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Problems in consolidated returns

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THE DETERMINATION OF WHETHER OR NOT A CONSOLIDATED RETURN is advantageous in a given situation in which separate returns can also be filed, can be readily made and does not usually involve many complicated problems or computations. At the outset of the consideration to file consolidated returns, comparisons should be made between the tax on a consolidated basis and the tax on a separate basis not only for the first year for which consolidated returns are to be filed, but also for a number of future years, on the basis of the best available forecasts. The results of these computations will afford an opportunity to consider the immediate advantages of filing a consolidated return and to compare them with some of the factors in the future and evaluate them in the light of problems which may arise. This is important because once consolidated returns are filed for any taxable year, such returns must generally be filed for subsequent years during which the consolidated group remains in existence.

In the field of consolidated returns, the provisions of the Code relating to such returns are brief and cover only 5 pages, whereas the regulations are in great detail and encompass more than 80 pages. The members of an affiliated group may file a consolidated return only if they all consent to all the consolidated return regulations prescribed prior to the last day prescribed by law for filing such return. The

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making of the consolidated return is considered as such consent. Congress has decided not to legislate in detail in the field of consolidated returns, and the Senate Finance Committee reports have noted that because of the complexities of the subject it is possible to deal with frequent amendments more easily in the form of regulations. Moreover, the regulations have become generally accepted over a period of many years, and may be said to be legislative by Congressional direction.

Creation of an Affiliated Group

The privilege of filing consolidated returns has been limited to includible corporations. These are generally any domestic corporations

which are not exempt from taxation. Certain corporations are excluded: insurance companies taxable under special sections of the Code, corporations receiving a large percentage of their income from U. S. possessions (which income is exempt from U. S. income tax), regulated investment companies, unincorporated businesses subject to tax as a corporation, and corporations organized under the China Trade Act, 1922. If a parent company has a subsidiary which falls in any of the above categories, it does not mean that consolidated returns cannot be filed for the whole group, but only that the corporation which is not an includible corporation is not eligible to join in the consolidated return. The parent company itself, however, must meet the tests of an includible corporation. Thus, for example, a corporation organized under the laws of a foreign country, with domestic U. S. subsidiaries, cannot elect to file a consolidated return. On the other hand, if a domestic corporation has a number of subsidiaries eligible as includible corporations and also one foreign subsidiary, it may file a consolidated return excluding therefrom the foreign company.

The affiliated group is formed at the time the common parent corporation becomes the owner directly of stock possessing at least 80% of the voting power of all classes of stock and at least 80% of each class of non-voting stock, (not including non-voting stock which is

CONSOLIDATED RETURNS

By Paul E. Kadden, San Francisco

limited and preferred as to dividends) of another includible corporation. Problems frequently arise in determining whether or not preferred stock meets these tests and it is important to examine the terms of issue of the stock. For example, it has been held that a potential right in the preferred stock to vote after the occurrence of a future event (such as the omission of two consecutive dividends) does not require it to be treated as voting stock until the event occurs. However, where preferred stock is fully convertible into voting stock on demand at any time it should be treated as voting stock. In one case, a circuit court held that where under the law of the state of incorporation preferred shareholders are entitled to vote, the stock should be treated as voting,

even though the articles of incorporation provide that the preferred shareholders are not entitled to vote.

Another requirement is that the ownership of 80% must be direct. Supposing the following situation existed:

Company A owns 75% of the stock of B
Company A owns 50% of the stock of C
Company C owns 25% of the stock of B

Company A owns 87½% of B indirectly, yet B cannot be included in a consolidated return. If A were to acquire the 12½% interest in B (which it indirectly owns) from C, and B met all the other tests of an includible corporation, it could then be included. Another example of indirect ownership is stock held in the name of a nominee or custodian, or qualifying shares held by directors. It has been held that such holdings shall not be regarded as indirect holdings so as to disqualify an otherwise eligible subsidiary from being a member of the affiliated group.

