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# The Consolidated Return

By J. Weldon Jones

## Introduction

If an accountant should turn historian, he might be tempted to label some of his chapters or volumes "Reconciliations between economic phenomena and legal concepts." In such a chapter, we should doubtless find a discussion of the consolidated return, for the root of the controversy around the consolidated return has its beginnings in the fact that economic phenomena have outrun the legal concepts and legislative pronouncements having to do with the phenomena. The phenomena have been nothing more or less than the consolidation or merger movements. It touches the present question when the consolidation is effected by means of the holding company, with some exceptions.

From an economic standpoint, it seems undisputed that these consolidations of corporations into an affiliated group in fact make one economic unit. They have been so treated in the philosophy underlying the anti-trust legislation. The accountant has long recognized that a true picture of the group could not be shown by presenting balance-sheets and profit-and-loss statements of the several corporations making up the affiliated group. Hence the accountant has resorted to consolidated statements. In many cases, banks and high financial officers have required such statements. It should be kept in mind that such statements are not taken from the books or ledgers of any one corporate entity, but are the product of the auditor's work-sheets. In his efforts to show the financial position of the affiliated group as it faces the business and economic world he has been forced to the use of the consolidated statement. He has had his own problems in developing a theory and a technique for the consolidation of the financial statements—but that for the most part is another story.

It is common knowledge that the law looks upon each corporation as a separate entity. As has been suggested, the law abandons such a view in philosophy, perhaps, in dealing with monopolies and restraint of trade, but such cases seem to be the exception. Certainly the law does not give any legal sanction to the concept of business enterprise which is behind the consolidated balance-sheet. It seems equally certain that the law will be called upon to express its opinion upon this interesting and important question.

Otis J. Tall, of the bureau of internal revenue, predicts that the question will be placed before the United States supreme court.

The opposing groups can muster arguments and logic to their respective causes. It is contended that the economic theory is strengthened by the fact that the parent corporation makes out the return and pays the tax for the group; hence the group becomes the taxpayer. But the other side sees in this action merely one of agency on the part of the parent corporation. The courts have given ammunition to each group. Under date of April 7, 1930, the United States circuit court of appeals for the second circuit, in the case of *Sweets Company of America, Inc.* vs. *Commissioner*, commenting on the decision of the court of claims in the case of *Swift and Company* vs. *United States* said:

> "We concur with the court of claims in the view that the several members of the affiliated group remain the taxpayers and that the statutory provisions for a consolidated return declare merely a method of computing the taxes of the corporate members of the group. A change in the group does not create a new taxpayer nor change the taxable year of those members whose affiliation continues. It does however affect the computation of the consolidated net income of the group."

In the *Gould Coupler* case (5 B. T. A. 499) the board of tax appeals held that the entire capital stock of the affiliation should be considered in finding a base for computing the 25 per cent. limitation on intangible assets which might be considered invested capital. It seems safe to say that the board of tax appeals has been a consistent defender of the economic view, with some exceptions. On the other hand the commissioner has from the beginning leaned to the legal view.

So the stage is set for the play. If we give some of the advantages which accrue to the affiliated groups using the consolidated return, perhaps we shall be ready to sketch the drama, which after fifteen years continues to furnish scenes and acts in legislative halls and court rooms. "And the end is not yet." The play goes on. The chief advantages to be considered in determining whether or not to file consolidated returns have been briefly summarized as follows:

(1) The offsetting of operating losses of one member of the group against the taxable profit of another member.
(2) The consummation of intercompany transactions without the recognition of taxable gain.
(3) The avoidance of tax on intercompany dissolutions, especially where the dissolution is a step in a statutory reorganization.

(4) The administrative advantage of the parent company's acting as agent for the group for all tax purposes.

The above advantages are potent ones. We shall see something of the struggle to achieve them. One can only guess the cost which has been incurred in the contest.

## History

Since the revenue act of 1917 did not clearly provide for consolidated returns, it may be said that the principles of the consolidated return originated with the commissioner of internal revenue in 1917. Treasury decision No. 2662, approved March 6, 1918, provided that affiliated corporations should file consolidated returns in accordance with articles 77 and 78 of regulations 41. These recur in articles on the consolidated return. It is of interest to note that treasury decision No. 2662 provided, among other things, that to be affiliated the corporations must be engaged in the same or closely related business. It was required that "substantially all" of the stock be owned by the same corporation, person or partnership. Treasury decision No. 3389 interpreted "substantially all" to be 95 per cent., a figure that continues to the present day, although some discussion has advocated a change in the percentage. In these early regulations, it was provided that the excess profits taxes be computed on the consolidated basis and that the affiliated corporations should file individual returns in the office of the collector of the respective districts.

