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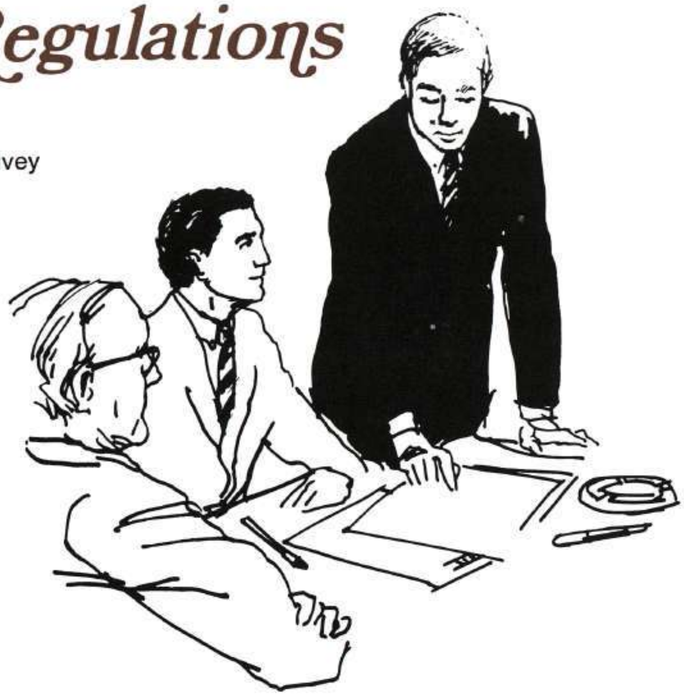

In an effort to simplify and clarify the tortuous provisions of the old regulations governing the filing of consolidated returns, the Treasury has issued new final regulations which concomitantly include a number of important substantive innovations. These provisions apply to all taxable years beginning after December 31, 1965. However, taxpayers required to file consolidated returns for years beginning after 1965 have been granted automatic permission to file separate returns for the first year to which the new regulations apply, if they so desire. Thus, the importance of the changes cannot be overemphasized, either for those groups already filing consolidated returns or for those groups which may be contemplating doing so in the future. In this article, the first of two, the author will highlight some of the more significant aspects of the new regulations, including in his discussion some suggestions for possible tax planning.

Intercompany Transactions

A radical change in the revised regulations[1] concerns the treatment of intercompany transactions. An intercompany transaction is defined as a transaction occurring during a consolidated return year between corporations which are members of the same group immediately after such transaction. While this definition appears to be all-embracing, the regulations specifically exclude from their purview such items as distributions with respect to stock between members of the affiliated group, or contributions to capital on which no gain is realized. For example: dividend distributions, redemptions and liquidations would not constitute intercompany transactions.

To fully understand the impact of the new provisions, we need to distinguish between two types of intercompany transactions: 1) "deferred intercompany transactions," and 2) all other types of intercompany transactions. The term "deferred intercompany transaction" is defined as the sale or exchange of property, the performance of services, or any other payment by one affiliated corporation to another during a consolidated return year, where the amount of the expenditure is required to be capitalized (e.g., a builder's fee, or interest which is included in the basis of property). On the other hand, the category of *non*-deferred intercompany transactions includes such items as interest, rent, and royalty payments. If a particular dealing between member corporations falls within the first category, new deferred accounting principles will come into play. If it falls within the second category the new regulations require the paying corporation to deduct and the receiving corporation to include the amounts in question currently, depending upon their respective accounting methods.[2]

Let us examine more closely the treatment prescribed for the "deferred intercompany transaction," as this is the area which, no doubt, will cause endless difficulties for accounting and tax personnel. Under the old regulations, any gain or loss realized in "deferred intercompany transactions" was absolutely eliminated (if not realized by closed transactions with outsiders by year's end), and the basis of property transferred from one affiliate to the other remained unchanged. In effect, there were transactions with no immediate income tax consequences although, of course, the affiliate effecting a transaction at a future date with someone outside the group had then to recognize the full gain or loss. An inherent defect in these rules was that they enabled an affiliated group to shift income from one member to another to gain a tax advantage to which it was not otherwise entitled. Additionally, in the *Henry C. Beck Builders, Inc.*[3] case the tax-avoidance possibilities provided became only too clear, and the need for revision was practically mandated.

In the *Beck Builders* case, the parent corporation formed a subsidiary and constructed a building which it sold to the subsidiary at a profit. This profit was eliminated in the consolidated return year as an intercompany transaction. In a subsequent year, the stock of the subsidiary was sold to a non-related buyer who proceeded to liquidate it under I.R.C. S 334(b)(2), with the result that the basis of the building to the purchaser became the cost of the subsidiary's stock. The Internal Revenue Service was unsuccessful in an attempt to tax the parent on the previously eliminated profit in the year it sold the subsidiary's stock, the court finding no authority for the Service's contention.

