § 1.1504-4(c)(4). A "measurement date" does not include a transfer between spouses that is covered by § 1041, or a transfer between persons

option is treated as exercised, it will be taken into account in determining the percentage of the value of stock held by the option holder relative to other parties, but not for purposes of determining the option holder's voting power.³⁹

B. Includible Corporations

An includible corporation is any domestic corporation that is a member of the affiliated group at any time during the taxable year under the stock ownership tests of section 1504(b). Includible corporations do not include, among others, tax-exempt corporations, insurance companies,⁴⁰ possessions corporations under section 936 (certain U.S. owned corporations doing business in Puerto Rico), regulated investment companies (mutual funds) and real estate investment trusts. An includible corporation must be included in the consolidated return of an affiliated group for the part of any year during which the includible corporation meets the stock ownership tests.⁴¹ If a corporation ceases to be a member of an affiliated group, absent the consent of the Commissioner, the corporation may not again be included within the consolidated return of the affiliated group for five years after the close of the taxable year in which the corporation ceased to be a member of the group.⁴²

In *Elko Realty Co. v. Commissioner*,⁴³ the court held that two subsidiaries acquired for the purpose of using losses to offset income of the profitable acquiring corporation were not includible on a consolidated return. The court indicated that if ownership of a subsidiary's stock serves no business purpose other than a tax reduction purpose, the subsidiary is not an affiliate for purposes of the consolidated return provisions. The court also disallowed loss deductions under the predecessor to section 269.

none of whom is a member (or related to a member) of an affiliated group that includes the issuing corporation. Reg. § 1.1504-4(c)(4)(ii).

39. Reg. § 1.1504-4(b)(2)(iii).

40. Section 1504(c) permits insurance companies to form a consolidated group that includes only affiliated insurance companies. In addition, the common parent of an affiliated group can elect to include an insurance company on the consolidated return of the group after the insurance company has been a member of the affiliated group for five consecutive years.

41. I.R.C. § 1501.

42. I.R.C. § 1504(a)(3). *But see* Rev. Proc. 2002-32, 2002-1 C.B. 959 (permitting certain qualifying corporations to obtain a waiver of the § 1504(a)(3) bar).

43. 29 T.C. 1012 (1958), *aff'd per curiam*, 260 F.2d 949 (3d Cir.1958).

IV. CONSOLIDATED TAXABLE INCOME

The consolidated group computes its regular federal income tax liability on the basis of its combined consolidated taxable income. The computation of consolidated taxable income begins with the determination of the separate taxable incomes of each member of the consolidated group.⁴⁴ In general, each member of the consolidated group computes its separate taxable income as a separate corporation.⁴⁵ In determining separate taxable income, with limited exceptions all of the generally applicable rules of the Code apply, except as modified by the consolidated return regulations themselves.⁴⁶ However, separate taxable income excludes distributions with respect to the stock of other members of the group, deferred gains and losses from intercompany transactions, capital gains and losses, section 1231 gains and losses, and charitable contributions. Items excluded from the taxable income of members are separately consolidated and accounted for in consolidated taxable income as provided in specific Regulations.⁴⁷ Tax liability for the consolidated group is determined by applying the rates of section 11, and other relevant provisions of the Code, to the consolidated taxable income of the group. Tax liability is reduced by consolidated credits attributable to members of the group. Each member of a consolidated group is severally liable for the tax on consolidated taxable income.⁴⁸

In some instances, it may be important to determine whether a particular item is characterized separately by a member corporation, whose net taxable income or loss is then separately calculated based on that characterization and aggregated with the net taxable income or loss of other member corporations, or whether the item must be characterized with reference to the overall income and expense items of the consolidated group viewed as a single entity without regard to how it would separately be taken into account by a member in computing the member's separately taxable income. In other words, it can be important whether the consolidated group computes its income with respect to certain items on a "single entity" basis in which all such items are consolidated, or whether the different impact of an item on the taxable income of separate entities is taken into account.

The consolidated net operating loss of a consolidated group generally includes the consolidated net operating loss carrybacks and carryovers of the consolidated group.⁴⁹ In addition, the net operating losses of a member of a consolidated group can be carried over from a pre-

44. Reg. § 1.1502-11(a)(1).

45. Reg. § 1.1502-12(a).

46. Reg. § 1.1502-80.

47. Reg. § 1.1502-11(a)(2) - (8).

48. Reg. § 1.1502-6(a).

49. Reg. § 1.1502-21(a).

consolidation return period against the consolidated income of the group.⁵⁰ This general rule, is, however, subject to two limitations: (1) if the loss year was a “separate return limitation year” (SRLY), then the loss may be carried over only against the income of the member of the group that generated the loss,⁵¹ or (2) if section 382 is applicable, then the carryovers are limited accordingly.⁵² The SRLY rule does not apply in the case of an acquisition of a new member of a consolidated group if the net operating loss limitation of section 382 applies to the losses of the new member.⁵³

V. FORMATION OF A CORPORATE SUBSIDIARY

A. Generally

Wholly apart from whether consolidated return regulations apply, section 351 permits the tax-free creation of a corporation, including the formation of a subsidiary corporation by another corporation, if the transferor or transferors or property own at least 80 percent of the combined voting power and at least 80 percent of each class of nonvoting stock of the transferee corporation immediately after the transaction.⁵⁴ Section 351 also permits the transfer of property to an existing corporation without the recognition of gain where the contributing shareholder has, or as a result of receiving additional stock in consideration for the transferred property acquires, control. Under section 351 losses are not recognized on the transfer of property to a controlled corporation in exchange for stock of the corporation. Like many other Code provisions, section 351 applies within consolidated returns.

For purposes of determining subsequent taxable gain or loss on a sale, section 358 provides that the basis of stock received in exchange for property contributed to the corporation in a nonrecognition transaction under section 351 will be the same as the basis of property transferred to the corporation. The stockholder’s basis in the stock must be allocated among stock of different classes in proportion to the fair market values of the stock in each class.⁵⁵

Regardless of whether or not section 351 provides nonrecognition of gain or loss to the shareholder, section 1032 and the Regulations

50. Reg. § 1.1502–21(b).

51. Reg. § 1.1502–21(c); *see also* Reg. § 1.1502–22(c) (applicable to capital loss carryovers).

52. Reg. § 1.1502–91.

53. Reg. § 1.1502–21(g).

54. *See* Rev. Rul. 59–259, 1959–2 C.B. 115.

55. I.R.C. § 358(b)(1); Reg. § 1.358–2(b)(2).

thereunder⁵⁶ provide that the corporation does not recognize gain or loss on the issuance of stock in exchange for cash, property, or services.

If section 351 applies to a transferor-shareholder, section 362(a) generally provides the corporation with a basis in the property equal to the transferor's basis for purposes of determining the corporation's (1) gain or loss on a subsequent sale, and (2) depreciation and amortization deductions.

Outside of a consolidated return context, section 362(e)(2) prevents taxpayers from transmuting a single economic loss into two (or more) tax losses by taking advantage of the dual application of the substituted basis rules in section 358 for stock received in a section 351 transaction and in section 362 for assets transferred to a corporation in a section 351 transaction. If the aggregate basis of the property transferred to a corporation by any particular transferor in a section 351 transaction exceeds the aggregate fair market value of the property, the aggregate basis of the property must be reduced to its fair market value. When both depreciated property and appreciated property is transferred to the corporation, section 362(e)(2) does not necessarily result in the basis of every item of loss property being reduced to its fair market value. Section 362(e)(2)(A) requires that the aggregate basis of the transferred property be reduced by the excess of the aggregate basis over the aggregate fair market value, and section 362(e)(2)(B) requires that the aggregate basis reduction be allocated among the transferred properties in proportion to the built-in losses in the properties before taking into account section 362(e)(2).

Section 362(e)(2) generally does not apply to transfers to a controlled subsidiary that is a member of the transferor's consolidated group.⁵⁷ It is not necessary to apply section 362(e)(2) within consolidated returns because within consolidated groups, the problem otherwise addressed by section 362(e)(2) is addressed by the investment adjustment rules in Treasury Regulation section 1.1504-32.

B. Receipt of Other Property

If the transferor receives money or other property ("boot") in addition to stock as the consideration for the transfer of property to a controlled corporation, under section 351(b) the transferor's realized gain is recognized to the extent of money and the fair market value of property received. Loss, however, is never recognized even though boot may be received.⁵⁸

Under section 358(a), the transferor's basis in stock received is adjusted to reflect receipt and taxation of the boot. Generally speaking, the

56. Reg. § 1.1032-1.

57. Reg. § 1.1502-80(h).

58. I.R.C. § 351(b)(2).

adjustment increases the amount of the stock's basis by the amount of gain recognized and decreases the amount of the stock's basis by the amount of boot received. The corporation's basis in property received is increased by gain recognized to the transferor.⁵⁹

C. *Assumption of Transferor's Debts*

Section 357 provides that the assumption of a liability or the acquisition of property subject to a liability does not constitute boot for the purpose of section 351, unless a tax avoidance scheme is involved or unless the liabilities assumed exceed the basis of the property transferred.

Outside of the consolidated return regime, section 357(c)(1) provides that if the amount of liabilities assumed exceeds the basis of the property transferred, gain results to the extent of such excess, regardless of the purpose of the debt or the assumption.⁶⁰ However, under the regulations, section 357(c) does not apply to transfers with an affiliated group of corporations filing a consolidated return.⁶¹ Instead the transferor takes a negative basis in the stock of the transferee corporation equal to the amount by which the debt(s) exceeds the aggregate basis of the transferred property.

For purposes of determining the transferor's basis in nonrecognition property received in the exchange, section 358(d) treats the assumption of a liability of the transferor or a transfer of property subject to a liability as the receipt of cash by the transferor, without regard to how the debt is treated under section 357. The result is a reduction in the transferor's basis to the extent of the liability.

However, if the shareholder's basis for stock received in a section 351 transaction otherwise would exceed its fair market value, section 358(h) requires that the basis of the stock be reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any section 357(c)(3) liability that was assumed by the corporation. For this purpose, "liability" is broadly defined to include "any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of [the income tax]." Under this definition, a liability that is not cognizable under section 357 — for example, a cash method account payable, a contingent liability, or an obligation of an accrual method taxpayer that is not yet deductible because of the operation of the economic performance rules of section 461(h) — nevertheless will be taken into account under

59. I.R.C. § 362(a).

60. For purposes of applying the exception in section 357(c)(1), section 357(c)(3)(A) provides that a liability the payment of which would give rise to a deduction is excluded.

61. Reg. § 1.1502-80(d).

section 358(h) to reduce the transferor shareholder's stock basis. Section 358(h) does not apply in all instances, however. Section 358(h)(3) provides that, except as provided in Regulations, section 358(h) does not apply if, as part of the exchange (1) "the trade or business with which the liability is associated is transferred to the person assuming the liability," or (2) "substantially all of the assets with which the liability is associated are transferred to the person assuming the liability." As permitted by the statute, the Regulations narrow this exception by providing that the exception for a transfer of "substantially all of the assets with which the liability is associated" to the corporation assuming the liability is inoperative.⁶² The exception in section 358(h)(3) does not apply to selective transfers of assets that may bear some relationship to the liability, but do not represent the full scope of the trade or business (or substantially all the assets) with which the liability is associated.

D. Transfers to Foreign Corporations

Section 367(a) denies nonrecognition under section 351 for transfers to foreign corporations. However, section 367(a)(3) generally restores the nonrecognition rule of section 351 with respect to a transfer of property to be used in the active conduct of a foreign trade or business.⁶³ This exception is in fact of limited use. Although, for example, the transfer of machinery and equipment to a foreign subsidiary to be used in manufacturing abroad initially appears to be tax-free, that gain must be recognized to the extent that depreciation deductions have been taken on the property while the asset was used in the U.S.⁶⁴ Furthermore, the active trade or business exception does not apply to transfers of inventory, foreign currency, installment obligations, or property leased to third persons.⁶⁵

Section 367(d) provides a special rule for intangible property (other than goodwill and going concern value) that makes most transfers of

62. Reg. § 1.358-5.

63. Temp. Reg. § 1.367(a)-2T. The active trade or business exception does not apply to the incorporation of a foreign branch to the extent that the branch has been operating at a loss in prior years. In effect the prior losses that have been deducted for U.S. tax purposes must be "recaptured" on the incorporation of the branch. I.R.C. § 367(a)(3)(C); Temp. Reg. § 1.367(a)-6T.

Section 367(a)(5) provides that the active trade or business exception does not apply to the transfer of business assets to a foreign corporation in a type (C), (D), or (F) reorganization, unless five or fewer corporations own at least 80 percent of the transferee foreign corporation and certain conditions are met that are designed to insure that gain inherent in the assets remains subject to U.S. taxation.