The principles of the consolidated return first received statutory recognition in the revenue act of 1918. Congress stated that the return was for the purpose of preventing tax evasion and affording an equitable method of taxation for affiliated corporations. The 1918 act in section 240 (b) also provided for the different classes of consolidations, around which much discussion has arisen. The section referred to reads as follows:

> "For the purposes of this section, two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests. . . ."

Early the department of internal revenue attempted to read the word "legal" into the above section so as to make the provisions read "legal control." The solicitor of internal revenue said that it meant "legal control." It may be noted that the accountant in preparing his consolidated statements has been influenced by

the concept of "legal control" to a large extent. The conditions of (1) above came to be called class A consolidations, and the conditions of (2) above came to be known as class B consolidations. Doubtless it was inevitable that a storm of discussion should gather around the meaning of "substantially all" and "the same interests." At least, such has been the history of the consolidated return legislation and its problems.

The most important change in the consolidated return in the 1921 act was the fact that the return was no longer mandatory. After January 1, 1922, the filing of a consolidated return was optional. This option has continued to the present time, although the 1932 act puts a penalty in the way of a higher rate of taxation if the consolidated return is selected. In view of the broad powers which were later to be given the commissioner in reference to consolidated returns, it is interesting to note that the 1921 act gave legal effect to treasury decision No. 2662, inasmuch as there was considerable doubt as to the legal effect of treasury decision No. 2662. This gave legal status to the commissioner's interpretation that "substantially all" meant 95 per cent. or more of the stock of the subsidiary company.

As mentioned elsewhere, the legal theory versus the economic theory shows outcroppings throughout the entire history of the consolidated return. It may be seen in the interesting basis of assessment which was incorporated in the 1921 act. Section 240 (b) follows:

"In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as shall be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income assignable to each. There shall be allowed in computing the income tax only one specific credit computed as provided in subdivision (b) of section 236."

The legal entity of each corporation is here recognized in the basis of the assessment. Doubtless it is pushing logic and justice too far to wonder if a strict regard for the "legal theory" would not have allowed the affiliated corporations to have compounded the specific exemptions to which they might have been entitled.

In reading regulations 62, which related to the act of 1921, one may feel that on a number of points the consolidated return got off to a good start and that subsequent history might have been different if these early tendencies had been followed and developed.

Article 631 of regulations 62 begins as follows:

> "Consolidated returns are based on the principle of levying the tax according to the true net income and invested capital of a single enterprise, even though the business is operated through more than one corporation. Where one corporation owns or controls the capital stock of another corporation or other corporations, or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and the net income of the branch form a part of the invested capital and the net income of the entire organization."

Perhaps it was too much to hope that this view would prevail in dealing with all the problems of the consolidated return. However, good authority in both the tax and accounting fields would like to see this "branch" concept extended in toto to the consolidated return. The commissioner has felt that to do so would contravene certain other parts of the revenue act.

Another indication of a good start may be found in the following quotation taken from article 633 (b) of regulations 62:

> "The words 'substantially all the stock' can not be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95% or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required for any taxable year beginning prior to January 1, 1922, even though the stock ownership is less than 95%. When the stock ownership is less than 95% but in excess of 70%, a full disclosure of the affiliation should be made, showing all pertinent facts, including the stock owned or controlled in each subsidiary or affiliated corporation and the percentage of such stock owned or controlled to the total stock outstanding."

The 1924 act gave more consideration to the consolidated return than did the 1921 act. Definitions were clarified by the language of section 240 (c):

> "For the purpose of this section, two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns at least 95 per centum of the voting stock of the other or others, or (2) if at least 95 per centum of the voting stock of two or more corporations is owned by the same interests. A corporation organized under the China trade act, 1922, shall not be deemed to be affiliated with any other corporation within the meaning of this section."

The term "voting stock" here appears for the first time. This term has been continued in the subsequent acts. Corporations organized under the China trade act have been made exempt from the workings of the income-tax laws in several instances. The 1924 act continued to allow an option to the taxpayer in the filing of a consolidated return.