To cure these inherent defects, the treatment provided for "deferred intercompany transactions" under the new regulations is deferral of gain or loss, rather than its elimination. Accordingly, if an asset is sold by one member of the group to another in a consolidated return year the seller's gain or loss will no longer be eliminated, but is to be held in suspense, to be reported at a later date upon the happening of certain specified events. Generally, these events concern the sale of property outside the group, or the depreciation, amortization or depletion of property acquired in the deferred intercompany transaction by another member of the group. Additionally, if the selling member or the member which owns the property ceases to be a member of the group, the deferred gain or loss will then have to be taken into account.

Immediate recognition of previously deferred profits or losses from intercompany transactions may also result from deconsolidation (the filing of separate returns after consolidated returns have been filed previously), the intent of the law in this area being to deter a one-shot consolidation to affect non-taxable shifts of assets. Thus, if at the time of deconsolidation, consolidated returns have been filed by the group for fewer than three consecutive taxable years immediately preceding the separate return year, all remaining deferred income will be taxable in the first separate return year. For all other groups, any deferred profits or losses with respect to non-inventory items will be reported as if the group was continuing to file consolidated returns. On the other hand, deferred profits and losses on inventory will, in all cases, be immediately recognized upon deconsolidation.

(In effect, it appears that this provision operates to penalize an affiliated group that seeks to break the consolidation for a valid business reason. It would seem that the Commissioner has sufficient authority under his discretionary powers to discourage any tax abuses in this area. [Under the new regulations he has to give his approval in the first instance before deconsolidation can be effectuated.] In addition, if the Commissioner grants blanket permission to deconsolidate because of an adverse change in applicable tax law, it is unfair to require corporations under such circumstances to pay in effect, a penalty if they take advantage of the election.)

The character and source of deferred gain or loss is determined at the time of the "deferred intercompany transaction" as if such transaction had not occurred in a consolidated return year. An exception lies in the case of gain or loss required to be taken into account by the seller as a result of depreciation, amortization, or depletion of transferred property taken by the buyer. Such deferred gain or loss is to be reported by the seller as ordinary income or loss at the same rate as

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the property is depreciated, amortized, or depleted. Unlike the case under the old rules, the purchasing member's basis is its own cost of acquisition and, in determining the holding period for which it has held the property, the period such property was held by the selling member is not included. In effect, therefore, the result of the changes is that deferred income ultimately realized when property transferred in an intercompany transaction is disposed of outside the group (or used in its operations) is reported by the party that earned it.

The above principles can best be illustrated by the following example: At the beginning of the consolidated taxable year Corporation A (a machinery manufacturer) sells to affiliated Corporation B a machine that cost \$50, for its fair market value of \$110. Assuming a useful life of five years, using the straight line method of depreciation, and a salvage value of \$10, B would be entitled to a depreciation deduction of \$20 for the first year. Corporation A, in turn, must report \$12 as ordinary income for the same period. This amount is arrived at by taking the amount of deferred gain (\$60) and multiplying it by a fraction, the numerator being the amount of depreciation allowed for the year (\$20) and the denominator being the depreciable basis (cost minus salvage value) to the buyer (in this case, \$100). Mathematically it would look like this:

$$\text{deferred gain} \times \frac{\text{depreciation allowed for year}}{\text{depreciable basis}}$$

At the beginning of the following year, Corporation B sells the machine to individual X for \$130. As of this date, Corporation A must take into account the remaining balance of the deferred gain (or \$48) since the machine has been disposed of outside the group. This \$48 retains its identity as ordinary income.

Elaborate bookkeeping will be required to implement the new provisions. The regulations[4] now specifically provide that the amount of deferred gain or loss must be reflected on permanent records (including work papers). From such permanent records the group must be able to identify the character and source of the deferred gain or loss to the selling member and must be able to apply the deferred reporting rules. Depending upon the frequency and type of transfers, this could be a massive and expensive undertaking.

However, a group may avoid the above cumbersome record keeping requirement by electing,[5] with the consent of the Commissioner, to report deferred gains and losses currently. The application for such consent must be filed with the Commissioner on or before the due date of the consolidated return (not including extensions of time) for the taxable year to which the election is to apply. It will govern all members of the group for the consolidated return year for which made and all subsequent consolidated return years ending prior to the first year for which the group does not file a consolidated return. Since such an election is irrevocable (unless consent is secured from the Commissioner to revoke), care should be exercised before the election is made.

Of what tax importance are these new rules? Since consolidated returns are being filed, isn't the attribution of gains (or losses), to one member rather than another, an exercise in futility? The answer is No! In addition to the tax avoidance device illustrated by the Beck case, the ability of one member of an affiliated group to shift income to another without incurring tax liability bestowed many other benefits on corporations electing to file consolidated returns. This was especially true in areas where certain deductions and credits depended solely upon the taxable incomes of the individual corporations. For example, the limitation on the foreign tax credit,[6] the deduction for net operating loss carry-overs from certain return years[7] as well as the Western Hemisphere deduction[8] all turn upon the computation of the taxable income of a particular member of the group.