64. Temp. Reg. § 1.367(a)-4T(b).

65. Temp. Regs. §§ 1.367(a)-4T and -5T(c) provide detailed rules governing these exceptions to the trade or business exception.

intangible assets taxable, regardless of whether or not the intangibles are to be used in an active foreign business. The income deemed to be realized on the intangible transfer is calculated as if the intangible had been transferred for a royalty. The deemed royalty is for the lesser of the intangible's useful life or twenty years,⁶⁶ and is treated as foreign source income. The amount is determined with reference to the transfer pricing rules under section 482.⁶⁷ If the U.S. person receiving the stock of the foreign corporation in exchange for the intangible property disposes of the stock to any person, other than certain related parties, before the end of the useful life of the intangible property, the transferor must immediately recognize the gain (but may not recognize loss) inherent in the intangible property (reduced by any gain on the transfer of the stock that was subject to U.S. tax).⁶⁸

VI. DIVIDEND DISTRIBUTIONS: FUNDAMENTAL RULES

A. *Generally*

Section 301(c) requires the inclusion in gross income (under section 61(a)(7)) of distributions received as dividends. Section 316(a) defines a dividend as any distribution to a shareholder if it is out of either (1) earnings and profits accumulated after February 28, 1913, or (2) earnings and profits of the current year regardless of a lack of, or deficit in, accumulated earnings and profits. Earnings and profits differ substantially from taxable income, being more akin to net income in a financial accounting sense. But, because some significant adjustments to earned surplus in the corporate sense are not taken into account in computing earnings and profits, it is not entirely accurate to say that the taxability of the shareholder depends essentially on the earned surplus account of the corporation.

The earnings and profits of parent and subsidiary corporations that do not file consolidated returns are generally not consolidated for purposes of determining whether distributions by the parent corporation to its shareholders are out of earnings and profits and hence taxable as dividends. As a result, in the non-consolidated return context, it is possible for the parent corporation to make distributions to its shareholders that will not be treated as dividends despite the existence of earnings and profits in the

66. Reg. § 1.367(d)-1T(c)(3).

67. Reg. § 1.367(d)-1T(c)(1).

68. Reg. § 1.367(d)-1T(d), (h). The amount of the gain subject to tax is the excess of the fair market value of the intangible at the time of the stock transfer over the original transferor's basis in the intangible at the time of the original transfer, reduced, as noted in the text, by any gain on the subsequent transfer of the stock that was subject to U.S. tax. Reg. § 1.367(d)-1T(d).

subsidiary corporation. Members of an affiliated group of corporations filing consolidated returns do combine the earnings and profits of the group.⁶⁹

If affiliated corporations file a consolidated return, dividends received from another member of the group are not included in gross income by the recipient in computing taxable income.⁷⁰ However, the corporation receiving the dividend must reduce its basis in the stock of the dividend-paying corporation, and the resulting basis may be negative.⁷¹

Outside of the consolidated return context, section 243(a)(1) provides a U.S. corporation that is a shareholder in another corporation with a deduction equal to 70 percent of intercorporate dividends received; section 243(c) increases the deduction to 80 percent if the shareholder corporation owns at least twenty percent of the stock of the payor corporation;⁷² and section 243(a)(3) extends this deduction to 100 percent for affiliated corporations that so elect.⁷³ (The test for affiliation in section 1504(a)(2) requires the parent corporation to own both (1) 80 percent or more of the voting stock, and (2) 80 percent or more of the total value of all stock of the subsidiary corporation, except that pursuant to section 1504(a)(4), nonparticipating, nonconvertible, nonvoting preferred stock is not counted in determining control.) The recipient corporation is not required to reduce its basis in the stock of the distributing corporation unless the dividend is an “extraordinary dividend” as defined in section 1059.⁷⁴

69. Reg. § 1.1502-33.

70. Reg. § 1.1502-13(f)(2)(ii).

71. Reg. § 1.1502-32.

72. Section 246A reduces the intercorporate dividend received deduction under § 243 by the percentage of the corporation’s portfolio stock that was debt financed during the applicable measuring period.

73. Section 246(c) disallows the dividends received deduction with respect to any dividends on any share of stock that is held for less than 45 days during the 91 day period beginning on the date that is 45 days before the date on which the stock becomes ex-dividend. For preferred stock, if the dividends received are attributable to a period in excess of 366 days, the holding period is extended to 91 days during the 181 day period beginning on the date that is 90 days before the date on which the stock becomes ex-dividend.

74. Generally speaking, section 1059 requires that a corporate shareholder that receives an “extraordinary dividend” on stock that it has not held for more than two years before the dividend announcement date must reduce the basis of the stock (but not below zero) by the amount of the untaxed portion of the dividend, i.e., the amount of the section 243 dividends received deduction. If the untaxed portion of any extraordinary dividend exceeds the shareholder’s basis for the stock, the excess is taxed as gain on the sale of the stock in the taxable year in which the extraordinary dividend is received. Section 1059(c) defines an extraordinary dividend in terms of the size of the dividend in relation to the shareholder’s adjusted basis in its stock, subject to an alternative test using fair market value instead of basis at the taxpayer’s

B. Dividends In Kind

If a dividend is paid in property (other than the corporation's own stock or promissory note), the distributing corporation must recognize gain under section 311(b) as if it sold the property to the shareholder at fair market value. Loss may not be recognized.⁷⁵

The amount of the distribution, and thus potential dividend, received by the shareholder is the fair market value of the property. If the shareholder assumes any liabilities of the corporation in connection with the distribution, section 301(b) provides that the amount of the distribution is reduced by the amount of the liabilities. The shareholder's basis for the property is its fair market value, unreduced by any liabilities.⁷⁶

Within consolidated returns, dividends in kind, and the accompanying gain or loss recognition, are governed by the intercompany matching rules of Treasury Regulation section 1.1502-13, resulting in deferral of gain or loss recognition, as discussed below.⁷⁷

election. A dividend is extraordinary if aggregate dividends received in any 85-day period exceed 10 percent of the basis of common stock, or 5 percent of the basis of preferred stock, with respect to which the dividends were paid. Furthermore, if aggregate dividends paid with respect to stock in any one year period exceed 20 percent of the corporate shareholder's basis for the stock, then all such dividends are aggregated and considered to be an extraordinary dividend. Certain distributions are treated as *per se* extraordinary dividends. Distributions to a corporate shareholder that has held the stock of the distributing corporation for the entire period the distributing corporation has been in existence are exempt. I.R.C. § 1059(d)(6). The basis reduction rules do not apply to distributions between members of an affiliated group filing consolidated returns or to distributions that constitute qualifying dividends within the meaning of section 243(b)(1), except to the extent the dividends are attributable to pre-affiliation earnings or appreciation of the payor corporation. I.R.C. § 1059(e)(2). Any distribution (without regard to the holding period for the stock or the relative magnitude of the distribution) to a corporate shareholder (1) in partial liquidation of the distributing corporation (as defined in section 302(e)), or (2) that is a non-pro rata redemption is treated as an extraordinary distribution. I.R.C. § 1059(e)(1). The section 1059(d)(6) and section 1059(e)(2) exceptions do not apply to distributions in partial liquidations or non pro rata redemptions treated as extraordinary dividends under section 1059(e)(1). Reg. § 1.1059(e)-1.

75. I.R.C. § 311(a).

76. I.R.C. § 301(d).

77. See *infra* Part IX.B.

VII. INVESTMENT ADJUSTMENTS

A. *Stock Basis*

Each member of the group owning stock in another member of the group must adjust its basis for that stock to account for income, losses and other items attributable to the subsidiary that are reflected in consolidated taxable income.⁷⁸ The purpose of the investment adjustment rule is to prevent gain or loss which has been recognized by the subsidiary from being recognized a second time as investment gain or loss by the parent upon disposition of the subsidiary's stock. These rules treat the consolidated group as a single entity by accounting for gains and losses within the consolidated group only once.

A parent corporation's basis in the stock of its consolidated subsidiary is increased or decreased annually by the net amount of the subsidiary's taxable income or loss, tax exempt income, nondeductible noncapital expenses, and distributions to the parent corporation.⁷⁹ (This rule applies with respect to both the common parent and subsidiaries that are in turn parents of lower-tier subsidiaries.) A positive adjustment increases basis, while a negative adjustment decreases basis. These items cause an adjustment to the parent's basis in subsidiary stock in the taxable year in which the item is taken into account in determining consolidated taxable income. Thus, items of income and loss, and distributions, will result in adjustments to the parent's basis in the stock of a consolidated subsidiary. Adjustments to the basis of a member's stock are taken into account in determining the basis adjustments of higher-tier members; the adjustments are applied in the order of the tiers, from lowest to highest. The basis adjustment is made at the end of the year unless an interim basis adjustment is necessary to determine a tax liability, for example, as a result of the sale of some of the stock.⁸⁰

Basis adjustments attributable to distributions are allocated to the shares on which the distribution was made.⁸¹ Negative adjustments are allocated only to common stock and then among the shares to reflect the manner in which the shares suffer the economic loss. Positive adjustments are allocated first to preferred stock to reflect distributions and dividend arrearages accrued during the period the subsidiary was a member of the group,⁸² and then to the common stock.⁸³ Adjustments to the common stock

78. Reg. § 1.1502-32.

79. Reg. § 1.1502-32(a) and (b).

80. Reg. § 1.1504-32(b)(1).

81. Reg. § 1.1504-32(c)(1)(i).

82. Reg. § 1.1504-32(c)(1)(ii), (c)(3).

83. Reg. § 1.1504-32(c)(2).

generally are made equally to each share, but if any shares have an excess loss account, the adjustments are first allocated among the shares with an excess loss account to equalize and then to eliminate the excess loss accounts.⁸⁴

For purposes of the investment adjustment rules, a member's taxable income or loss includes items of income or loss attributable to the member that are included in the consolidated taxable income of the group.⁸⁵ Operating losses are included in the investment adjustment in the year the loss is absorbed into consolidated taxable income. Thus, a net operating loss carryforward is reflected in a basis adjustment for the year to which the loss is carried. A carryback loss is reflected as an adjustment in the year in which it arose.⁸⁶

The amount of gain on the sale resulting from the excess loss account is treated as capital gain. Arguably, the gain attributable to the excess loss account should be treated as ordinary income when it represents deductions previously taken against ordinary income. However, the Regulations allow capital gain treatment, apparently on the theory that, had the subsidiary realized the appreciation in its assets prior to the disposition, the earnings and profits so generated would have eliminated the excess loss account and this is in effect what is happening when the parent sells the stock at a gain. If the subsidiary is insolvent at the time of the disposition, however, then ordinary income results from the transaction to the extent of the insolvency.⁸⁷ The amount treated as ordinary income is limited to the amount of the excess loss account redetermined to exclude distributions to the parent.⁸⁸

The existence of an excess loss account also can affect transactions that otherwise would be tax-free. For example, the disposition of stock in a reorganization involving an unrelated corporation will trigger recognition of gain if the subsidiary involved had generated an excess loss account.⁸⁹ On the other hand, tax-free reorganizations within the group generally do not

84. *Id.*

85. Reg. § 1.1502-32(b)(3)(i).

86. Reg. § 1.1502-32(b)(3)(i)(A) and (B).

87. Reg. § 1.1502-19(b)(4)(i) (specially defining "insolvency"). *Covil Insulation Co. v. Commissioner*, 65 T.C. 364 (1975), upheld the validity of Reg. § 1.1502-19, and required the parent corporation to include as ordinary income the excess loss account with respect to a subsidiary whose stock had become worthless. Both the treatment of the stock's worthlessness as an income generating event with respect to the excess loss account and characterization of the gain as ordinary were "permissible exercise[s] of the rulemaking power granted by section 1502." *Id.* at 374.

88. Reg. § 1.1502-19(b)(4)(ii).

89. Reg. § 1.1502-19(b)(2)(ii) and (c)(1)(ii).

require the inclusion of the excess loss account in income; instead the excess loss account is applied to the stock received without recognition of gain or loss under section 354, either reducing basis or adding to the excess loss account of that stock.⁹⁰ A liquidation to which sections 332 and 334(b) apply eliminates the excess loss account. The transaction is in effect treated as if the parent had owned the subsidiary's assets directly from the beginning; triggering the excess loss account in this situation could lead to duplication of gain.

Other events, such as the discontinuation of filing consolidated returns or the worthlessness of the stock of the subsidiary, also can require the inclusion in income of the amount of the excess loss account.⁹¹ Recognition of gain attributable to an excess loss account of a worthless subsidiary is deferred from the date the stock becomes worthless under the normal facts and circumstances test of section 165(g) to the date on which substantially all of the subsidiary's assets are disposed of or abandoned or the date on which the subsidiary realizes cancellation of indebtedness income that is accorded nonrecognition under section 108(a) by virtue of insolvency or in a bankruptcy proceeding.⁹²

In *Garvey, Inc. v. United States*,⁹³ the parent corporation acquired stock of a subsidiary in a tax-free type (B) reorganization (an exchange of stock for stock under section 368(a)(1)(B) pursuant to which under section 354 no gain or loss is recognized) that resulted in a \$250,000 basis in the subsidiary stock for the common parent under section 358. Subsequent to acquisition, the subsidiary distributed \$4.9 million in dividends out of pre-affiliation earnings and profits. Under the predecessor of Treasury Regulations sections 1.1502-32(b)(2)(iv) and 1.1502-19(a)(2), the dividend distribution created an excess loss account of \$4.65 million which was required to be recognized as income when the group disaffiliated. The court rejected the taxpayer's argument that application of the Regulations unfairly created phantom income that would not have existed had the group filed separate tax returns. The court pointed out that in electing consolidated treatment the taxpayer "must now take the bitter with the sweet."⁹⁴

90. Reg. § 1.1502-19(b)(2)(i).

91. Reg. § 1.1502-19(c)(1)(iii) and (2).

92. Reg. § 1.1502-19(c)(1)(iii).

93. 726 F.2d 1569 (Fed. Cir. 1984).