As is the case with many transactions, care must be exercised to the end that it can be proved to the satisfaction of the Commissioner of Internal Revenue that the affiliation served a valid business purpose. The acquisition of the stock of another corporation with a view towards filing of a consolidated return is subject to the provisions of Section 269 of the Internal Revenue Code of 1954 if the principal purpose for the acquisition was evasion or avoidance of tax by securing the benefit of a deduction, credit, or other allowance which would otherwise not be available to the acquiring corporation. The courts have denied to taxpayers filing consolidated returns the right to offset income with losses of an acquired company which was acquired for no valid business purpose.

Termination of the Affiliated Group

Once consolidated returns are filed for any taxable year, such returns must generally be filed for subsequent years during which the consolidated group remains in existence. For this purpose an affiliated group is considered as remaining in existence if the common parent remains as a common parent and at least one subsidiary stays affiliated with it. This subsidiary need not have been a member of the group at the time the group was formed, and one or more corporations may have become subsidiaries of, or have ceased to be subsidiaries of, the parent company at any time after the group was formed. One of the most common misconceptions about consolidated returns is that the

reduction of ownership in one subsidiary below 80% (either by sale, liquidation or otherwise) terminates the affiliated group or gives rise to a new election to file consolidated returns. This is not so. A termination of an affiliated group occurs only where the parent corporation ceases to be the common parent or if there is no subsidiary affiliated with it. In such a situation, consolidated returns must still be filed in the year of termination. A situation can also arise where there are two or more affiliated groups within the year. For example, assume that a corporation and its sole subsidiary had been filing consolidated returns for a number of years including the year 1959. On April 30, 1960 the parent disposes of the stock of the subsidiary. On May 15, 1960 a new subsidiary is acquired. In this instance (unless a new election is available for reasons outlined subsequently) a consolidated return must be filed by the parent and the subsidiary which was disposed of April 30. Since a new affiliated group is formed on May 15, 1960, a new election is available to that group. Even if the new affiliated group does not elect to file consolidated returns, the additional 2% surtax would apply to the parent's income for the entire year. If the new group does elect to file a consolidated return, except for intercompany eliminations there would be no effect on the parent but the new subsidiaries' income or loss (limited to the period of affiliation) would have to be included in the consolidated return.

When Is a New Election Available?

In addition to complete termination of the affiliated group, a new election to file separate or consolidated returns may be available in certain instances. The addition of a new member to the group results in a new election, unless the corporation was created or organized directly or indirectly by a member of the group. The election is available for the entire year and results whether the stock of the new member was purchased for cash, or stock of the parent company was issued to acquire such new members. The regulations do not contain any restrictions as to the size or nature of business of the new member, and presumably this would not be important, unless it were an indication of the business purpose of the acquisition. It has even been held that where a member of an affiliated group of corporations which filed a consolidated return in one year and in a later year purchased all of the stock of another corporation (not organized directly or indirectly by any member of the group) and the acquired company was later liquidated into the parent, a new election to file consolidated

returns is available. However, where the liquidation of the acquired company occurs promptly after its acquisition, the Service has taken the position that this is an acquisition of assets rather than an acquisition of stock. Accordingly, a new election might not be permitted merely because there has been an acquisition of a subsidiary if there was no valid business purpose in acquiring the subsidiary other than the right to change the consolidated return election. (See Rev. Rul. 56-271, C.B. 1956-1, 440 and Rev. Rul. 57-53, C.B. 1957-1, 291.)