That the new intercompany transaction regulations substantially curtail many of the benefits formerly enjoyed by affiliated groups filing consolidated returns cannot be denied. In this connection, note Regulation 8 1.1502-3(a)(2) which provides that there shall be no investment credit with respect to the gain or loss realized in intercompany transactions, whether or not such gain or loss is deferred. Referring back to the example given above for a moment where Corporation A sold machinery with a basis of $50 to Corporation B for $110 (but assuming that the machinery had a useful life of eight rather than five years), B would be eligible for a credit of only $3.50 ($50 × 7%), since the deferred intercompany profit would be ignored for purposes of this computation. This could result in a substantial loss in tax benefits if a manufacturing member of the group should make frequent sales of qualified investment credit property to member corporations.

Numbered among other disadvantages is the fact that the selling member in a "deferred intercompany transaction" may not report gain on the installment method under S. 453. However, if properly acquired in a deferred intercompany transaction is disposed of outside the group, and the *purchasing member-vendor* reports its income on the installment method, then on each date on which the purchasing member-vendor receives an installment payment the selling member must take into account an amount equal to the deferred gain or loss attributable to such property (after taking into account any prior reductions) multiplied by a fraction, the numerator being the installment payment received, and the denominator being the total contract price.

It should be noted that S. 482 will probably come into play in the audit of any consolidated return containing a great many intercompany transactions if there is any question as to whether said transactions were priced at fair-market value. Tax personnel must be prepared to defend on this issue upon an examination.

All is not black, however. If we said that the changes make filing consolidated returns *completely* uninviting where member corporations engage in frequent intercompany transactions, we would not be painting an accurate picture. After all, by filing consolidated returns the tax burden on such transactions is still being deferred into the future. In addition, the regulations provide that in determining the amount of deferred gain or loss, the cost of property, services, or any other expenditure shall include only direct and indirect costs.[9] Apparently, therefore, general, administrative and selling expenses may still de deducted currently to offset other types of current income.

Another overlooked attraction of the deferred accounting provisions exists with respect to installment receivables. Under the new rules a member of an electing affiliated group can transfer installment receivables to another member without accelerating the reporting of the balance of the installment gain. Instead, such gain will be triggered off *pro rata* as the obligations are satisfied.[10] For those groups of corporations which utilize a finance subsidiary, this may prove an effective means of transferring installment receivables without the incurring of immediate tax consequences.

Consolidated Net Operating Loss Deduction

Probably no single area of the consolidated return regulations has been given as much attention in tax planning as the net-operating loss deduction. The planning aspects come into play principally on two distinct occasions: 1) where an affiliated group of corporations which have been filing separately for a period of years now decide to file a consolidated return; and 2) where a profitable corporation acquires a loss corporation (or vice versa). Relevant provisions of the new regulations cannot help but have a substantial effect on both planning situations.

Let us look at some of the rules governing the first situation. Prior to 1965, if a corporation sustained a loss in a year in which a separate return was filed and then subsequently joined in a consolidated return with affiliated corporations, such loss could not be used to offset consolidated taxable income contributed by other members of the consolidated group,[11] i.e., the loss arising from the separate return year could only be used to reduce the consolidated taxable income attributed to the former separate loss corporation. Accordingly, if a member of an affiliated group of corporations filing separate returns possessed a net-operating loss carry-over and a loss position for it was predicted indefinitely into the future, little benefit from the carry-over would be derived from a decision to file a consolidated return. In effect, a penalty was imposed on the affiliated group for not filing a consolidated return in prior years.

In April, 1965, Treasury Decision 6813 was issued, liberalizing the above rules on an interim basis. In an apparent attempt to encourage the filing of consolidated returns, it permitted pre-consolidated losses to be carried over and used to offset the consolidated taxable income of the other members of the affiliated group provided said losses arose in a year in which for each day the loss corporation was a member of the affiliated group. The new amendments[12] have partially incorporated this liberalization by imposing no limitation at all on carry-backs or carry-overs from a separate return year unless the year in question falls within the confines of a new definition, "a separate return limitation year."

A "separate return limitation year" is defined as any year for which a separate return was filed by a member of the group. However, this term does not include a separate return year of a member which is the common parent of the group or was a member of the group for each day of the taxable year for which the separate return was filed, *provided that* an election under S. 1562 to claim multiple surtax exemptions was not effective for such year. An election for a fiscal year beginning in 1963 and ending in 1964 will be disregarded.[13]

Let us illustrate the above principles by the use of a common situation: Corporation A is a member of an affiliated group consisting of corporation A, B and C, all of which filed separate returns in 1966. A finds itself in a loss position and such condition is expected to continue indefinitely into the future. Conceivably A can carry back its losses to the three prior years; even with this flexibility a point will be reached where its losses can no longer be used to offset taxable income. Under such circumstances, Corporations A, B, and C might consider filing a consolidated return in order that A's current losses can be used to offset the taxable income of B and C. Also under the new rules A's pre-consolidated losses may be carried over to further reduce the incomes of B & C, provided that the two conditions noted above are met.