94. *Id.* at 1571.

B. Section 357(c) Situations

In the consolidated return context, the Regulations provide that section 357(c) does not apply to an intercompany transaction.⁹⁵ Instead, section 358 applies, sometimes resulting in a negative basis (*i.e.*, excess loss account), due to investment adjustments. Suppose that P Corporation, the parent of a consolidated group, forms S Corporation, which immediately becomes a member of the P Corporation consolidated group. In exchange for all of the stock of S Corporation P contributes to S an asset with a basis of \$100, subject to a liability of \$130, which S corporation assumes. Apart from the consolidated return rules, section 357(c) would require P to recognize gain of \$30—an amount equal to the excess of the liabilities assumed over the basis of the property transferred. But P Corporation takes a basis of negative \$30 in the stock of S Corporation, and S Corporation's basis in the asset remains \$100.⁹⁶

C. Unified Loss Rules

1. Generally

In some cases, application of the investment adjustment rules conflicts with the principles of sections 311 and 336, which require recognition of gain on the distribution by a corporation of appreciated property, and permit the recognition of loss on the distribution of depreciated property by a liquidating corporation, because it permits assets that are sold out of the consolidated group to obtain a step up in basis without the payment of a current corporate level tax. Suppose, for example, that S Corporation holds a single asset with a basis of \$100 and a fair market value of \$300. P Corporation purchases all of the stock of S Corporation for \$300, P and S do not make a section 338 election, and P and S Corporations elect to file a consolidated return. S Corporation then sells the asset for \$300. S Corporation recognizes a \$200 gain, and P Corporation increases its basis in the S Corporation stock from \$300 to \$500. P Corporation then sells the stock of S Corporation for \$300, realizing a \$200 loss, which offsets the \$200 gain. Absent a limitation on the recognition of this loss, tax on the gain realized from the sale of the assets effectively would be eliminated by P Corporation's loss on the sale of the stock of S. P Corporation's tax loss is artificial; it does not reflect an economic loss. The same problem arises if the asset is a depreciable asset which is consumed in the course of S Corporation's business.

95. Reg. § 1.1502-80(d).

96. *Id.*

To deal with this issue, Treasury Regulation section 1.1502-36 provides unified rules for loss on subsidiary stock transferred by a member of an affiliated group filing a consolidated return. A transfer of a loss share of stock (defined as a share of stock of an affiliate having a basis in excess of fair market value) includes any event in which (1) gain or loss would be recognized (apart from the rules in the Regulations), (2) the holder of a share and the subsidiary cease to be members of the same group, (3) a nonmember acquires an outstanding share from a member, or (4) the share is treated as worthless. The purpose of these rules is twofold, to prevent the consolidated return provisions from creating non-economic losses on the sale of subsidiary stock and to prevent members of the affiliated group filing the consolidated return from claiming more than one tax benefit from a single economic loss. Under the Regulations, any transfer of a loss share requires the application in sequence of three basis rules.

First, under Treasury Regulation section 1.1502-32, a basis redetermination rule is applied to deal with tax losses attributable to investment adjustment account allocations among different shares of stock that result in disproportionate reflection of gain or loss in shares' basis.⁹⁷ Second, if any share is a loss share after application of the basis redetermination rule, a basis reduction rule is applied under Treasury Regulation section 1.1502-36(c) to deal with artificial loss attributable to investment adjustment account adjustments, but this reduction does not exceed the share's "disconformity amount." Third, if any duplicated losses remain after application of the basis reduction rule, under Treasury Regulation section 1.1502-36(d) an attribute reduction rule is applied to the corporation the stock of which was sold to prevent the duplication of a loss recognized on the transfer or preserved in the basis of the stock. If a chain of subsidiaries is transferred (rather than a single subsidiary) the order in which the rules are applied is modified. In this case, the basis redetermination rule and the basis reduction rule are applied sequentially, working down the chain, and the attribute reduction rule is then applied working up the chain, starting with the lowest tier subsidiary.

2. *The Basis Redetermination Rule*

The basis redetermination rule in Treasury Regulation section 1.1502-36(b) does not apply when all of the stock of the subsidiary has been transferred in a taxable transaction; thus it typically does not apply. When the basis redetermination rule does apply, investment adjustments (exclusive of distributions) that were previously applied to members' bases in subsidiary stock are reallocated in a manner that, to the greatest extent possible, first eliminates loss on preferred shares and then eliminates basis disparity on all

97. Reg. § 1.1502-36(b).

shares. This rule affects both positive and negative adjustments, and thus addresses both noneconomic and duplicated losses. First, the basis of any transferred loss share is reduced by any positive investment adjustments, but the basis will not be reduced to less than the value of the loss share. Second, to the extent of any remaining loss on the transferred shares, negative investment adjustments are removed from shares that are not transferred loss shares and are applied to reduce the loss on transferred loss shares. Third, the positive adjustments removed from the transferred loss shares are allocated to increase basis of other shares only after the negative adjustments have been reallocated. This rule does not affect the aggregate basis of the shares, and thus does not apply if all of the shares of a subsidiary are sold or become worthless; it is important only when some, but not all, shares are sold. A number of special limitations on basis reallocation also must be considered in various specific circumstances.

3. *The Basis Reduction Rule*

If, after applying the basis redetermination rule in step one, any transferred share is a loss share (even if the share only became a loss share as a result of the application of the basis redetermination rule), the basis of that share is subject to reduction. The basis reduction rule in Treasury Regulation section 1.1502-36(c) eliminates noneconomic losses that arise from the operation of the investment adjustment account rules. Under this rule, the basis of each transferred loss share is reduced (but not below its value) by the lesser of (1) the share's disconformity amount, or (2) the share's net positive adjustment.

The "disconformity amount" with respect to a subsidiary's share is the excess of its basis over the share's allocable portion of the subsidiary's inside tax attributes (determined at the time of the transfer). Every share within a single class of stock has an identical allocable portion. Between shares of different classes of stock, allocable portions are determined by taking into account the economic arrangements represented by the terms of the stock. "Net inside attributes" is the sum of the subsidiary's loss carryovers, deferred deductions, cash, and asset bases, minus the subsidiary's liabilities. The disconformity amount identifies the net amount of unrealized appreciation reflected in the basis of the share.

A share's net positive adjustment is computed as the greater of (1) zero, or (2) the sum of all investment adjustments (excluding distributions) applied to the basis of the transferred loss share, including investment adjustments attributable to prior basis reallocations under the basis reallocation rule. The net positive adjustment identifies the extent to which a share's basis has been increased by the investment adjustment provisions for items of income, gain, deduction and loss (whether taxable or not) that have been taken into account by the group. Special rules apply when the

subsidiary the stock of which is transferred itself holds stock of a lower-tier subsidiary.

4. *The Attribute Reduction Rule*

If any transferred share remains a loss share after application of the basis reallocation and basis reduction rules, any loss recognized with respect to the transferred share is allowed. However, in this instance, the subsidiary's tax attributes (including the consolidated attributes, e.g., loss carryovers, attributable to the subsidiary) are reduced pursuant to Treasury Regulation section 1.1502-36(d). The attribute reduction rule addresses the duplication of loss by members of consolidated groups, and is designed to prevent the group from recognizing more than one tax loss with respect to a single economic loss, regardless of whether the group disposes of the subsidiary stock before or after the subsidiary recognizes the loss with respect to its assets or operations. However, under a type of *de minimis* rule, unless the group so elects, the attribute reduction rule does not apply if the aggregate attribute reduction amount in the transaction is less than five percent of the total value of the shares transferred by members in the transaction.⁹⁸

Under the attribute reduction rule, the subsidiary's attributes are reduced by the "attribute reduction amount," which equals the lesser of (1) the net stock loss, or (2) the aggregate inside loss. The "attribute reduction amount" reflects the total amount of unrecognized loss that is reflected in both the basis of the subsidiary stock and the subsidiary's attributes. "Net stock loss" is the amount by which the sum of the bases (after application of the basis reduction rule) of all of the shares in the subsidiary transferred by members of the group in the same transaction exceeds the aggregate value of those shares.⁹⁹ The subsidiary's "aggregate inside loss" is the excess of its net inside attributes over the aggregate value of all of the shares in the subsidiary.¹⁰⁰ (Net inside attributes generally has the same meaning as in the basis reduction rule, subject to special rules for lower-tier subsidiaries.)

The attribute reduction amount is first applied to reduce or eliminate items that represent actual realized losses, such as operating loss carryovers (Category A), capital loss carryovers (Category B), and deferred deductions (Category C) in that order unless the taxpayer elects to make a different allocation. If the subsidiary does not hold stock of any lower-tier subsidiaries, any excess attribute reduction amount is then applied to reduce the basis of assets (Category D) in the asset classes specified in Treasury Regulation section 1.338-6(b) other than Class I (cash and general deposit accounts, other than certificates of deposit held in depository institutions),

98. Reg. § 1.1502-36(d)(2)(ii).

99. Reg. § 1.1502-36(d)(3)(ii).

100. Reg. § 1.1502-36(d)(3)(iii).

but in the reverse order from the order specified in that section. Thus, the basis in any purchased goodwill is the first item reduced. If the subsidiary holds stock of one or more lower-tier subsidiaries, the Category D attribute reduction is first allocated between the subsidiary's basis in any stock of lower-tier subsidiaries and the subsidiary's other assets (treating the non-stock Category D assets as one asset) in proportion to the subsidiary's basis in the stock of each lower-tier subsidiary and its basis in the Category D assets other than subsidiary stock. Only the portion of the attribute reduction amount not allocated to lower-tier subsidiary stock is applied under the reverse residual method. (Additional special rules apply to prevent excessive reduction of attributes when the subsidiary itself holds stock of a lower-tier subsidiary.¹⁰¹) If the attribute reduction amount exceeds all of the attributes available for reduction, that excess amount generally has no effect. If, however, cash or other liquid assets are held to fund payment of a liability that has not yet been deducted but will be deductible in the future (e.g., a liability the deduction for which is subject to the economic performance rules of section 461(h)), loss could be duplicated later, when the liability is taken into account. To prevent such loss duplication, the excess attribute reduction amount will be held in suspense and applied to prevent the deduction or capitalization of later payments with respect to the liability.¹⁰² Additional special rules apply to prevent excessive reduction of attributes when the subsidiary itself holds stock of a lower-tier subsidiary.

In cases where as a result of the stock transfer the subsidiary ceases to be a member of the group, an election may be made to reattribute attributes (other than asset basis) and/or to reduce stock basis (and thereby reduce stock loss) in order to avoid attribute reduction.¹⁰³ If an election is made and it is ultimately determined that the subsidiary has no attribute reduction amount the election will have no effect (or if the election is made for an amount that exceeds the finally determined attribute reduction amount, the election will have no effect to the extent of that excess). In addition, taxpayers may elect to reduce (or not reduce) stock basis, or to reattribute (or not reattribute) attributes, or some combination thereof, in any amount that does not exceed the subsidiary's attribute reduction amount.¹⁰⁴

Finally, if the subsidiary ceases to be a member of the consolidated group as a result of the transfer, the common parent of the group can elect to reduce stock basis (thereby reducing an otherwise allowable loss on the sale of the stock), reattribute attributes, or apply some combination of basis

101. Reg. § 1.1502-36(d)(4)(ii).

102. Reg. § 1.1502-36(d)(4)(ii)(C).

103. Reg. § 1.1502-36(d)(4).

104. The reattribution election may be made only if the subsidiary ceases to be a group member.

reduction and attribute reattribution after the otherwise required attribute reduction.

5. *Worthlessness*

If a member treats stock of the subsidiary as worthless under section 165(g) and the subsidiary continues as a member, or if a member recognizes a loss on subsidiary stock and on the following day the subsidiary is not a member and does not have a separate return year following the recognition of the loss, all Category A, Category B, and Category C attributes (i.e., capital loss carryovers, net operating loss carryovers, and deferred deductions) that have not otherwise been eliminated or reattributed, as well as any credit carryovers, are eliminated.¹⁰⁵

VIII. EARNINGS AND PROFITS

Earnings and profits are one of those categories of tax attributes that are tracked on a separate member basis because it is necessary to know when each member pays a dividend. Section 301(a) generally covers all distributions of property by a corporation to its shareholders in their capacity as shareholders unless displaced by another rule. There are important exceptions: (1) the distribution of stock or rights to stock of the corporation is not considered a distribution of “property” for this purpose, and (2) distributions in redemption of stock under certain circumstances and complete liquidations are not considered section 301 distributions. Section 301(c) classifies distributions between dividends, which are included directly in gross income (section 301(c)(1)), and distributions that are not dividends, which are first treated as a return of capital applied against the stock basis (section 301(c)(2)), with amounts in excess of that basis being treated as gain from the sale or exchange of property (section 301(c)(3)), thus bringing the capital gain provisions into play. Section 61(a)(7) also requires that dividends in the tax sense be included in gross income.

Section 316(a) defines a dividend as any distribution to a shareholder if it is out of either (1) earnings and profits accumulated after February 28, 1913, or (2) earnings and profits of the current year regardless of a lack of, or deficit in, accumulated earnings and profits. Earnings and profits differ substantially from taxable income, being more akin to net income in a financial accounting sense.