The 1926 act made no substantial changes in the 1924 act. However, the growth of mergers and consolidations during this

period brought the consolidated-return problem to the fore. Case after case was taken to the courts. If we may believe articles current at the time, it seems safe to say that the commissioner, the board of tax appeals and the courts had conflicts and reversals in their own decisions and were at variance with each other. One can believe that the form passed for the substance in many cases and on the other hand that the astuteness of accountants and lawyers found loophole after loophole allowing avoidance of tax. It was inevitable that the consolidated return should be in the fore of discussion when the time came for the enactment of the 1928 act. Let us glance at some of the discussions current in 1928 concerning the consolidated return. This study will indicate some of the collateral problems while continuing the historical sequence.

### Collateral Problems and the Revenue Act of 1928

Although the 1928 act did not make any substantial changes in the wording of the statute regarding consolidated returns, several interesting features characterize the act, and with the advent of regulations 75, material changes in the law have taken place. In the statute proper two items deserve attention. In section 142 (f) the following language appears:

> "If a notice under section 272 (a) in respect of a deficiency for the taxable year 1928 is mailed to a corporation, the suspension of the running of the statute of limitations, provided in section 277, shall apply in the case of corporations with which such corporation made a consolidated return for such taxable year."

The same thought appears in simpler language in section 141 (i) of the 1932 act. It is believed that this section was written into the law because of a decision of the board of tax appeals in the *Cincinnati Mining Company Case*, 8 B. T. A. 79, September 16, 1927. This decision held that the statute of limitations could be invoked by affiliated corporations which had not received an individual notice of the deficiency that had been assessed against the group. The case is interesting, for it might be argued that the board here leaned to the "legalistic theory" (contrary to some of its other decisions). The section is indicative of the way in which laws are made.

It is interesting to recall some of the discussions concerning the consolidated return which were going on as the time to consider the 1928 act approached. I shall do that, and then turn to the unusual feature of the 1928 act which in effect told the commis-

sioner to write out the technical details that should govern the filing of consolidated returns.

Previous to the enactment of the revenue act of 1928, the National Tax Association appointed a committee on the simplification of the income tax. From the reports of this committee and in the discussions of the annual meetings of the association, one finds a record that throws much light on the problems surrounding the consolidated return. It seems well to indicate some of the collateral problems of the subject while following the more or less chronological order.

The following opinion of the committee mentioned above is interesting:

"It is generally believed that the requirement of section 240 that 95% of the stock shall be owned is too strict. In many instances of genuine consolidation, the actual ownership is less than 95%. This committee recommends consideration of a more flexible rule, a lower percentage of ownership, combined with actual inter-company relations which require consideration in arriving at true net income. The present high percentage of ownership required by the statute renders the administrative officers powerless to consider cases other than those in which the ownership is practically complete. The present law excludes from the test of ownership 'all non-voting stock which is limited and preferred as to dividends.' The position of preferred stockholders whether having voting powers or not is in some respects analogous to that of creditors in the distribution of profits; their share is not primarily affected by the amount of taxes paid; their interest in consolidation is very slight, if any. Furthermore, the right of preferred stock to vote is often a limited and exceptional one, so that it is 'non-voting' in some years and 'voting' in others. On the whole, we believe that a step towards simplification lies in the elimination of the word 'non-voting' in section 240 (d), the effect of which would be to exclude all preferred stocks from consideration in determining affiliation."

It may be noted that neither of the above recommendations has been incorporated in the revenue acts of 1928 or 1932. As I suggest elsewhere, the accounting problems concerning minority interests would become more complicated if the percentage for affiliation were lowered. If no arbitrary percentage were set, the cases involving individual consideration would be numerous. Perhaps it is well, in the absence of better technique for determining economic units that the arbitrary percentage has been set high, even if it is much higher than accountants require to justify the use of consolidated financial statements. As to the second recommendation, the committee has a potent position. However, the wording "non-voting stock limited and preferred as to dividends" has been adjudicated by the courts and a very strict literal interpretation prevails. I presume that a hesitancy to change the status quo may have something to do with the failure of legislation to make changes in this wording. At the

annual meeting of the National Tax Association for 1928, George E. Holmes read a report of the committee on simplification of the income tax, setting forth the extent to which the recommendations of the committee has been embodied in the 1928 act. Mr. Holmes discussed fully and clearly a number of the more important changes in the law relating to the consolidated return. The changes were both important and novel and deserve some attention.