If, in the above example, Corporation A's future earnings picture was somewhat in doubt, it would be advisable to defer a decision to file consolidated returns until the picture became clearer. Given these circumstances, many tax advisers have been recommending a tax planning device which is worth mentioning. Let us assume that an election under Section 1562 was effective for 1965 with respect to affiliated group A, B and C. During 1966, A's operations resulted in a loss and its future prospects are uncertain. The group should continue to file separate returns for 1966. If A should experience a recovery in 1967 or during 1968 the need for filing a consolidated return may be obviated and A would not have precipitated a termination of the surtax exemption (this would have precluded A, B and C from enjoying the benefits of a future multiple surtax exemption for five years).[14] If, on the other hand, A continues to experience losses in 1967 and 1968 (and a loss is predicted indefinitely) a retroactive revocation of the election under Section 1562 can be made, enabling A, B and C to file a consolidated return without losing the right to use A's prior losses to offset the taxable income of B and C.[15]

In the case of a net-operating loss by a member of the group arising in a "separate return limitation year," the amount of the loss which may be carried over or back to a consolidated return year of the group is limited by a formula.[16] In computing the limitation, the first step is to take the consolidated taxable income of the group as a whole (computed without regard to the consolidated net operating loss deduction) and subtract the consolidated taxable income of the group recomputed by excluding the items of income and deductions of the particular member. The difference is the amount allowable as a carry-over or carry-back for that particular member from the separate return year in question. However, this amount must be further reduced by any net-operating losses attributable to such member which may be carried to the consolidated return year and which arose in years ending prior to the particular separate return limitation year.

The above formula appears to be complex. However, its more salient provisions may be illustrated by the following example: Corporation A (parent of Corporation B) on January 1, 1966 acquires Corporation C. Corporation C has a $100,000 net operating loss carry-forward. A, B and C file a consolidated return for calendar year 1966, reflecting consolidated taxable income (without regard to any operating loss deduction) of $125,000. The consolidated taxable income of A and B without regard to the income and deductions of C is $120,000. Since the years in which C incurred the losses are "separate return limitation years," only $5,000 ($125,000 less $120,000) of C's net operating loss carry-forward can be utilized in 1966. The balance ($95,000) can only be used to offset C's future contribution to consolidate taxable income.

The formula used by the new regulations for determining the amount of loss carry-overs (or carry-backs) from separate return limitation years avoids the rule under the old regulations[16A] which required that consolidated taxable income be prorated to all members contributing to consolidated taxable income without regard to whether the members had separate loss carry-overs. Thus, under the old rules, the amount of consolidated income so allocated to each affiliate which had a separate net-operating loss carry-over constituted the maximum extent to which such separate net-operating loss carry-over could be used in computing taxable consolidated net income. The new regulations permit a member to utilize its carry-overs (and carrybacks) from separate return limitation years to the extent of its separate taxable income or consolidated taxable income, whichever is the lesser.

Let us now turn to the second situation: that is, where a profitable corporation is acquiring a loss corporation. The long standing rule has been that pre-affiliation losses of a new subsidiary can be used to offset only that part of post-affiliation income which is attributable to the new subsidiary. In addition, anyone contemplating the purchase of a loss corporation should also carefully consider the effect of I.R.C. S. 382(a), and the new consolidated rules pertaining thereto.[17] Section 382(a) provides for the *complete disallowance* of the net operating loss carryover of a corporation if: 1) At the end of the taxable year its ten principal shareholders own a percentage of the total fair market value of the outstanding stock of the corporation which is at least 50 percentage points more than such persons owned at the beginning of the same or prior taxable year; 2) the increase is due to a purchase from unrelated persons or a decrease in the amount of stock outstanding; and 3) the corporation has ceased to carry on substantially the same business as before within the two year period starting with the first increase in ownership.

The new consolidated return regulations have further strengthened these rules by providing that if at the end of a taxable year (consolidated or separate) there is a change of ownership of the stock of the common parent of a group (within the meaning of (1) and (2) above) and *any* corporation in the group fails to continue to carry on a trade or business substantially the same as that conducted before the change wtihin the requisite two year period, then *no* portion of any consolidated net operating loss sustained in prior years attributable to such member will be allowed as a carryover to such taxable year or to any subsequent taxable year.

The following example should illustrate the drastic impact of this new provision: Corporations P, S, and T file a consolidated return for the calendar year 1968, reflecting a consolidated net operating loss attributable in part to each member. P owns 100% of the stock of both S and T. On January 1, 1969 A purchases 60% of P's stock. Later on during the same year, T's business is discontinued. Since there has been the requisite increase by A in stock ownership of P (the common parent), coupled with T's discontinuance of business, the portion of the 1968 consolidated loss attributed to T is not allowable in 1969 or in any subsequent years.

The inequity of this extension of Section 382 is readily apparent. If there should be the requisite ownership change in a parent corporation with one hundred subsidiaries, and one such subsidiary should go sour within two years of the change, the group is penalized by the denial of the subsidiary's losses unless it continues to operate it at a loss for more than two years. The result seems ludicrous. A more equitable approach would be to base the change-of-business concept of Section 382(a) on a consolidated group basis rather than on a company-by-company basis.