Special adjustments are required in the earnings and profits accounts of the parent corporation in a consolidated group to reflect the consolidated situation. If the parent of the group were not required to include in its

105. Reg. § 1.1502-36(d)(7). A worthlessness determination must take into account the rules in Reg. § 1.1502-80(c), as well as under section 165.

earnings and profits the earnings and profits of subsidiaries in the group, under section 301 a parent corporation with profitable subsidiaries and no earnings and profits of its own could make tax-free distributions to its stockholders despite the group as a whole having current or accumulated earnings. The earnings and profits of a consolidated subsidiary are determined under the applicable provisions of the Code and passed up through higher-tier entities to be consolidated in the earnings and profits of the common parent.¹⁰⁶ If the common parent, or any other member of the group, owns less than all of the common stock of a lower-tier member of the group, only a proportional amount of the earnings and profits is tiered-up.¹⁰⁷

A separate determination of the parent's basis in the stock of a consolidated subsidiary is required for purposes of determining the increase or decrease in earnings and profits resulting from the sale of the subsidiary's stock.¹⁰⁸ Gain or loss on the disposition of the stock of a member of the consolidated group is determined from the basis of the stock as adjusted by the investment adjustment rules of Treasury Regulation section 1.1502-32, which are based on the subsidiary's contribution to taxable income. There are differences in the computation of earnings and profits and taxable income, however, primarily because sections 312(k) and (n) require adjustments to earnings and profits for a number of items including depreciation, inventory amounts, and installment sales, which differ from the amounts taken into account in computing taxable income or loss. To account for these differences in determining the effect on the parent's earnings and profits of the sale of stock in a subsidiary, the basis of a subsidiary's stock must be determined using earnings and profits as the basis for investment adjustments. Thus, the basis of stock of a subsidiary for earnings and profits purposes is increased by the earnings and profits of the subsidiary and decreased by a deficit in earnings and profits.¹⁰⁹

Under section 1552, tax liability of the consolidated group is apportioned against the earnings and profits of each of the members in proportion to the member's contribution to consolidated taxable income, as a percentage of the total tax attributable to the member if the tax of each member were computed on a separate return basis, on the basis of each member's actual contribution to consolidated taxable income including reductions in income, or by any other method selected by the group and approved by the Commissioner. Section 1552 does not provide a device to account for the effect of the absorption of one member's tax attributes by another member, e.g., one member's income may be absorbed by another member's losses. The Regulations provide rules to account for the impact of

106. Reg. § 1.1502-33(a) and (b).

107. Reg. § 1.1502-33(b)(3)(ii), Ex. 3.

108. Reg. § 1.1502-33(c).

109. Reg. § 1.1502-33(c)(1).

the absorption of tax attributes which are intended to reflect in earnings and profits the reduction of one member's tax liability by attributes of another that would have reduced the latter member's earnings and profits in a different year if not used by the first member.¹¹⁰

Finally, to the extent a lower-tier member of the group's earnings and profits were taken into account by a higher-tier member of the group under the tiering-up rules, upon deconsolidation the lower-tier member's earnings and profits are eliminated.¹¹¹

IX. INTERCOMPANY TRANSACTIONS

A. *Transactions Between Members of a Consolidated Group*

1. *Generally*

Treasury Regulation section 1.1502-13 provides rules for transactions between members of the same consolidated group involving the sale or exchange of property, the provision of services by one member of the group to another, the licensing or rental of tangible and intangible property, and the lending of money. The regulation also controls the treatment of intercompany distributions with respect to the stock of a member.¹¹² The intercompany transaction rules are treated as a method of accounting that is applied in addition to the member's other methods of accounting.¹¹³ The timing rules of the intercompany transaction Regulations control over other accounting methods, however.¹¹⁴

The Regulations treat members engaging in an intercompany transaction in some ways like a separate corporations and in other ways like divisions of a single corporation. In determining the amount and location of items related to those transactions, the members are treated as separate corporations. For example, if one member sells an asset to another member, the seller recognizes gain or loss under section 1001, while the buyer takes a cost basis in the asset under section 1012. However, to determine the timing, character, and other attributes of the transaction, the members are treated as divisions of a single corporation. Thus, in the example above, the seller does not take its gain or loss on asset sale into account until the buyer takes its basis into account, and the character of the seller's gain or loss may depend

110. Reg. § 1.1502-33(d).

111. Reg. § 1.1502-33(e).

112. Reg. § 1.1502-13(f).

113. Reg. § 1.1502-13(a)(3).

114. *See also* Reg. § 1.446-1(c)(2)(iii), which provides that the consolidated return rules are a method of accounting under section 446(e).

on the buyer's and seller's collective activity. The Regulations accomplish these results with two rules, the matching rule and the acceleration rule.

2. *Matching Intercompany Items Related to Deferred Gains and Losses*

Gain or loss recognized by the selling member in an intercompany transaction is accounted for by the selling member under its method of accounting, but is not accounted for in consolidated taxable income until the "corresponding item" resulting from the transaction is taken into account by the buying member under its method of accounting.¹¹⁵ For example, on a sale of property, the selling member's gain or loss is not accounted for in consolidated taxable income until the buying member disposes of the property outside of the consolidated group, or otherwise recovers its corresponding basis in the acquired property. In this fashion, items resulting from an intercompany transaction are taken into account in a manner that produces the same net result in terms of consolidated taxable income as if the transaction occurred between divisions of a single entity. If a member sells an asset at a gain to another member and the purchasing member later sells that asset outside the consolidated group, the purchasing member's reduced gain or increased loss attributable to the purchase price paid to the selling member is offset in consolidated taxable income by the selling member's deferred gain. Under this single entity principle, the character, source, and other attributes of intercompany transactions are determined with reference to the activities of both the selling and buying members of the consolidated group.¹¹⁶ However, for purposes of identifying the amount and location of

115. Reg. § 1.1502-13(c)(2); *see also* Reg. § 1.1502-13(b)(3).

Note that even outside of the consolidated return context, losses (but not gains) on sales of property between members of a "controlled group" of corporations are deferred using consolidated return matching principles. I.R.C. § 267(f); *see* Reg. § 1.267(f)-1. A parent-subsidiary controlled group is one or more chains of corporations connected through stock ownership with a common parent if 50 percent of the voting power or value of each corporation (except the common parent) is owned by another member of the group, and the common parent owns at least 50 percent of the voting power or value of all classes of stock of at least one of the other corporations (determined by excluding stock of any member of the group held directly by another member of the group). I.R.C. §§ 267(f), 1563(a)(1). A brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates, or trusts own (or constructively own) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation. I.R.C. §§ 267(f), 1563(a)(2).

116. Reg. § 1.1502-13(c)(1).

specific items, each party to an intercompany transaction is treated as a separate entity.¹¹⁷

The Regulations illustrate the single entity approach with the following example.¹¹⁸ In year one, S Corporation sells property for \$100 that it has held for investment with a basis of \$70 to B Corporation, which is a member of the consolidated group that includes S Corporation. The accounting in consolidated taxable income for S Corporation's recognized gain on the sale is deferred. As a separate entity, B Corporation holds the property with an adjusted basis of \$100 and S Corporation will be required to recognize its deferred gain when B Corporation takes advantage of the \$30 basis increase.¹¹⁹ In year three B Corporation resells the property for \$90 to a customer in the ordinary course of B Corporation's business. If S Corporation and B Corporation were divisions of a single entity, B Corporation would succeed to S Corporation's \$70 basis in the land and realize \$20 of gain. Under the matching principle of Treasury Regulation section 1.1502-13(c), in the year of B Corporation's sale, S Corporation must take into income an amount that reflects the difference for the year between the "corresponding item," which is the amount actually taken into account by B Corporation as a separate entity (\$10 loss),¹²⁰ and the "recomputed corresponding item," which is the amount that B Corporation would take into account if S Corporation and B Corporation were divisions of a single entity (\$20 gain).¹²¹ Thus, in year three, S Corporation is required to recognize \$30 ($\$20 - (\$10) = \30).¹²² B Corporation recognizes its \$10 loss in year three.¹²³ The net effect on consolidated taxable income is \$20 gain. The character of S Corporation's and B Corporation's gain (or loss) is also determined as if S Corporation and B Corporation were divisions of a single entity. Thus, if B Corporation's activities with respect to the property convert the property from investment property into property described in section 1221(a)(1), both S Corporation's and B Corporation's gain or loss will be ordinary.¹²⁴ The gain and loss taken into account by S Corporation and B Corporation will be preserved on a separate entity basis for purposes of stock basis and earnings and profits adjustments as required by Treasury Regulation sections 1.1502-32 and -33.¹²⁵

117. Reg. § 1.1502-13(a)(2).

118. Reg. § 1.1502-13(c)(7)(ii), Ex. 1(f).

119. Reg. § 1.1502-13(a)(2).

120. Reg. § 1.1502-13(b)(3).

121. Reg. § 1.1502-13(b)(4); *see also* Reg. § 1.1502-13(c)(7)(ii), Ex. 1(d).

122. Reg. § 1.1502-13(c)(2)(ii).

123. Reg. § 1.1502-13(c)(2)(i).

124. Reg. § 1.1502-13(c)(1) and (7)(ii), Ex. 2.

125. Reg. § 1.1502-13(a)(2).

The matching principle of the Regulations also requires an accounting for the selling member's deferred gain as the buying member claims capital recovery deductions on its purchase price basis of depreciable property in an intercompany transaction. Assume for example, that S Corporation and B Corporation are members of the same consolidated group. In 2008, S Corporation acquires depreciable five year property for \$150 and properly claims capital recovery deductions of \$30 in 2008 and \$48 in 2009. On the first day of its 2010 taxable year, S Corporation sells the property to B Corporation for \$110. At the time of sale, S Corporation's basis in the property is \$72 ($\$150 - [\$30 + 48]$). S Corporation recognizes \$38 of gain, which is deferred. Under section 168(i)(7), B Corporation must use the same depreciation rate as S Corporation with respect to so much of the adjusted basis of the property in B Corporation's hands as does not exceed S Corporation's adjusted basis at the time of the transfer. Thus, in taxable year 2010, B Corporation deducts \$28.80, which is the depreciation deduction that would have been available to S Corporation under section 168. In addition, B Corporation is permitted to recover its remaining basis as if the property were new five-year property. Thus, in 2010 B Corporation claims an additional \$7.60 depreciation deduction (20 percent of adjusted basis of \$38, applying the half-year convention as if the property were new five-year property). The additional depreciation deduction claimed by B Corporation requires that S Corporation take into account \$7.60 of its deferred intercompany gain in 2010. In 2011, B Corporation deducts \$17.28 of depreciation with respect to the basis that would have been its basis had it taken a transferred basis from S Corporation, plus \$12.16 of depreciation based on its \$28 basis increase from the intercompany transaction. S Corporation is required to take into account \$12.16 of its deferred intercompany gain in 2011.¹²⁶ Under the single entity principle, which treats S Corporation and B Corporation as divisions of a single corporation, the character of S Corporation's recognized gain will reflect the tax consequence of B Corporation's depreciation.¹²⁷ Thus, because S Corporation's deferred gain offsets B Corporation's increased depreciation, S Corporation's gain is treated as ordinary income.¹²⁸ In this fashion, the Regulations recognize separate entity aspects of the transaction as reflected in B Corporation's increased basis and depreciation, but treat the overall consequence to consolidated taxable income as though the property were transferred between divisions of a single entity through the matching of B Corporation's increased depreciation deductions with restoration of S Corporation's deferred intercompany gain.

126. Reg. § 1.1502-13(c)(7)(ii), Ex.(4).

127. Reg. § 1.1502-13(c)(1)(i) and (c)(4)(i).

128. *See also* Reg. § 1.1502-13(c)(7)(ii), Ex.(4)(d).

If, on the first day of its 2012 taxable year, B Corporation sells the property to X Corporation, which is not a member of the S–B consolidated group, for \$120 payable in two annual installments with adequate interest, both B Corporation and S Corporation must account for recognized gain. B Corporation recognizes gain of \$75.84 (\$120 – \$44.16).¹²⁹ As a consequence of B Corporation’s sale, S Corporation must also recognize recapture gain. If S and B Corporations were divisions of a single entity, on its 2012 sale of the property the Corporation would have realized \$94.08 of gain, determined by subtracting from the \$120 amount realized an adjusted basis of \$25.92 computed without regard to B Corporation’s purchase from S Corporation (\$150 original cost less four year’s capital recovery deductions totaling \$94.08). The difference between the gain recognized on a single entity basis and the gain recognized by B Corporation as a separate entity, \$18.24 (\$94.08 – \$75.84), is B Corporation’s “recomputed corresponding item,” which must be accounted for by S Corporation at the time of B Corporation’s disposition.¹³⁰ As a consequence, the consolidated taxable income of the group reflects the tax consequence of the sale of the property on a single entity basis; S Corporation’s gain of \$18.24 plus B Corporation’s gain of \$75.84 is the equivalent of the gain that would have been recognized on the sale of the property outside of the group without the intervention of the intercompany sale from S Corporation to B Corporation. Continuing with the single entity model, because all of the gain recognized on disposition of the property would have been recaptured as ordinary income under section 1245, the gain recognized by both S Corporation and B Corporation is treated as ordinary gain.¹³¹ Under section 453(i) none of the gain is eligible for installment reporting. If B Corporation had sold the property to X for \$160, an amount that would have produced \$10 of section 1231 gain in addition to depreciation recapture, B Corporation would have been eligible to report \$5 of its gain under the section 453 installment method in each of the two years payments are received from X. S Corporation’s deferred gain accounted for in the year of sale would not have been eligible for installment reporting, however, because all of S Corporation’s deferred gain on its intercompany sale to B Corporation is section 1245 ordinary income recapture gain.¹³²

129. B Corporation’s adjusted basis is its \$110 purchase price minus \$65.84 of depreciation for 2010 and 2011.

130. The recomputed corresponding item is equivalent to S’s deferred gain of \$38 less gain recognized by S Corporation in 2010 and 2011 as B Corporation claimed increased capital recovery deductions.