Another event which can give rise to a change from the filing of consolidated returns to separate returns is that subsequent to the exercise of the election to make consolidated returns, either Subtitle A to the extent applicable to corporations, or the consolidated return regulations which have been consented to, were amended so as to make it substantially less advantageous to continue filing consolidated returns. The most recent example of this was the enactment of the Technical Amendments Act of 1958 which changed provisions of the Code relating to carrybacks of net operating losses. The Commissioner issued a ruling permitting a new election for the first taxable year for which returns are due to be filed after September 2, 1958. Earlier rulings of this nature related to the taxable year affected by the change in law, rather than the date on which the law was signed by the President. This new procedure is one of the reasons why it is essential in most cases where consolidated returns are filed, or can be filed, that the maximum extension of time be obtained for the filing of such returns. For example, many taxpayers had obtained extension until September 15, 1958 within which to file their 1957 income tax returns. Many of these taxpayers had to decide prior to September 15, 1958 the effect of the 1958 Act on their election to file consolidated returns. If they decided to file a consolidated return for 1957 after September 2, 1958 they would then be bound to file consolidated returns for 1958, unless they "broke" the consolidation otherwise. The Commitee on Federal Taxation of the American Institute of Certified Public Accountants has recommended to Congress that the election should be made to apply to the taxable year during which the law is changed, irrespective of the filing of a return for a prior year before or after the date the change is effected or enacted.

When Maximum Extension of Time May Not Be Desirable

A situation in which the maximum extension of time might not be desirable is where the taxpayer wishes to continue to file or make an

election to file a consolidated return for the year recently ended but does not desire to file a consolidated return for the current year and knows that he can elect to file separate returns for the current year. Reverting to the example of 1958, returns due after September 2, 1958 were permitted a new election. If the taxpayer desired to continue filing consolidated returns for 1957 and such return was due after September 2, such filing would be deemed a new election and consolidated returns would be required for succeeding years. Presumably the 1957 return would be due after September 2 even though filed earlier if there had been an extension of time to September 15, 1958.

Lastly, once consolidated returns have been filed it is permissible to make application to the Commissioner prior to the time for filing a return to change to separate returns. In practice, the Commissioner has given few rulings of this nature and then only in hardship cases. It has been stated that a corporation filing consolidated returns must consider at the outset that it may not be able to change any time it desires and a mere tax disadvantage to continued filing will not constitute a proper reason.

While it is not simple to "break" the consolidation it may in many instances be possible to remove a company from the consolidated group by decreasing the ownership in that company to a point below 80%, by sale or other disposition. The reduction in ownership may come about by the sale of some of the stock in the subsidiary by the parent corporation so that ownership is less than 80%. Also it may be that the total outstanding shares of the subsidiary will be increased by sales of stock to outsiders, exercise of stock options, issuance of stock to others for assets acquired, so that without any action on the part of the common parent corporation, its ownership will fall below 80%.

Consolidated Returns and the "30-Day" Rule

There is also a provision in the regulations which states that if an acquired member has been a member of an affiliated group for a period of less than 31 days during the taxable year of the group, it may, at its option, be considered as not having been a member of the group during the taxable year. Therefore, reduction of the ownership below 80% before the subsidiary is in the group for 31 days will permit its exclusion. The converse is also true and can sometimes be used to advantage. A subsidiary may at its option be considered as having been a member of the affiliated group during the entire taxable year

of the group, if the period during which it was a member of such group does not exceed 30 days. This can work to a taxpayer's advantage in certain cases. Consider the situation of a group filing returns on a calendar year basis which acquired a subsidiary (also having filed on a calendar year basis) on January 20. Normally, the acquired subsidiary would have to file a separate return for the period January 1 to January 20 and the income from January 21 to December 31 would be includible in the consolidated return. There would be two taxable years, and if the newly acquired subsidiary has a net operating loss deduction, two taxable years (of the five-year carryover period) will be used in this manner. On the other hand, if the income of the subsidiary for the entire calendar year is included in the consolidated return under the "30-day" rule, there will be only one year of the five-year carryover period used.

Net Operating Loss Deduction

One of the most frequent reasons for the filing of consolidated returns is the offset of losses of one company against the income of another in the group, or the utilization of net operating losses by various members of the group. The net operating loss deduction is one of the items which is computed on a consolidated basis, rather than being taken into account in the determination of the separate taxable incomes of the corporations in the affiliated group.