In an attempt to limit the practice of acquiring a loss *group* for the purpose of utilizing its carry-overs to offset the earnings of a profitable corporation,[18] the Treasury introduced another new concept, "the consolidated return change of ownership."[19]

A consolidated return change of ownership occurs under the following conditions: 1) At the end of the taxable year, the ten principal shareholders of the common parent corporation own a percentage of the total fair market value of the outstanding stock of said corporation which is more than 50 percentage points greater than such persons owned at the beginning of that or the preceding taxable year, and 2) the increase is due to either a purchase or redemption. Should the group be subject to such a consolidated change in ownership, then certain carry-over items (including capital losses, foreign tax credit, and investment credit, as well as the net-operating loss deduction) will be limited, in effect, to the amount that would be allowable if the group consisted only of old members.[20]

If, as a result of a consolidated return change of ownership in the parent of an existing affiliated group, a previously unaffiliated corporation emerges as the new common parent of such group, an even more severe penalty results. The previous affiliation of the old members is ignored and the taxable years of the old members prior to the advent of the new common parent are treated as separate return limitation years even though the old members remain affiliated (under a common parent).

(It should be noted that while this concept is similar in nature to that encompassed in S. 382(a), it will take effect irrespective of any change in the business of either common parent or subsidiary).

Last but not least, taxpayers contemplating the acquisition of a loss corporation should bear in mind S. 269 which the Service has used with some success to deny carry-overs and other tax benefits upon a determination that the principal motivation for the acquisition was evasion or avoidance of tax.

Built-in Deductions

The new regulations[21] expand upon the old.[22] They restrict the use of "built-in deductions" of subsidiaries as an offset against consolidated taxable income attributable to other member of the group. The term "built-in deductions" is defined as those deductions or losses of a corporation which are "economically accrued" in a separate return limitation year. "Built-in deductions" do not include deductions or losses incurred both economically and tax-wise in a year which is not a separate return limitation year, including those deductions and losses incurred in rehabilitating corporation.

To illustrate the above, let us analyze the following example:

Assume P is the common parent of a group filing consolidated returns on the basis of a calendar year and that P purchases all the stock of S on December 31, 1966. Assume further that on December 31, 1966, S owns a capital asset with an adjusted basis of $100 and a fair market value of $50. If the group files a consolidated return for 1967, and S sells the asset for $30, $50 of the $70 loss is treated as a "built-in deduction," since it was economically accrued in a "separate return limitation year.' If S sells the asset for $80 instead of $30, the $20 loss is treated as a "built-in deduction." On the other hand, if such asset is a depreciable asset and is not sold by S, depreciation deductions attributable to the $50 difference between basis and fair market value are treated as "built-in deductions."

These deductions are not completely disallowed by the regulations but are governed by the rules relating to pre-acquisition losses of a corporation; i.e., they can be deducted only from that portion of the post-affiliation consolidated group income that is attributable to the new subsidiary. If, as a result of applying this limitation, the built-in deduction is not allowable in the consolidated return year, it is available for carry-back or carry-over, subject to the "separate return limitation year" rule. Moreover, this built-in deduction limitation will not be applicable at all if 1) the corporation became a member of the group more than ten years before the first day of the taxable year, 2) the aggregate adjusted basis of the corporation's assets (other than cash or good will), immediately before it became a member, did not exceed the fair market value of such assets by more than 15%, or 3) the Corporation became a member before October 1, 1965. (In the event that the third description applies, certain limitations imposed by the old regulations are applicable.)

It goes without saying that before any acquisition is made outside the group, those rules should be carefully studied. If, at the time of acquisition, the 15% exception is not applicable, it will be necessary to segregate those assets of the acquired corporation which meet the definition of "built-in deductions," so that subsequently these deductions and losses may be taken only against the income of the corporation.

However, it is important to note that this section will also work to limit those deductions and losses which are accrued in a post-affiliation year if separate returns are filed and a multiple surtax election is made.[23] Of course, if it becomes important tax-wise to save the deductions, the multiple surtax election may be revoked within three years. If not, the same segregation problem will exist as reported above.

Inventory Adjustments

Under the old regulations,[24] the opening inventory of each member of an affiliated group (for the first consolidated return year after separate return years) had to be reduced by the amount of intercompany profits included therein. Conversely, if the inventory reflected intercompany losses, it would be increased accordingly. It has been argued that were it not for this adjustment, the effect of shifting from separate to consolidated returns would be to reduce taxable income for the first consolidated return year because of the elimination (or now, the deferral) of profits on intercompany sales.

To illustrate the workings of this adjustment, assume P and S filed separate returns for calendar year 1962. At the end of 1962, S purchased from P certain inventory items in respect of which P made a $1000 profit. P included this profit in income in 1962. If P and S filed a consolidated return for 1963, S's opening inventory would have to be reduced by this $1000 intercompany profit. Obviously, a double taxation situation was created.

Thereafter, a compensating adjustment was made to the corporation's opening inventory at the time separate returns were filed.[25] This was subject, however, to certain limitations. Thus, the opening inventory of the first separate return year would be increased by the amount of profits reflected in the closing inventory of the last consolidated return year, but limited to the lesser of either: 1) the intercompany profits initially eliminated for the first consolidated return year, or 2) the intercompany profits reflected in the closing inventory for the following separate return year. (Reverse adjustments were made for losses.)