131. Reg. § 1.1502–13(c)(1)(i).

132. Reg. § 1.1502–13(c)(7)(ii), Ex. 5(f). In the case of an installment sale reported under section 453, the regulation also provides that B and S must account for the interest charge of section 453A on gains deferred under the installment

3. Acceleration of Deferred Gains and Losses

Under the acceleration rule, the presence of deferred intercompany gain or loss within the consolidated group will also affect transactions involving the stock of subsidiaries. The Regulations address stock transactions by requiring “acceleration” of deferred intercompany items in the case of an event that prevents accounting for an item under the matching rules.¹³³ For example, if either the selling or buying member leaves the consolidated group, it is no longer possible to match the selling member’s deferred gain or loss with the buying member’s subsequent accounting for its corresponding item. Thus, if either member ceases to be a member of the consolidated group, the selling member generally is required to account for its deferred gain or loss.¹³⁴ In the first example above, where S Corporation sold investment property with a \$70 basis to B Corporation for \$100, if B Corporation should cease being a member of the consolidated group in year two before selling the property, S Corporation would be required to account for its deferred \$30 gain in that year.¹³⁵ As a separate entity, or as a member of a different consolidated group, B Corporation would continue to hold the property with a \$100 basis. The character of S Corporation’s gain would be determined under the matching principles of Treasury Regulation section 1.1502–13(c) as if S Corporation and B Corporation were divisions of the same entity.¹³⁶ Thus, B Corporation’s activities with respect to the property could convert S Corporation’s deferred investment gain into ordinary gain.

The common parent of a consolidated group may request that the IRS consents to the group accounting for intercompany transactions on a separate entity basis.¹³⁷ This consent may be granted for all items or a class of items of the consolidated group.

method if the aggregate tax installment obligations of the group outstanding at the end of the taxable year exceed \$5 million. Reg. § 1.1502–13(c)(7)(ii), Ex. 5(b).

133. Reg. § 1.1502–13(d)(1).

134. The deferred gain or loss is not accelerated when the group is acquired in a reverse acquisition defined in section 368(a)(2)(E), another group acquires the common parent’s stock, or another group acquires the common parent’s assets in a section 381(a)(2) transaction. Reg. § 1.1502–13(j)(5).

135. See Reg. § 1.1502–13(d)(3), Ex. 1.

136. Reg. § 1.1502–13(d)(1)(ii).

137. Reg. § 1.1502–13(e)(3).

B. Distributions With Respect to the Stock of a Member

1. Section 301 Distributions

The single entity approach to intercompany transactions involving the stock of the members of a consolidated group applies to distributions on the stock of one group member made to another group member.¹³⁸ Intercompany distributions with respect to the stock of a member of the consolidated group that are subject to section 301 are excluded from the gross income of the distributee member, but only to the extent that the distributee reflects a corresponding negative adjustment to the basis of the stock of the distributing member.¹³⁹ Thus an intercompany distribution will increase recognized gain, or decrease loss, on a disposition of the stock of the distributing member. Under the investment adjustment rules of Treasury Regulation section 1.1502-32, if the distribution exceeds the recipient member's basis in the stock of the distributing member, the recipient's negative basis creates an excess loss account. The existence of an excess loss account will trigger recognition of gain if either the distributing or recipient member ceases to be a member of the consolidated group.¹⁴⁰

2. Intercompany Distributions of Appreciated and Depreciated Property

Both gain and loss on intercompany distributions of appreciated or depreciated property with respect to the stock of the distributing member are recognized under the principles of section 311(b) but are accounted for as deferred intercompany gain or loss under the matching rule if the property is sold to a non-member.¹⁴¹ If either member leaves the consolidated group, it will no longer be possible to match accounting for the distributing corporation's deferred item with the recipient's corresponding item, and the acceleration rule will require the distributing corporation to account for deferred gain or loss recognized on the distribution.¹⁴² However, while deferred section 311(b) gain always is included in consolidated taxable income, loss is allowed if the property subsequently is sold to a nonmember; the deferred loss in excess of the transferee's gain is permanently disallowed if the property is distributed to a nonmember shareholder.¹⁴³ The deferred

138. Reg. § 1.1502-13(f).

139. Reg. § 1.1502-13(f)(2)(ii).

140. Reg. § 1.1502-19.

141. Reg. § 1.1502-13(f)(2)(iii).

142. Reg. § 1.1502-13(d)(1).

143. Reg. § 1.1502-13(c)(6) and (f)(7), Ex. 4(d).

loss would also typically be allowed under the acceleration rule if either the distributing or distributee member ceases to be a member of the group.

The application of these rules in the context of a transaction that creates an excess loss account is illustrated by an example in the Regulations.

(a) *Facts.* S owns all of T's only class of stock with a \$10 basis and \$100 value. S has substantial earnings and profits, and T has \$10 of earnings and profits. On January 1 of Year 1, S declares and distributes a dividend of all of the T stock to P. Under section 311(b), S has a \$90 gain. Under section 301(d), P's basis in the T stock is \$100. During Year 3, T borrows \$90 and declares and makes a \$90 distribution to P to which section 301 applies, and P's basis in the T stock is reduced under § 1.1502-32 from \$100 to \$10. During Year 6, T has \$5 of earnings that increase P's basis in the T stock under § 1.1502-32 from \$10 to \$15. On December 1 of Year 9, T issues additional stock to X and, as a result, T becomes a nonmember.

(b) *Dividend exclusion.* Under paragraph (f)(2)(ii) of this section, P's \$100 of dividend income from S's distribution of the T stock, and its \$10 of dividend income from T's \$90 distribution, are not included in gross income.

(c) *Matching and acceleration rules.* Under § 1.1502-19(b)(1), when T becomes a nonmember P must include in income the amount of its excess loss account (if any) in T stock. P has no excess loss account in the T stock. Therefore P's corresponding item from the deconsolidation of T is \$0. Treating S and P as divisions of a single corporation, the T stock would continue to have a \$10 basis after the distribution, and the adjustments under § 1.1502-32 for T's \$90 distribution [which decrease basis] and \$5 of earnings [which increase basis] would result in a \$75 excess loss account [$\$10 - \$90 + \5]. Thus, the recomputed corresponding item from the deconsolidation is \$75. Under the matching rule, S takes \$75 of its \$90 gain into account in Year 9 as a result of T becoming a nonmember, to reflect the difference between P's \$0 gain taken into account and the \$75 recomputed gain. S's remaining \$15 of gain is taken into account under the matching and acceleration rules based on subsequent events (for example, under the matching rule if P

subsequently sells its T stock, or under the acceleration rule if S becomes a nonmember).¹⁴⁴

In the example, if the basis of the T stock had not been adjusted as a result of S's distribution of the T stock to P, the \$90 distribution to P would have resulted in an excess loss account with respect to the T stock. On a single entity basis, the excess loss account would have been \$75, the original \$10 of basis, increased by \$5 of earnings and profits and decreased by the \$90 distribution. Accordingly, S is required to take into account \$75 of deferred gain when T ceases to be a member of the consolidated group. The remaining \$15 of S's deferred gain remains a deferred item for S, which can be matched with P's disposition of its remaining T stock, or accelerated if either S or P ceases to be members of the same consolidated group.¹⁴⁵

3. *Liquidation of a Subsidiary*

Where a parent corporation completely liquidates a subsidiary corporation that it controls, under section 332 no gain or loss is recognized to the parent. This provision also applies if a controlled subsidiary merges into its parent corporation.¹⁴⁶ Section 332 is another one of the basic Code provisions that operates with the consolidated return regime as well as without the consolidated return regime.

"Control" is defined in section 332(b)(1), through a cross reference to section 1504(a)(2), as holding both (1) 80 percent or more of the voting power, and (2) 80 percent or more of the total value of all stock of the corporation, except that pursuant to section 1504(a)(4), nonparticipating, nonconvertible, nonvoting preferred stock is not taken into account.

When section 332 applies to the parent of a liquidating corporation, section 337 provides a general exception to the basic rule of section 336 that a liquidating corporation recognizes gain or loss on liquidating distributions.¹⁴⁷ Under section 337(a), no gain or loss is recognized on a distribution to an "80 percent distributee", defined in section 337(c) as a

144. Reg. § 1.1502-13(f)(7), Ex. 2.

145. Reg. § 1.1502-19. The deferred gain or loss is not accelerated when the group is acquired in a reverse acquisition, another group acquires the common parent's stock, or another group acquires the common parent's assets in a section 381(a)(2) transaction. Reg. § 1.1502-19(c)(3).

146. Reg. § 1.332-2(d).

147. To prevent the complete avoidance of tax on appreciation in the subsidiary's assets, subject to certain exceptions, section 337 does not apply to a liquidation of a subsidiary of a tax-exempt organization. I.R.C. § 337(b)(2). This provision is necessary because notwithstanding a carryover basis under section 334(b), a subsequent sale of the former subsidiary's assets generally would not be taxable.

corporation that meets the stock ownership requirements of section 332(b). The final sentence of section 337(c) requires that a single corporation must meet the 80 percent requirement: it is not sufficient for two or more affiliated corporations to have aggregate holdings meeting the 80 percent test.

Section 337 does not apply to a liquidating subsidiary if the 80 percent controlling parent is a foreign corporation (which, in any event, cannot be included in a consolidated return with an affiliated group of U.S. subsidiaries).¹⁴⁸ Both gains and losses are recognized. However, capital losses may not exceed capital gains and ordinary losses may not exceed ordinary gains. Excess losses in either category are disallowed. The gain recognition rule does not apply if the property remains within U.S. jurisdiction, for example, U.S. real property interests or U.S. real property holding company holding companies, or assets used in a U.S. trade or business, if certain conditions are met.¹⁴⁹

Under section 334(b) the basis of the assets in the parent corporation's hands remains the same as the basis of the assets to the subsidiary corporation, except that if gain or loss is recognized on a distribution of property, its basis is its fair market value.

Section 332(d) treats a liquidating distribution by a U.S. holding company to a foreign corporation as a section 301 distribution, which is a dividend to the extent of earnings and profits, thereby invoking the 30 percent withholding tax under sections 861 and 1441, if the holding company has not been in existence for five years.

Section 332 applies to provide nonrecognition upon the liquidation of a subsidiary within a consolidated group. Consequently, the parent corporation receiving the distribution takes a transferred basis under section 334(b). Furthermore, in determining whether one member of the group holds sufficient stock to qualify for nonrecognition under section 332, stock owned by other members of the group shall be taken into account.¹⁵⁰ Assume, for example, that Y Corporation and Z Corporation, which are members of the same consolidated group, owned 60 percent and 40 percent, respectively, of the stock of S Corporation, and S Corporation liquidates by distributing 60 percent of its assets to Y Corporation and 40 percent of its assets to Z. Section 332 accords nonrecognition to each of Y Corporation and Z Corporation. However, section 337(c) provides that the determination of whether a corporation receiving a liquidating distribution is an "80-percent distributee," distributions to which do not result in recognition the liquidating corporation under section 337(a), is to be made without regard to any consolidated return regulation. Thus, for purposes of section 337, neither Y Corporation nor Z Corporation meets the 80-percent stock ownership

148. I.R.C. § 367(e)(2).

149. Reg. § 1.367(e)-2(b)(2).

150. Reg. § 1.1502-34.

requirement of section 332(b) and S Corporation must recognize gain, but not loss.¹⁵¹ However, the gain is deferred, and Y and Z succeed to S's deferred gain.¹⁵² But the manner in which that deferred gain is allocated between the distributee corporations is unclear.