It should be noted that at the time the revenue bill of 1928 was being discussed, the confusion about the consolidated return was so great that the house bill actually abolished the consolidated return as the easiest way out of the difficulty. A certain amount of the confusion may have grown out of the attempts of the board of tax appeals to apply the "economic concept" of branches to consolidations and the commissioner's procedure, in many cases, to apply the legal theory of the separate entity of each corporation. In addition to the problems which I have presented more or less indirectly, the confusion over the profits and losses arising from the sale of the subsidiary's stock was great. Trouble arose here from many causes as the records of litigation show. In some cases the courts and the commissioner attempted to hold to the rule that the profit or the loss was the difference between the cost price and the sale price. It is easy to see that in the case of the subsidiary's stock, the cost basis might be materially affected by the losses and gains which had been sustained by the subsidiary and also by the dividends which had been received by the parent company during the affiliation. Again, the waters were troubled by the fact that the department has ruled for a number of years that a corporation could not make a taxable gain or a deductible loss in transactions involving its own stock. Now, from one point of view, the stock of the subsidiary might well be the same as the company's own stock. In fact, the board held in the *Crocker* case that the sales of subsidiary stock did not involve taxable gains or deductible losses. In *Remington-Rand, Inc.* vs. *Commissioner* the court reversed the board and applied the original treatment followed by the treasury, i.e., profit and loss arise from the difference between cost and sale price. It has been said that the commissioner was forced in one case to tax gains arising from sale of subsidiary's stock and to disallow losses. As a matter of fact, tax avoidance was possible under almost any interpretation which the courts or the depart-

ment might make. That is, the ingenuity of accountants and lawyers could by perfunctory form arrangements avoid taxation in many cases. It is interesting to note that Ralph C. Jones, of Yale, feels that much trouble could have been avoided if the technique of accountants had been closely followed in the rulings on these moot points. Cases that involved a statutory reorganization were sometimes affected. This in turn brings up the problem of the transfer of assets, which may well be called another dark continent of income taxation.

The most unusual (some call it novel) feature of the 1928 act applying to the consolidated return is to be found in section 141 (b). The wording of this section follows:

> "Regulations—The commissioner, with the approval of the secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making an affiliated return and of each corporation in the group, both during and after period of affiliation, may be determined, computed, assessed, collected and adjusted in such a manner as clearly to reflect the income and to prevent avoidance of tax liability."

This lengthy sentence has been hailed as a step forward in the proper technique for handling many of our technical problems. Some people feel that congress would do well to delegate almost or even full legislative powers to technical administrative officers in those cases where the intricacies of the problem are almost beyond solution in large political legislative bodies.

As a result of the mandate just quoted, the commissioner assembled experts, held open meetings to receive taxpayers' suggestions, and then worked almost four months behind closed doors. The result was regulations 75. This matter begins on page 357 of regulations 74 and extends to page 380.

This attempt to produce legislation more or less en masse induced generally favorable reaction by those concerned. The hopes of some men that litigation would cease were too sanguine. Litigation still goes on, but the legality of the commissioner's regulations 75 has apparently received court sanction. Some of the writers have drawn an analogy between this delegation of legislative power and the delegating of legislative power to the president to regulate duties under the tariff act of 1922. However, this is more of a matter of law than of tax. Yet, it is significant that the problems involved in the consolidated return should have been pressing enough to have caused congress to make the innovation that was made when section 141 (b) of the 1928 revenue act was written.

Section 141 (d) of the 1928 act abolished class B affiliations after the year 1928. It seems well that this change was made. It eradicated a needless source of litigation on the question of the interpretation of the phrase "by the same interests." Of course, those who would like to see an extension of the economic concept are inclined to feel that ground has been lost here. It must be admitted that where ownership is substantially with the same interests, the potential if not the actual conditions of an affiliation exist—the corporations so situated are likely to be "branches."

The following language in reference to the consolidated return from section 141 (a) of 1928 was new and evoked a lively discussion at the time.

> "The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under sub-section (b) prescribed prior to the making of such return; and the making of a consolidated return shall be considered as such consent."

Many corporations began to wonder if the advantages were worth the cost involved. They felt that they were required to consent to the constitutionality of regulations 75 without the chance of making a judicial presentation of the issue. As it later developed, article 12 (b) of regulations 75 required form 1122 to be executed by every corporation filing a consolidated return. The form provides among other things that the affiliates "consent to and agree to be bound by the provisions of treasury regulations 75."