Continuing with our example above, further assume that P and S filed consolidated returns for 1963 and 1964. In 1965 they revert to separate returns again. At the end of 1964, S's inventory included goods on which P made a profit in the amount of $1500. At the end of 1965, this amount was only $300. S's opening inventory for 1965 could only be increased by the $300 amount, thereby resulting in a failure to recover $700 of the original opening adjustment.

Under the new provisions,[26] an opening adjustment is still prescribed for a consolidated return year for such pre-consolidation intercompany profits. However, it is made by increasing the *income* of each selling member by its "initial inventory amount" (i.e., its profits with respect to goods which are, at the close of such corporation's last preceding separate return year, included in the inventories of other members of the group). This addition to income is made as the goods to which the intercompany profits relate are sold outside the group. Such amounts must be included as ordinary income.

Rules are also set forth for the recovery of this initial inventory amount under which the taxpayer may recover the full amount and need not wait for its recovery until separate returns are reverted to at some far-off time in the future. To understand the provisions governing recovery during the consolidated return year period, it will first be necessary to define still another new term, "unrecovered inventory amount."

The term "unrecovered inventory amount" for any consolidated year means the lesser of 1) the intercompany profit amount for such year; or 2) the initial inventory amount. To the extent that the "unrecovered inventory amount" of a corporation for a consolidated return year is less than such amount for its immediately preceding year, such decrease will be treated for such year by such corporation as an ordinary loss. To the extent that the unrecovered inventory amount for a consolidated return year exceeds such amount for the preceding year, such increase will be treated as ordinary income. In effect, then, the restoration process will occur only if the selling member's level of intercompany profits falls below the initial intercompany profit level. If, thereafter, the level should increase, the income will be increased accordingly.

To illustrate:

The last separate return year of the group was 1965. At the close of 1965 S's inventory included goods sold to it by P at a $100 profit. S sells these goods to an outsider in 1966. At the close of 1966, S's inventory included items on which P made a profit of $40. For 1966, P would increase its income by $100 (the initial inventory amount). However, since the unrecovered inventory amount for 1966 is only $40, $60 may be claimed as an ordinary loss. If, at the close of 1967, S's inventory included items on which P made a profit of $200, P would have to restore the $60 in income.

Finally, for the first separate return year of a member following a consolidated return year, the unrecovered inventory amount for such consolidated return year (minus any part of the initial inventory amount which was not added to income previously) will be treated as an ordinary loss. Getting back to our example, then, if P and S file separate returns in 1968, S could claim $100 as an ordinary loss.

A special transitional rule[27] applies to members of an affiliated group which joined in a consolidated return for 1965 and were previously required to adjust their inventories under the old rules. If, for taxable year 1966, they join in a consolidated return, then each such member who previously was required to reduce its inventory may now adjust it in the same manner as it would have been adjusted under the old regulations if separate returns were being filed in 1966.

It is interesting to note that in writing the new regulations on inventory adjustments, no provision is made for losses arising from intercompany transactions, as there had been under the old rules. If read literally, the opening inventory adjustment is only required where there exist intercompany profits on inventory items at the close of the last separate return year. In determining the initial inventory amount, will a member who has had several transactions with other members of the group be allowed to net intercompany losses with gains?

It is possible to mitigate the effect of the initial inventory adjustment by keeping intercompany transactions in inventory down to a minimum in the last separate return year. This can be done by having the selling member postpone sales to the buying member and/or having him sell directly to third parties. In addition, buying members of the affiliated group should also try to reduce the number of such items in inventory by concentrating on sales of same to third parties.

Methods of Accounting

Under the old regulations,[28] the general rule was set forth that all members of the affiliated group had to adopt the same accounting method; i.e., one member of the group could not report on the cash method while another reported on the accrual method. (Under certain limited circumstances, the Commissioner could grant permission for the use of different accounting methods.) The new rules now require that the method of accounting to be used by each member be determined as though such member filed a separate return.[29]

To illustrate, assume A and B affiliated corporations filed separately for calendar year 1965. During 1965, A was on the accrual and B on the cash method of accounting. A and B file a consolidated return for 1966. For 1966 and years thereafter, both corporations must continue to compute income under their respective methods of accounting (unless a change in method under I.R.C. S. 446 is made).

There were two basic reasons for the change in the rules. For one, the old provisions created a loophole whereby a corporation which could not obtain permission to change its method of accounting could effectuate such change by filing a consolidated return, 2) and perhaps the stronger motivation for change, was the desire to remove a major obstacle to the filing of consolidated returns by granting affiliated corporations greater leeway in selecting accounting methods. In addition, case law had held that any change in accounting methods occasioned by the consolidated return regulations was voluntary, thereby denying the corporation the benefits of Section 481 of the Code. (This section, in general, permits a taxpayer certain pre-1954 adjustments to offset any initial additional income occasioned by the change.)

The new regulations implicitly afford a corporation, which previously was required to change its method of accounting to conform to the old regulations, an opportunity to request a change back to its former, or to a more preferable, method. What strings the Commissioner will attach to the granting of approval remains to be seen.