There are some exceptions to the matching principle that will result in certain intercompany items being redetermined to be treated as excluded or as a nondeductible, noncapital amount.¹⁵³ However, this rule does not apply to gain on the sale of stock to another group member, followed by a section 332 liquidation in which the purchaser does not recognize gain.¹⁵⁴ An intercompany sale of the stock of a member of the consolidated group, followed by a liquidation of the subsidiary creates an interesting problem under the single entity approach. The problem is illustrated by the following example.¹⁵⁵ B Corporation, S Corporation and T Corporation are members of the same consolidated group. S Corporation owns all of the T Corporation stock, which has a fair market value of \$100. S Corporation's basis in the T Corporation stock is \$70. The fair market value of T Corporation's assets is \$100 and the assets have a basis of \$10. On July 1 of Year 1, B Corporation purchases the T Corporation stock from S Corporation for \$100. S Corporation's \$30 gain on the intercompany sale to B Corporation in Year 1 is deferred in determining consolidated taxable income in that Year. On July 1 of Year 3, when T Corporation's assets are still worth \$100, T Corporation distributes all of its assets to B Corporation in a complete liquidation governed by section 332. B Corporation's basis in the T Corporation stock is \$100. On liquidation of T Corporation, B Corporation receives a \$100 distribution and thus has zero realized gain. In addition, B Corporation recognizes no gain or loss on the liquidation under section 332. If the transfer of T Corporation stock from S Corporation to B Corporation had been between divisions of a single entity, B Corporation's realized gain on liquidation of T Corporation would have been \$30, but the gain would not have been recognized under section 332. Thus, B Corporation's recomputed corresponding item is \$30 of unrecognized gain, which must be taken into account by S Corporation in Year 3. Although the attributes of S Corporation and B Corporation's gain, including its status as a nonrecognition item, are determined as if S Corporation and B Corporation were divisions of a single entity,¹⁵⁶ gain subject to a nonrecognition provision that is not permanently and explicitly disallowed is not treated as having the attribute of an item

151. I.R.C. § 336(d)(3).

152. Reg. § 1.1502-13(j)(2)(ii); Reg. § 1.1502-13(j)(9), Ex. 7.

153. Reg. § 1.1502-13(c)(6).

154. Reg. §§ 1.1502-13(c)(6)(ii), 1.1502-13(f)(5), and 1.1502-13(f)(7), Ex. 6(c).

155. The example is based on Reg. § 1.1502-13(f)(7), Ex. 6(c).

156. Reg. § 1.1502-13(c)(1)(i).

excluded from income.¹⁵⁷ Thus, S Corporation's \$30 of deferred gain is taken into account as capital gain in Year 3. This result seems to be necessary because B Corporation inherits T Corporation's asset basis and the T Corporation stock is no longer available as a corresponding item to match S Corporation's deferred gain from the sale of the T Corporation stock to B Corporation. However, the Regulations allow elective relief from S Corporation's accounting for its deferred gain.¹⁵⁸

Deferred loss on an intercompany sale of stock of a subsidiary followed by a section 332 liquidation of the subsidiary is treated as a nondeductible, noncapital item,¹⁵⁹ and thus is not taken into account by the selling member. However, the Regulations allow elective relief from S Corporation's treating its deferred loss as a nondeductible, noncapital item.¹⁶⁰

Section 381(a) provides that the tax attributes of the subsidiary carry over to the parent. The most notable of these attributes are net operating loss carryovers, capital loss carryovers, and the earnings and profits accumulations or deficits. If either the parent or the subsidiary has a deficit in its earnings and profits accounts after a section 332 liquidation, the parent must maintain separate earnings and profits accounts; the deficit of one corporation cannot be used to offset the surplus in the earnings and profits account of the other.¹⁶¹ Earnings and profits accumulated by the parent after the liquidation are used to exhaust the deficit account before the accumulated earnings and profits account of the parent is increased.¹⁶²

Section 332 generally applies to the liquidation of a controlled subsidiary whether the subsidiary is a U.S. corporation or a foreign corporation. (An exception to nonrecognition with respect to certain foreign holding companies is provided in section 332(d)). If the controlled subsidiary is a foreign corporation, however, section 334(b)(1)(b) limits the U.S. parent's basis in properties received in the liquidation to the properties' fair market values if the subsidiary's aggregate basis in the transferred properties exceeds their aggregate fair market value. The rule thus prevents the importation of assets with built-in losses into the U.S. tax system.

157. Reg. § 1.1502-13(c)(6)(ii).

158. Reg. §§ 1.1502-13(f)(5)(ii) and 1.1502-13(f)(7), Ex. 6(b).

159. Reg. §§ 1.1502-13(f)(7), Ex.(6)(c).

160. Reg. §§ 1.1502-13(f)(5)(ii) and 1.1502-13(f)(7), Ex. 6(c).

161. I.R.C. § 381(c)(2).

162. Reg. § 1.312-11(b)(2) and (c).

C. *Transactions in Which a Member Acquires Stock of Another Member*

Outside of the consolidated return context, if one affiliated corporation purchases the stock of another affiliated corporation, section 304 applies to determine whether the transaction will, generally speaking, be respected as a sale and purchase or instead recharacterized as a dividend distribution from the purchaser to its controlling shareholder. However, the Regulations provide that section 304 does not apply in the consolidated return context.¹⁶³ Thus, the transaction is respected as a stock sale and purchase. The selling member of the group has a deferred intercompany transaction subject to the rules of Treasury Regulations section 1.1502-13,¹⁶⁴ and the purchasing member of the group takes a section 1012 cost basis in the stock. Special rules apply to transactions involving the intra-group sale of stock of the common parent.¹⁶⁵

D. *Transactions in Which a Member Acquires its Own Stock*

When a corporation acquires its own stock, as a consequence of the nonrecognition rules of section 1032, there will be no subsequent transaction in which the basis of the acquired stock is accounted for. To deal with this situation, the Regulations provide, in effect, that if a member of a consolidated group acquires its own stock in an intercompany transaction, gain or loss recognized by the selling member must be accounted for at the time of the transaction under the acceleration rule.¹⁶⁶ The gain or loss is accelerated to the date of the intercompany transaction under the acceleration rule because there is no corresponding item with which to match deferred gain.¹⁶⁷ If a corporation acquires its own stock in a redemption subject to section 302(a), the selling member must account for its gain. If a corporation acquires its own stock in a section 301 distribution from another member, the distributing member must account for gain recognized under section 311(b).¹⁶⁸ If the selling or distributing corporation realizes a loss on the transaction, the loss is accounted for as a noncapital, nondeductible amount.¹⁶⁹

163. Reg. § 1.1502-80(b).

164. See Reg. § 1.1502-13(f)(7), Ex. 6.

165. Reg. § 1.1502-13(f)(6).

166. Reg. § 1.1502-13(f)(4).

167. See Reg. § 1.1502-13(f)(7), Ex. 4.

168. Reg. § 1.1502-13(f)(7), Ex. 5(c).

169. Reg. § 1.1502-13(c)(6) and (f)(7), Ex. 5(d).

E. Transactions in Which a Member Acquires Debt of Another Member

The Regulations address the treatment of debt obligations between members of the same consolidated group, an “intercompany obligation.”¹⁷⁰ The rules apply to three types of transactions: (1) transactions in which an obligation between a group member and a nonmember becomes an intercompany obligation, for example, the purchase by a consolidated group member of another member’s debt from a nonmember creditor or the acquisition by a consolidated group member of stock of a nonmember creditor or debtor (inbound transactions); (2) transactions in which an intercompany obligation ceases to be an intercompany obligation, for example, the sale by a creditor member of another member’s debt to a nonmember or the deconsolidation of either the debtor or creditor member (outbound transactions); and (3) transactions in which an intercompany obligation is assigned or extinguished within the consolidated group (intragroup transactions).¹⁷¹ In each of these circumstances the following sequence of events is deemed to occur immediately before, and independently of, the actual transaction: (1) the debtor is deemed to satisfy the obligation for a cash amount equal to the obligation’s fair market value, and (2) the debtor is deemed to immediately reissue the obligation to the original creditor for that same cash amount. The parties are then treated as engaging in the actual transaction but with the new obligation.¹⁷² As a result, in the year of the purchase, the debtor recognizes cancellation of debt income under section 61(a)(12) unless one of the exceptions in section 108 applies, and the deemed reissuance of the obligation for an amount equal to its fair market value causes it to be an original issue discount (OID) obligation. Under the OID rules,¹⁷³ over the life of the obligation, the purchasing member (the creditor) recognizes interest income and the debtor member recognizes interest deductions.

The Regulations contain a number of exceptions to the application of the deemed-satisfaction-reissuance model where it is determined that application of the model is not necessary to achieve its purposes or that burdens associated with valuing the obligation or applying the mechanics of the deemed satisfaction-reissuance model outweigh the benefits achieved by its application.

To avoid misuse of the exceptions to the satisfaction-reissuance model, the Regulations provide two anti-abuse rules. The material tax benefit rule applies to an intragroup assignment or extinguishment of an obligation if the transaction is undertaken with a view to shifting built-in items among

170. Reg. § 1.1502-13(g).

171. Reg. § 1.1502-13(g)(3)(i)(B).

172. Reg. § 1.1502-13(g)(3)(ii).

173. I.R.C. §§ 1272-1274, and the Regulations thereunder.

members to achieve a material tax benefit.¹⁷⁴ The off-market issuance rule applies if an intercompany obligation is issued at a materially off-market interest rate with a view to shifting of built-in items from the obligation to secure a material tax benefit. In such cases, the intercompany obligation will be treated as originally issued for its fair market value, and any difference between the amount loaned and the fair market value of the obligation will be treated as transferred between the creditor member and the debtor member, as appropriate (for example, as a distribution or a contribution to capital).¹⁷⁵

F. *Anti-Abuse Rules*

Treasury Regulation section 1.1502-13(h)(1) provides that, “If a transaction is structured with a principal purpose to avoid the purposes of this section, (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section.” Specific examples of abusive transactions described in the regulation include the transfer of property to a partnership to avoid the SRLY limitation, the use of corporations formed under section 351 or partnerships to mix assets for the purpose of avoiding gain on disposition of appreciated property, and the use of a sale-leaseback transaction to create gain for the purpose of absorbing losses subject to the SRLY limitation.¹⁷⁶ Similar anti-abuse language is attached to other consolidated return Regulations.¹⁷⁷

X. NET OPERATING LOSS CARRYOVERS

A. *Generally*

If corporations are members of an affiliated group of corporations filing a consolidated return, the consolidated net operating loss of a consolidated group generally includes the consolidated net operating loss (NOL) carrybacks and carryovers of the group.¹⁷⁸ Furthermore, the Regulations allow the net operating losses of a member of an affiliated group to be carried over from a pre-consolidation return period against the consolidated income of the group.¹⁷⁹ This general rule, is, however, subject to two generally mutually exclusive limitations. If after a change of

174. Reg. § 1.1502-13(g)(3)(i)(C).

175. Reg. § 1.1502-13(g)(4)(iii).

176. Reg. § 1.1502-13(h)(2).

177. *See e.g.*, Regs. §§ 1.1502-19(e), -32(e), and -33(g).

178. Reg. § 1.1502-21(a).

179. Reg. § 1.1502-21(b).

ownership, the corporation is a member of an affiliated group of corporations filing a consolidated return and section 382 is applicable, then the carryovers are limited accordingly.¹⁸⁰ Alternatively, if there was not a change of control within the meaning of section 382, but the loss year was a “separate return limitation year” (SRLY), then the loss may be carried over only against the income of the member of the group that generated the loss.¹⁸¹ The SRLY rules allow the use of losses from a separate return year of a member of the group only to the extent of income produced by that member. The SRLY rule does not apply if a corporation becomes a member of a consolidated group within six months of the change date of an ownership change.¹⁸² Thus, in cases of overlap, generally only the section 382 limitation is applicable.¹⁸³

As noted above, in *United Dominion Industries, Inc. v. United States*,¹⁸⁴ the Supreme Court adopted the single entity approach regarding consolidated net operating losses, making it clear that there is only a consolidated net operating loss, not a collection of the separate members’ losses, although separate member losses must be identified when members enter and leave a group. United Dominion Industries was the parent of an affiliated group that reported a consolidated net operating loss in each of three years. The consolidated net operating losses included losses attributable to so-called product liability expenses that gave rise to product liability losses. Product liability losses can be carried back under section 172(b)(1)(I) for ten years, rather than the much shorter carryback allowed under section 172(b)(1)(A). Five of the corporate members of the affiliated group, which collectively generated \$3.1 million of product liability expenses over three years, had sufficient income to offset their product liability expenses, thereby producing positive separate taxable income in each entity. The government argued that the consolidated group could not carry back product liability expenses incurred by a profitable member because the product liability expenses that were offset with positive income did not enter into the

180. Reg. § 1.1502-91.

181. Regs. §§ 1.1502-21(c) (NOLs) and -22(c) (capital loss carryovers).

182. Reg. § 1.1502-21(g).

183. In limited cases generally beyond the scope of this article, both the SRLY rule and § 382 may apply. This generally occurs when there are two different acquisitions. For example, if X Corporation, which is the common parent of a consolidated group, owns 50 percent of Y Corporation and acquires an additional 30 percent of the Y Corporation stock at a time when Y Corporation has net operating loss carryovers, the SRLY rules apply to Y Corporation’s net operating loss carryovers. If P Corporation, which is the common parent of a consolidated group, subsequently acquires 80 percent of X Corporation, resulting in both X Corporation and Y Corporation becoming members of P Corporation’s consolidated group, § 382 applies to the P Corporation subgroup’s net operating loss carryovers, while the SRLY rules continue to apply to Y Corporation’s net operating loss carryovers.

184. 532 U.S. 822 (2001).

consolidated net operating loss of the group. The Supreme Court reasoned that there is only a single definition of consolidated net operating loss in Treasury Regulation section 1.1502-21(f) and no definition in the Regulations of a separate NOL for a single member of the consolidated group. The subsidiary's specified liability loss deduction items reduced the subsidiary's separate taxable income dollar-for-dollar and thereby contributed to the overall consolidated net operating loss of the affiliated group. A product liability loss subject to the special ten year carryback is the lesser of product liability expenses or the taxpayer's NOL for the taxable year.¹⁸⁵ Identifying the product liability loss first requires calculation of the consolidated group's consolidated net operating loss, the only NOL available under the consolidated return Regulations, then determining product liability loss from all of the product liability expenses within the consolidated group. Thus, a portion of the consolidated NOL could be carried back ten years.