The consolidated net operating loss carryovers consist of the consolidated net operating losses for the five preceding taxable years. In computing the consolidated net operating loss carryovers there is also taken into account a net operating loss sustained by a corporation in a taxable year for which a separate return was filed to the extent that this was not absorbed as a carryback or carryover prior to the time that the corporation which incurred the loss became a member of the consolidated group. However, the carryover of a net operating loss from a separate return is limited to the taxable income in the consolidated return year which is attributable to the corporation with which such net operating loss arose. Similar rules are set up in the case of carrybacks. These rules are much more strict than those set forth in Section 381 of the 1954 Internal Revenue Code. Consequently, the treatment of loss carryovers in cases of acquisitions of loss corporations may be more liberal where such loss corporations are merged into the acquiring corporation, rather than retaining corporate identity to permit the filing of a consolidated return with the parent.

Losses of the current year offset profits of that year first in a consolidated return, before the application of loss carryovers. This rule is also observed in situations involving carrybacks. If an affiliated group sustains a net operating loss and if some of the members of the group filed separate returns in preceding years, the portion of the loss attributable to the loss members is determined in an amount proportionate to the net losses of the loss companies, but only to the extent that these losses were taken into account in the computation of the consolidated net operating loss. For example:

	Taxable income (Loss)
A	$ 100,000
B	200,000
C	(300,000)
D	(100,000)
	$(100,000)

In the foregoing example, of the consolidated net loss of $100,000, the amount of $75,000 is available as a carryback to the separate return of C and $25,000 to D.

An interesting situation can arise where a member of the consolidated group has available to it, losses arising in years in which separate returns were filed. The following examples will illustrate the point:

	Example A	*Example B*
Parent Company	$ 125,000	$ 125,000
Subsidiary X	110,000	110,000
Subsidiary Y	(25,000)	(125,000)
Subsidiary Z	(75,000)	(135,000)
Consolidated taxable income	$ 135,000	$(25,000)

Assuming that Subsidiary X has available a loss in the amount of $100,000 from a prior year in which a separate return was filed, the results would be as follows:

1. In Example A the amount of $100,000 could be used as an offset against the income of $110,000, and thus reduce the consolidated taxable income to $35,000. The losses of Y and Z need not be apportioned among the two companies having taxable income before application of the net operating loss.

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2. In Example B, however, the loss of $100,000 is not available even though X has taxable income in excess of that amount. This is so because the net operating loss from a separate return cannot be carried over so as to increase the consolidated net operating loss and in that way indirectly increase the loss carrybacks from the consolidated return year.

The limitation of the use of pre-consolidation losses also applies to the parent company. If a parent acquires a subsidiary during a taxable year, and creates an affiliated group for the first time, the net operating loss of the parent company attributable to the portion of the year before it acquired the subsidiary may not be carried over and used to offset income of the subsidiary in subsequent consolidated return years.

Conclusion

The preceding discussion covers only some of the problems in three of the many areas which are encountered in the field of consolidated returns. One point which cannot be overemphasized is that we should usually obtain the maximum extension of time when filing consolidated returns, especially where the taxpayer desires to break the election immediately. A careful study of the advantages and disadvantages should also be made. This should not be merely limited to a comparison of taxes payable on consolidated and separate bases, but should also include studies of the differences in bases of various assets as a result of filing consolidated returns, possibilities of merging subsidiaries rather than consolidated filing, comparison of the utilization of such items as foreign tax credits, charitable contributions, and dividends received deduction. Only when the whole picture is seen with respect to consolidated returns can a proper decision be made as to whether or not to file on a consolidated basis.

About the Author . . .

BORN IN GERMANY, Paul E. Kadden is a graduate of the University of California at Berkeley, where he received his B.S. degree in business administration in 1945. Mr. Kadden belongs to two honor societies, Phi Beta Kappa and Beta Gamma Sigma. He lives in Oakland, California with his wife and three children.