Election to Discontinue Filing Consolidated Returns

The new regulations have sharply restricted the ability of an affiliated group to switch from consolidated to separate returns. Previously, there were two circumstances under which such a group was automatically free to change to separate returns: 1) if a corporation (other than a corporation created or organized, directly or indirectly, by a member of the group) became a member of the group during the taxable year, or 2) if there was a change in law or regulations making substantially less advantageous to affiliated groups as a *class* the continued filing of consolidated returns, regardless of the effective date of such amendment.[30]

Under the new provisions,[31] the consent of the Commissioner will have to be obtained in all cases, upon a showing of good cause, before any shift from consolidated to separate returns can be effectuated. Ordinarily, the Commissioner will grant a specific group permission to discontinue filing consolidated returns if the net result of all amendments to the tax law effective dates commencing within the taxable year has a substantial adverse effect on the consolidated tax liability og the *group* for such year. Other factors specifically listed in the regulations which the Commissioner is to take into account in arriving at good cause determinations include:

1) changes in law or circumstances, including changes which do not affect Federal income tax liability;

2) changes in law which are first effective in the taxable year and which result in a substantial reduction in the consolidated net-operating loss (or consolidated unused investment credit) for such year relative to what the aggregate net-operating losses (or investment credits) would be if the members of the group filed separate returns for such year; and

3) changes in the Code or regulations which are effective prior to the taxable year but which first have a substantial adverse effect on the filing of a consolidated return relative to the filing of separate returns by members of the group in such year.

In addition to the above the Commissioner is also given authority to grant blanket permission to all groups or to a class of groups to discontinue filing consolidated returns if any provision of the Code or regulations has been amended, and such amendment is of a type which could have a substantial adverse effect on the filing of consolidated returns by substantially all such groups, relative to the filing of separate returns.

It is interesting to note that the unrestricted right of a group to file consolidated returns, because of the acquisition of a new corporation, not only is omitted from the new regulations, but such an occurrence is not even specifically listed as a factor which the Commissioner will consider in determining whether good cause exists. Also dead and buried is another method, sometimes used to effect an automatic deconsolidation under the old regulations, that of causing the affiliated group to disappear through a downstream merger of the parent-corporation into one of the subsidiaries. The new rules now specifically provide that the group will be considered as remaining in existence, notwithstanding the fact that the common parent is no longer in existence, if the members of the affiliated group succeed to and become the owners of substantially all of the assets of the former parent and there remains one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation and which was a member of the group prior to the date the former parent ceased to exist. Similarly, the common parent will remain the common parent irrespective of a mere change in identity, form, or place of organization.

There is some opinion that the new regulations may in practice prove more generous to taxpayers wishing to deconsolidate.[32] Under the old rules, it was fairly uncommon for a group to get permission from the Commissioner to deconsolidate. Now, as this vein of thought points out, the specific factors which are set forth in the regulations delineating areas in which the Commissioner will give favorable consideration cannot help but limit his previous absolute authority.

However, notwithstanding the above expression of optimism, it is clear that the difficulties and uncertainties which the above rules may present to any group wishing to deconsolidate should make corporations think long and hard before filing a consolidated return. Until there is some administrative history to go on, any decision will be made against a background of uncharted and potentially perilous seas. In this connection, corporations should also pay special attention to I.R.C. S. 1562(c)(3) and S. 1562(d) which provide that if a group which has elected multiple surtax exemptions files a consolidated return (thereby automatically terminating the election), such group is prohibited from re-electing multiple surtax exemptions (even if separate returns are subsequently filed) until the sixth year after the year of determination.

Estimated Tax Payments

Until now, consolidated groups had a choice of filing either consolidated or separate estimates for a taxable year.[33] In this way, even if an affiliated group intended to file a consolidated return, each separate member could still avail itself of a $100,000 credit by the filing of separate declarations of estimated tax.

Now the rules[34] have been significantly tightened. Thus, if a group files a consolidated return for two consecutive taxable years, it will be *required* to file its declaration of estimated tax on a consolidated basis for each subsequent taxable year, until such time as separate returns are properly filed. If a group is not required to file a consolidated declaration of estimated tax, separate estimates should be executed.

These provisions may best be illustrated by the following example:

Corporations P and S file a consolidated return for the first time for calendar year 1966. They also file consolidated returns for 1967 and 1968. For 1966 and 1967, separate declarations of estimated tax must be filed, and separate $100,000 exemptions taken. For 1968, however, the group must compute its estimated tax on a consolidated basis, and is limited to one $100,000 exemption. Assuming permission to file separate returns is obtained for 1969, the declaration for 1969 would still have to be made on a consolidated basis, since separate returns would not be properly filed until 1970.

New 1122 Rules

Under previous rules,[35] each subsidiary had to file form 1122 annually, signifying its consent to the consolidated return regulations and authorizing the common parent corporation to make a consolidated return on its behalf for the taxable year. Such form was required even in cases where the subsidiary left the affiliated group during the taxable year.