B. Application of Section 382 to Consolidated Groups

The ability to use the target acquired corporation's net operating loss carryovers following an acquisition, whether taxable or a tax-free reorganization, is substantially restricted by section 382. Section 382 applies whenever there is a greater than 50 percentage point increase in the ownership of the stock of a corporation with a net operating loss carryover by one or more five percent stockholders over a three year testing period. The annual limitation on post-acquisition income that can be offset by net operating loss carryovers following an ownership change is computed by multiplying the value of the loss corporation by the "federal long-term tax-exempt rate", a number that is published by the IRS monthly.

The Regulations provide detailed rules applying the section 382 limitation in the consolidated return context.¹⁸⁶ The Regulations generally treat the members of a consolidated group as a single entity for purposes of determining whether an ownership change has occurred with respect to a loss corporation and ascertaining the value of the loss corporation stock. Before an ownership change, a consolidated group of corporations is able to absorb net operating losses of some members against the income of other members as a single entity. Following an ownership change, the consolidated taxable income of a group that may be offset by pre-ownership change losses and built-in losses of the group is limited by the section 382 consolidated limitation applied to the group as a whole.¹⁸⁷ A consolidated loss group has an ownership change for purposes of section 382¹⁸⁸ if there has been an

185. I.R.C. § 172(j)(1).

186. Regs. §§ 1.1502-90 through 1.1502-99.

187. Reg. § 1.1502-91(a)(1).

188. Temp. Reg. § 1.382-2T.

ownership change of the common parent.¹⁸⁹ In determining whether an ownership change has occurred, losses of the group are treated as the losses of the common parent, and the testing period is measured by losses of members of the loss group.¹⁹⁰

The Regulations provide for the identification of loss subgroups within a consolidated group for the purpose of applying the section 382 limitation on the basis of a loss subgroup.¹⁹¹ There is an ownership change with respect to a loss subgroup if there is an ownership change of the common parent of the loss subgroup.¹⁹² The Regulations also treat brother-sister corporations as a loss subgroup if two or more corporations that become members of a consolidated group at the same time were affiliated with each other immediately before becoming members of the new group and the common parent of the acquiring group elects to treat the new members as a loss subgroup.¹⁹³

The section 382 limitation, which under section 382(b)(1) is based on the value of the stock of the loss corporation multiplied by the applicable long-term tax-exempt rate, is determined from the value of the stock of the consolidated loss group or subgroup as a single entity.¹⁹⁴ The value of the consolidated loss group immediately before an ownership change is the value of the stock of each member of the group, other than the value of stock of a member of the group that is held directly or indirectly by another member of the group.¹⁹⁵

In some circumstances, a subsidiary will be required to recognize an ownership change on a separate corporation basis with respect to its portion of the consolidated return net operating loss of the group.¹⁹⁶

A separate set of rules apply section 382 to carryover losses of a new member of a consolidated group that were incurred by the new member in a separate return limitation year with respect to the current consolidated group.¹⁹⁷ In general, a new loss member of a consolidated group is treated as a separate entity for purposes of applying the section 382 limitation. Thus, the amount of consolidated taxable income of the group that may be offset with losses of the new member is limited by a section 382 limitation that is computed with respect to the value of the new member corporation's stock at

189. Reg. § 1.1502-92(b)(1).

190. Reg. § 1.1502-92(b)(1)(ii)(A) and (B).

191. Reg. § 1.1502-91(d).

192. Reg. § 1.1502-92(b)(1)(ii).

193. Reg. § 1.1502-91(d)(4).

194. Reg. § 1.1502-93(a).

195. Reg. § 1.1502-93(b)(1).

196. Reg. § 1.1502-96(b)(1) and (2).

197. Reg. § 1.1502-94.

the time of its ownership change.¹⁹⁸ If the section 382 limitation does not apply, under the SRLY limitation, the amount of the new member's losses that may be absorbed by the consolidated group is also limited to the new member's aggregate contribution to the consolidated taxable income of the group.¹⁹⁹

As explained previously, a consolidated loss group subject to the section 382 limitation is treated as a single entity subject to the limitation on the basis of the stock value of the entire group. If a loss corporation leaves a consolidated loss group or subgroup that has had an ownership change while the departing corporation was a member of the group, a portion of the consolidated net operating loss carryover is apportioned to the departing loss corporation,²⁰⁰ and those losses remain subject to the section 382 limitation. The section 382 limitation applicable to the departing loss corporation will be zero unless the common parent (not a loss subgroup parent) elects to apportion part of the section 382 limitation of the consolidated loss group to the departing loss corporation.²⁰¹ The section 382 limitation apportioned to the departing member will reduce the section 382 limitation of the remaining consolidated loss group.²⁰² The Regulations also permit an election to apportion part of the net unrealized built-in gain of the loss group, which increases the section 382 limitation, to the departing member.²⁰³ A pro-rata portion of the group's net unrealized built-in loss must be allocated to the departing member of a consolidated group.²⁰⁴

C. *Separate Return Limitation Year*

1. *Generally*

Generally, the definition for "separate return limitation year" is a year in which any member of the consolidated group filed a separate return.²⁰⁵ But there are exceptions. The parent is excepted from the general rule.²⁰⁶ This exception permits a loss corporation to acquire a profitable subsidiary and apply its own loss carryovers against the profits of the newly acquired subsidiary. Acquisition of a corporation with built-in gain, however, is subject to the limitations of section 384, which restricts the use of

198. Reg. § 1.1502-94(b)(1).

199. Regs. §§ 1.1502-21(c) and 1.1502-94(b)(4), Ex. 1(iii).

200. Reg. § 1.1502-21(b)(2).

201. Reg. § 1.1502-95(c)(2).

202. Reg. § 1.1502-95(c)(3).

203. Reg. § 1.1502-95(c)(2)(ii).

204. Reg. § 1.1502-95(e).

205. Reg. § 1.1502-1(f).

206. Reg. § 1.1502-1(f)(2)(i).

preacquisition losses against recognized built-in gain of either the acquired or acquiring corporation. In addition, a SRLY does not include a separate return year for a subsidiary that was a member of the affiliated group at the time the loss was incurred but which was not included in a consolidated return for that year.²⁰⁷

The deduction of a SRLY loss by the consolidated group in any taxable year is limited to the taxable income contributed to the group by the member with the SRLY loss.²⁰⁸ The member's contribution to consolidated taxable income is measured on a cumulative basis over the entire period during which the SRLY corporation is a member of the group. Thus, a member's SRLY losses may be absorbed in any consolidated return year to the extent of the member's cumulative net contribution to consolidated taxable income in prior consolidated return years of the group, even though the member may not have taxable income in the year the loss is absorbed.

Similar rules apply on the basis of a SRLY subgroup, rather than fragmenting the limitation on a corporation-by-corporation basis.²⁰⁹ A SRLY subgroup consists of corporations affiliated with the loss corporation continuously from the year in which the loss was incurred to the year into which the loss is carried.

2. *Reverse Acquisition*

Since the SRLY limitation does not apply in the case of a change of ownership of the common parent, there remains a possibility that the common parent of the loss group might acquire a profitable corporation in a transaction that results in the acquired corporation's shareholders owning more than 50 percent of the stock of the common parent of the loss group.²¹⁰ For example, assume that a profitable P Corporation merges into L Corporation, which is the common parent of a consolidated group of corporations, and as a result of the merger the persons who were shareholders of former P Corporation immediately before the merger end up owning more than 50 percent of the stock of L Corporation. SRLY does not limit the losses of the L Corporation consolidated group none of which were incurred in a separate return limitation year. However, the Regulations

207. Reg. § 1.1502-1(f)(2)(ii).

208. Reg. § 1.1502-21(c)(1).

209. Reg. § 1.1502-21(c)(2).

210. The section 382 limitation applies where there is a more than 50 percent change in ownership of the loss corporation, but the section 382 limitation would not apply, for example, if the profitable corporation's shareholders already owned 10 percent of the loss corporation stock and by virtue of the transaction increased their ownership interest to 52 percent, which is an increase of only 42 percent.

recognize that while in form the loss corporation acquired the profitable corporation, in substance the profitable corporation acquired the loss group and treat this transaction as a “reverse acquisition” to deny the net operating loss carryover against the profits of the profitable “acquired corporation.”²¹¹

Wolter Construction Co., Inc. v. United States,²¹² upheld the validity of the SRLY Regulations. The taxpayer argued that the common parent exception to the SRLY limitation and the reverse acquisition exception to the exception were intended to insure that loss carryovers were available only to the stockholders who owned the corporation when the losses were incurred, and that this policy should be applied to allow use of losses by the common parent affiliated with its former sister corporation. The court rejected the argument and described the reverse acquisition rule as follows:

In a typical reverse acquisition in the loss carryover context, substantially all the assets or stock of a profit corporation are nominally acquired by a loss corporation in exchange for more than 50 percent of the latter’s stock, so that control of the loss corporation has shifted to the stockholders of the profit corporation as they existed prior to the acquisition. The Regulations essentially treat the loss corporation as having been acquired, and under Section 1.1502–1(f)(3) of the Treasury Regulations, all taxable years of the loss corporation prior to the reverse acquisition are treated as separate return limitation years, notwithstanding its status as the common parent corporation of the new affiliated group consisting of it and the profit corporation. Conversely, the separate return years of the profit corporation prior to the acquisition are not treated, in general, as the separate return limitation years. Accordingly, the net operating losses sustained by the loss corporation, but not the profit corporation, in its separate return years are subject to the carryover limitation contained in Section 1.1502–21(c). The purpose and effect of the reverse acquisition rules is to prevent trafficking in loss corporations. This is accomplished by redirecting the SRLY limitation to the ostensibly acquiring corporation. This “simple technical rule thwarts the attempts of those who would seek to present that the ailing David is trying to improve its financial strength by

211. Regs. §§ 1.1502–1(f)(3) and 1.1502–75(d)(3).

212. 634 F.2d 1029 (6th Cir. 1980).

drawing on the earning power of Goliath.” Gans [A Practical Guide to Consolidated Returns (1976)], at 828.2.²¹³

3. *Built-In Deductions*

If losses are economically incurred in a prior separate return year but recognized for tax purposes in a consolidated year, the losses are treated as arising in a separate return limitation year and thus may not be applied against consolidated income but may be used only to offset the income of the corporation which realized the loss.²¹⁴ Net unrealized built-in losses are thus subject to the SRLY limitations. The Regulations adopt the definitions of built-in loss contained in section 382(h)(3), which refers to the excess of adjusted basis of assets over their fair market value.²¹⁵ The SRLY limitation applies to the recognition of “net unrealized built-in losses” of a new member of a consolidated group (as determined under section 382(h)(3)) but only during a five year recognition period after the new member joins the group.²¹⁶ However, the SRLY limitation on built-in-loss does not apply if the losses are also subject to the built-in-loss limitation of section 382.²¹⁷

4. *Post Acquisition Losses of an Acquired Member*

Consolidated net operating losses of the group are subject to being carried back and carried forward the under the general principles of section 172(b)(two year carryback and twenty year carryforward).²¹⁸ However, the consolidated net operating loss does not include losses apportioned under to a separate return year of a member of the consolidated group.²¹⁹ In *Amorient, Inc. v. Commissioner*,²²⁰ the taxpayer incurred a consolidated net operating loss that was allocable in part to separate return years of a corporation that had been a Subchapter S corporation prior to acquisition by the consolidated group. The Tax Court held that the portion of the taxpayer’s consolidated net operating loss allocable to separate return years of the former S corporation was to be carried back to the S corporation’s separate return year even though deduction of net operating losses by an S corporation is barred by

213. *Id.* at 1035-36.

214. Reg. § 1.1502-15.

215. Built-in loss under section 382(h) includes deduction items that are attributable to a SRLY but which are accounted for in a consolidated return year. I.R.C. § 382(h)(6)(B).