The new regulations[36] liberalize this by requiring form 1122 to be filed only for the first consolidated return year; none are now needed for subsequent years. And, even if a member of the group fails to file the form, consent may be given by the Commissioner under all the facts and circumstances. The following circumstances, among others, will be taken into account in making this determination:

(1) Whether or not the income and deductions of the member were included in the consolidated return;

(2) Whether or not a separate return was filed by the member for that taxable year, and

(3) Whether or not the member was included in the affiliations schedule, Form 851.

In addition to the above, even if a member corporation has failed expressly or impliedly to file form 1122, if the Commissioner is satisfied that such failure was due to a mistake of law or fact, or to inadvertence, such member will be treated as if it had filed the form for such year, and thus joined in the making of the consolidated return.

In Conclusion

After delving into the many substantive and administrative changes resulting from the revision of the regulations, one may wonder just where the new rules clarify or simplify their predecessors. If they were implicitly intended to encourage multi-corporate groups to file consolidated returns, their effect may be just the opposite. One thing is certain; no longer may the decision to consolidate or deconsolidate be relegated to the mere pushing of a pencil to determine mathematically the dollar savings each alternative affords. Inherent in each corporate set-up may be some minor factor which will turn the balance.

For example, a decision to consolidate so that profitable members of a group may benefit from a loss member may not result in a benefit at all after consideration is given to a possible initial inventory adjustment, loss of multiple surtax exemptions, possible loss of foreign tax and investment credits, deferral of loss on intercompany transactions, and the effect of the recapture of excess losses of a subsidiary. Further complications may arise where minority shareholders of less than wholly-owned subsidiaries may seek just recompense for the tax benefit bestowed upon the profitable parent. Under such circumstances, the additional possibilities of effecting a formal merger or other form of combination should not be overlooked.

Perhaps the best advice the author can give to someone faced with a problem in the consolidated return area is to look before you leap. It is important to keep in mind that many of the avowed advantages to filing a consolidated return contained in one section of the regulations may be counterbalanced by other provisions which may negate the sought-after benefit. Not only must the tax advisor become acquainted with the many provisions of the new regulations but he must also be able to tie in many other areas of the Internal Revenue Code. Finally, due consideration must be paid to non-tax consequences. All in all, this is one area where an experienced and imaginative tax man will find it necessary to draw upon all his resources in arriving at the best possible tax plan for a client.

(Part two of this article will appear in the June 1967 issue of the Quarterly.)

1. Regs. Section 1.1502-13.
2. Note that under Regs. Sec. 1.1502-13(b)(2) the reporting of income and the deduction must be synchronized.
3. 41 T.C. 616 (1964). The Service has acquiesced in the Beck case for tax years ending before 1965 (T.I.R. 764, September 28, 1965). Note also Regs. Section 1.1502-13 (h), example (17).
4. Regs. Sec. 1.1502-13(c)(4).
5. Regs. Sec. 1.1502-13(c)(3).
6. Regs. Sec. 1.1502-4(o); Old Regs. Sec. 1.1502-43(g).
7. Regs. Sec. 1.1502-21(c); Old Regs. Sec. 1.1502-31 (38)(b)(3).
8. Rev. Rul. 60-289 (CB 1960-2, 268); Proposed Regs. 1.1502-25.
9. Regs. Sec. 1.1502-13(c)(2).
10. ibid, subsection (e)(1).
11. Regs. Sec. 1.1502-31(b)(3).
12. Regs. Sec. 1.1502-21.
13. Regs. Sec. 1.1502-1 (f)(2).
14. Sec. 1562 (d) of I.R.C.
15. Sec. 1562(e) of I.R.C. It should be noted that the point of time as to which the three year period commences is the December 31 for the year the termination is to be made.
16. Regs. Sec. 1.1502-21(c).

16A. *T. J. Foster*, TC Memo 1966-273.

17. Regs. Sec. 1.1502-21(c).
18. This was accomplished by having the loss parent corporation remain in existence as the common parent but with the shareholders of the profit corporation assuming control of the parent.
19. Regs. Sec. 1.1502-1(g) and 1.1502-21(d).
20. Regs. Sec. 1.1502-21(d)(2). (See also Regs. Sec. 1.1502-22(d); Regs. Sec. 1.1502-4(g); Regs. Sec. 1-1502-3(e)).
21. Regs. Sec. 1.1502-15.
22. Old Regs. Sec. 1.1502-31(b)(9).
23. Regs. Sec. 1.1502-15(a)(2).
24. Old Regs. Sec. 1.1502-39(b).
25. Old Regs. Sec. 1.1502-39(c).
26. Regs. Sec. 1.1502-18.
27. Regs. Sec. 1.1502-18(f).
28. Old Regs. Sec. 1.1502-44.
29. Regs. Sec. 1.1502-17.
30. Old Regs. Sec. 1.1502-11(a).
31. Regs. Sec. 1.1502-75(c).
32. See Consolidated Returns: A Panel Discussion, 24th Annual N.Y.U. Institute of Federal Taxation, page 14-66.
33. Old Regs. Sec. 1.1502-10(c).
34. Regs. Sec. 1.1502-5.
35. Old Regs. Sec. 1.1502-12(b).
36. Regs. Sec. 1.1502-75(b).