216. Reg. § 1.1502-15.

217. Reg. § 1.1502-15(g).

218. Reg. § 1.1502-21(b)(1).

219. Reg. § 1.1502-21(b)(2).

220. 103 T.C. 161 (1994).

section 1373(d). The Tax Court justified its result in part on its conclusion that losses that are not deductible in carryback separate return years of the S corporation are to be carried forward to a year when either the former S corporation or the consolidated group can utilize the loss. The Regulations partially address the issues raised in *Amorient* by providing that the portion of a consolidated net operating loss that is apportioned to a member and carried back to a separate return year of the member may not be carried back to an equivalent or earlier year of the consolidated group.²²¹ Likewise, if a consolidated net operating loss is carried forward to a separate return year of a member of the group, that carryforward loss may not be used in an equivalent or later consolidated return year of the group.²²²

XI. FOREIGN SUBSIDIARIES

A. Generally

Foreign affiliates of a U.S. consolidated group are not included in the consolidated return.²²³ The income of a foreign corporation with U.S. shareholders generally is not taxed to the shareholder(s) until it is repatriated, either as a dividend or a liquidation distribution. Because of the foreign tax credit, this treatment is of major significance only when the foreign corporation is in a country with tax rates lower than the U.S. rates. If the country of the foreign corporation has tax rates lower than the U.S., the deferral effected by the general rule is limited by the “Subpart F” rules.²²⁴

A U.S. shareholder (including individuals as well as corporations) that owns ten percent or more of the total combined voting power of all classes of voting stock of a controlled foreign corporation (CFC) must include in income each year its *pro rata* share of the CFC’s “Subpart F income.”²²⁵ A CFC is a foreign corporation in which more than 50 percent of either (1) the total combined voting power of all classes of voting stock or (2) the total value of all stock, is owned by U.S. shareholders on any day during the taxable year of the CFC.²²⁶ A U.S. corporate shareholder is entitled to a foreign tax credit for the foreign income taxes it is deemed to

221. Reg. § 1.1502-21(b)(2)(i).

222. Reg. § 1.1502-21(b)(2)(i).

223. I.R.C. § 1504(a)(1)(A) and (b).

224. I.R.C. §§ 951 – 964.

225. I.R.C. §§ 951(a) and (b). Section 958(a) requires that indirect ownership be taken into account and Reg. § 1.958(b) applies constructive ownership rules for determining the amount of stock owned by a U.S. shareholder.

226. I.R.C. § 957(a). Section 958(a) requires that indirect ownership be taken into account, and Reg. § 1.958(b) applies constructive ownership rules for determining the amount of stock owned by a U.S. shareholder.

have paid on the Subpart F income (and must include the amount of the deemed foreign tax credit in income). The U.S. shareholder's basis in the CFC's stock is increased by the amount of income taxed under subpart F and decreased by subsequent distributions of such previously taxed income.

The primary category of income taxed under Subpart F is "foreign base company income."²²⁷ Speaking very generally, subject to a variety of special rules and limitations, foreign base company income includes income, reduced by properly allocable deductions, in the following five categories:

(1) Foreign personal holding company income (FPHCI). This income consists of (i) dividends, interest, rents and royalties;²²⁸ (ii) net gains from the sale or exchange of property that produces dividends, interest, rents and royalties or that does not produce any income; (iii) gains from certain commodities transactions; (iv) gains from certain foreign currency transactions; and (v) income that is the equivalent of interest.

(2) Foreign base company sales income. This category encompasses income from property purchased from or sold to a related person if the property is manufactured outside *and* sold for use outside the CFC's country of incorporation. If, however, the CFC purchases property from a related party but sufficiently transforms the property to constitute "manufacturing" by it, the income from the sale of the property is not foreign base company sales income.²²⁹

(3) Foreign base company services income, which is income derived from performing services outside the CFC's country of incorporation for or on behalf of a related person.

(4) Personal services contract income.²³⁰

(5) Foreign base company oil related income.

If the gross foreign base company income of a CFC for the taxable year is less than the lesser of 5 percent of its total gross income or \$1 million, the CFC is treated as having no foreign base company income. Conversely, if the gross foreign base company income for the taxable year exceeds 70 percent of the CFC's gross income, then all of its gross income, less allocable deductions, is considered foreign base company income. If a taxpayer (generally the U.S. parent) establishes that the income was subject to an *effective* tax rate in a foreign country that exceeded 90 percent of the

227. I.R.C. §§ 952(a) and 954.

228. Reg. § 1.954-2.

229. Reg. § 1.954-3(a)(4).

230. Reg. § 1.954-4.

maximum *marginal* U.S. corporate tax rate — which currently calculates to 31.5 percent — the income is not foreign base company income.

Section 951(a)(1) also currently taxes U.S. shareholders on the amount determined under section 956, which generally speaking is the earnings and profits of the CFC invested in U.S. assets. This prevents a CFC that had no Subpart F income to avoid U.S. taxation on its income but nevertheless makes that income available to its U.S. shareholders.

The Subpart F regime has been significantly undermined by the “check-the-box” entity classification rules.²³¹

B. *Anti-Inversion Rules*

Section 7874, enacted in 2004, is intended to combat “inversion” transactions, which are designed to escape Subpart F by moving a widely-held U.S. multinational corporation’s place of incorporation abroad. (The U.S. applies a place of incorporation test to determine corporate residency.) If 80 percent or more of the interests in the new foreign parent created in the inversion are owned by former shareholders of the U.S. corporation, the foreign parent (statutorily termed a “surrogate foreign corporation”) continues to be treated as a U.S. corporation. Treaty provisions that would prevent this treatment are expressly overridden. As a result, Subpart F continues to apply to the group and the parent is taxed on any foreign source income it earns directly. If the former U.S. shareholders own at least 60 percent but less than 80 percent of the new foreign parent, its status as a foreign corporation will be respected but the inverted U.S. corporation cannot use any of its tax attributes, such as net operating loss carryforwards or foreign tax credits, to offset the corporate level “inversion gain” realized on the inversion transaction.²³² Inversion gain includes any gain realized on the inversion or any gain realized on the transfer of assets to a related foreign inversion, including royalties on licensed intangibles, for a ten-year period after the inversion transfer. Neither of these rules applies, however, if the foreign corporation has substantial business activities in the country of its incorporation.

231. See Lawrence Lokken, *Whatever Happened to Subpart F - U.S. CFC Legislation after the Check-the-Box Regulations*, 7 FLA. TAX REV. 185 (2005).

232. I.R.C. § 7874(a).

C. *Foreign Tax Credit*

1. *Direct Credit*

U.S. citizens and corporations can either deduct foreign income taxes under section 164 or claim a foreign tax credit (FTC) against their U.S. income tax liability under section 27, calculated under the rules in sections 901 through 908 and 960.²³³ The amount of the FTC is limited to the amount of U.S. tax imposed on the income.²³⁴ If the foreign tax is imposed at a higher rate than the U.S. rate, the FTC is based on the tax at the U.S. rate. The ceiling on the amount of the FTC can be expressed by the following formula:

$$\text{U.S. Tax Liability} \quad \times \quad \frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}}$$

Excess FTCs above the ceiling can be carried back one year and forward ten years.²³⁵

The FTC is limited to the amount of U.S. tax imposed on foreign source income. The limitation on the FTC is imposed separately on two categories of foreign source income — (1) the general income category, and (2) the passive income category. The passive income category includes dividends from foreign corporations in which a U.S. corporate shareholder owns less than ten percent of the stock,²³⁶ interest, annuities, certain rents and royalties and net gains from sales of assets that produce passive income. The general income category includes all income that is not passive category income.²³⁷

Dividends, interest, rents and royalties from a corporation in which a U.S. corporate shareholder owns at least ten percent of the stock or from a controlled foreign corporation (CFC) are assigned to the proper basket by “looking through” to the character of the underlying income of the foreign corporation from which the payment was made.

233. The credit applies only to foreign income, war profits, and excess profits taxes. I.R.C. § 901(b)(1). Special limitations apply to the credit with respect to foreign mineral income. I.R.C. § 901(e).

234. I.R.C. § 904.

235. I.R.C. § 904(c).

236. Section 901(k) disallows the foreign tax credit for withholding taxes on dividends if the stock is held for 15 days or less.

237. Special rules are provided for high-taxed income (I.R.C. § 904(d)(2)(F)) and financial services income (I.R.C. § 904(d)(2)(C))

2. *Indirect Credit*

Foreign income taxes paid by a foreign corporation are not normally creditable by a U.S. shareholder of the foreign corporation. However, if a U.S. corporation directly owns at least 10 percent of the voting stock of a foreign corporation from which it receives a dividend, the U.S. corporation is deemed to have paid the foreign income taxes paid by the subsidiary attributable to the dividend.²³⁸ As a result, the U.S. corporation is entitled to a foreign tax credit under section 901 for those taxes. To treat repatriated subsidiary profits in the same manner as profits from direct foreign branch operations for purposes of the foreign tax credit, section 78 requires the U.S. parent to include the amount of the credit in its income.

The indirect credit also applies with respect to dividends paid by second, third, fourth, fifth and sixth tier foreign corporations if each respective parent meets the 10 percent voting stock requirement, provided the U.S. parent has indirect ownership in each subsidiary of at least five percent. For foreign corporations below the third tier, the corporation must be a CFC for the indirect credit to be available.

D. *Dual Consolidated Losses*

Section 1503(d) denies the use of the losses of one U.S. corporation by another affiliated U.S. corporation where the loss corporation is also subject to the income tax of a foreign country. Section 1503(d) was enacted to prevent the double counting of net operating losses resulting from a member of a consolidated group being a U.S. corporation for U.S. tax purposes and simultaneously being a domestic corporation of another country for purposes of that country's tax laws (i.e., a dual resident corporation). If the consolidation regime of a foreign country generally allows losses of a dual resident corporation to be offset against income of affiliated corporations, a net operating loss of the corporation is a dual consolidated loss, even if the foreign country's equivalent of the dual consolidated loss rule disallows the loss. However, the Regulations permit a method by which the loss can be allowed pursuant to an agreement with the other country that permits the loss to be deducted in only one country.²³⁹

A "separate unit" of a U.S. corporation is treated as a dual resident corporation. Separate entities include foreign branches, partnership interests and trust interests, as well as hybrid entities. A hybrid entity separate unit is an entity that is treated as a disregarded entity or partnership for U.S. tax

238. I.R.C. § 902.

239. Reg. § 1.1503-2(g)(1).

purposes but under the laws of a foreign country is taxed as a corporation either on its worldwide income or on a residence basis.²⁴⁰

Foreign entities that are *per se* corporations are listed in the Treasury Regulations.²⁴¹ The following are among the many others included as *per se* corporations: Belgium, Societe Anonyme; France, Societe Anonyme; Germany, Aktiengesellschaft; Italy, Societa per Azioni; Ireland, Public Limited Company; Luxembourg, Societe Anonyme; Netherlands, Naamloze Vennootschap; Norway, Allment Aksjeselskap; Spain, Sociedad Anonima; Sweden, Publica Aktiebolog; Switzerland, Aktiengesellschaft; United Kingdom, Public Limited Company. For foreign entities with limited liability that are not *per se* corporations, the default rule is that the entity is a corporation unless it elects to be a partnership or disregarded entity.²⁴² For U.S. tax purposes a foreign entity lacking in limited liability is treated as a partnership if it has two or more members or as disregarded if it has only one owner, unless the foreign entity elects to be treated as a corporation.²⁴³

XII. CONCLUSION

The U.S. consolidated return rules are fearsomely complex, but they need to be that complex to so thoroughly implement the “single entity” approach to dealings within the group, which attempts to treat the several members of a consolidated group in the same manner as divisions of a single corporation. It has been critical to the successful implementation of the “single entity” approach that Congress has left the development of the rules, other than the definition of an “affiliated group” eligible to elect to file a consolidated return, entirely to the Treasury Department and Internal Revenue Service. Moreover, the one instance in which a court held a consolidated return regulation to be invalid on the grounds that it was inconsistent with a provision of the Internal Revenue Code²⁴⁴ prompted Congress to amend section 1502 specifically to provide that the consolidated return Regulations may contain “rules that are different from the provisions . . . that would apply if such corporations filed separate returns.”

There is, however, one glaring statutory weakness in the consolidated return regime. That weakness is the exclusion of foreign affiliates in section 1504(b)(3) from the consolidated return. The exclusion of foreign affiliates from the consolidated return appears to have been as much an accident of the early history of the development of various Code

240. Reg. § 1.1503-2(c)(3) and (4).

241. Reg. § 301.7701-2(b)(8)(i).

242. Reg. § 301.7701-3(b).

243. Reg. § 301.7701-3(b).

244. *Rite-Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001) (invalidating former Reg. § 1.1502-120 as manifestly contrary to section 165).

provisions dealing with related corporations as it was a carefully considered policy decision. From a policy perspective, it would be much better to include foreign affiliates in the consolidated group.²⁴⁵ That issue, however, has become part of the much larger debate on whether the United States should move from its quasi-world-wide-taxation / semi-territorial tax system to either a robust world-wide-taxation regime or to a purely territorial regime.²⁴⁶

Subject to legal constraints on the ability of the Revenue Department in other countries to promulgate detailed Regulations, the U.S. consolidated return Regulations should be examined carefully by any country seeking to implement or improve a consolidated corporate tax return regime. Of course, for a country that provides a participation exemption for gains on the sale of stock of a subsidiary, rules analogous to many of the stock basis adjustment rules in the U.S. consolidate corporate tax return Regulations would be unnecessary.²⁴⁷ Conversely, for a country seeking to deal with the proposed EU directive on the common consolidated corporate tax base (CCCTB),²⁴⁸ the omission from U.S. consolidated corporate tax returns of foreign affiliates leaves a hole in the U.S. regime as a model.

245. See Jasper L. Cummings, *Consolidating Foreign Affiliates*, 11 FLA. TAX REV. 143 (2011).

246. See Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L.J. 79 (2009).

247. For discussion of participation exemptions, see HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION*, 372-75 (2D ED. 2004); ARTURO REQUENEZ II & TIMOTHY SHUMAN, *U.S. PRIVATE EQUITY FUNDS MAKING CROSS-BORDER INVESTMENTS*, 1152-53 (Practicing Law Institute 2008).

248. See European Commission, Proposal for a Council Directive on a Common Consolidated Corporate tax Base (CCCTB), http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf; European Commission, Taxation and Customs Union, http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.