In regulations 75, articles 33 and 34, the commissioner attempted to settle the knotty problem of gains and losses arising from sales of the subsidiary's stocks. The regulations are complicated, but the result seems to be somewhat of a compromise, with a leaning toward the legal-entity theory. Apparently the cost basis to be used in determining the gain or loss is to be adjusted for certain losses which may have been sustained by the parent company, but no provision is to be made for the gains accruing to the subsidiary. As Professor Jones remarks, the basis may go down from cost but may never rise above cost. Again the amount of the loss which may be applied in the adjustment is limited to that which has been deducted on a consolidated return but could not have been deducted if an individual return had been filed. Professor Jones raises the question as to what would have been the amount of the statutory loss if the corporations had not been affiliated. He concludes that congress will do well to adopt

the accountant's technique, for determining gains or losses in the case of sales of subsidiary stock, and underwrites completely the economic view in consolidated returns, i.e., that the various affiliated corporations are in effect branches.

The act of 1932 follows the act of 1928 in delegating to the commissioner the duty of prescribing the proper regulations for the filing of consolidated returns. Section 141 (e) of the act makes certain exceptions in the case of insurance companies which are taxed under other special sections. By far the most important feature of the 1932 act as it relates to the consolidated return lies in section 141 (c):

"Regulations 75 shall apply in case new regulations are not prescribed prior to the making of the consolidated return; except that for the taxable years 1932 and 1933 there shall be added to the rate of tax prescribed by sections 13 (a), 201 (b), and 204 (a), a rate of ¾ of one per centum."

The original house bill increased the tax on a consolidated return 1½ per cent. over the rate of 13½ per cent. originally levied on ordinary corporations. The "penalty" assessed in these measures brought sharp criticism from no less a person than the secretary of the treasury. Some excerpts from messages of the secretary, as reported in the *New York Times* during April, 1932, are of interest, since they disclose some of the latent issues and forces behind the consolidated return. On April 7, 1932, the secretary said:

"The higher tax on consolidated returns is one of those provisions the cumulative effect of which is very great. They tend to converge the full weight of each of them on capital actively employed in business and to discourage the normal flow of capital into industry and commerce at a time when business men are hesitant and industry is stagnant. In my judgment, they tend to retard business recovery."

One may construe this to mean that the secretary feels that the flow of capital into combinations and affiliated groups such as have the option of filing a consolidated return should not be discouraged, but perhaps the secretary did not have this question in mind.

Again, in the same message, the secretary writes:

"The bill provides that consolidated returns may be made by corporations having subsidiaries, but that, for the right to make such returns, the corporations shall pay a price of 1½% more of their net incomes than would be required as tax in the case of a corporation filing a separate return. I can conceive of no sound argument for putting a price upon the right to file a particular kind of income-tax return.

"The provisions for consolidations should be retained in the law, like other parts of the law which represent sound business practices and are designed to permit recognition of such practice in the computation of taxable income. . . . Any departure from the use of that basis (1928 act) in the law would be a back-

ward step. The novel idea of putting a price upon the use of sound accounting methods by affiliated corporations should be eliminated from the bill.

"The statement of this committee (i.e. senate finance) on the subject of the consolidated return in reporting the revenue bill of 1928 was in part as follows:

"'Your committee has considered the matter very carefully and is convinced that the elimination of the consolidated return provision will not produce any increase in revenue, will not impose any greater tax on corporations and will in all probability permit of tax avoidance to such an extent as to decrease revenues.'"

It is difficult to follow the senate finance committee in the statement quoted. Has not the consolidated return been an option since the 1921 act? Suffice it to say that logic has not always been present in the controversies about the consolidated return.

The committee on legislation of The American Institute of Accountants filed a brief with the finance committee of the senate relative to the revenue act of 1932. The brief has some pertinent observations on the consolidated return. The committee of accountants feel that the increase in the rate of tax on the consolidated return is tantamount to precluding the return entirely in most cases. How keenly the accountants feel that ground has been lost here may be evidenced by the following paragraph from the brief:

"Consolidated federal income-tax provisions have been in effect for 15 years. Great difficulty, confusion and uncertainty will result if they are now to be practically discontinued because of an excess tax imposed for their use. . . . One point is certain, and that is that none of the difficulties regarding consolidated returns which may exist in the future will compare with the difficulties which would result from trying now to unscramble the affairs of corporations which for years have been making their consolidated returns."

Again the accountant should be heard. None know better than he of the real but unknown costs which law, taxation and accounting have poured into the salient known as the consolidated return.

## Recent Decisions

I have touched at various times in this paper on the collateral problems of the consolidated return. It seems well to show the present status of some of these moot problems as they have been set forth by the commissioner, the board of tax appeals and the various courts in late decisions.

In the matter of gain or loss in disposition of the subsidiary's stock, regulations 75 have materially altered the somewhat harsh ruling of the commissioner prior to 1928. In short, prior to 1928, the board and the commissioner had both held that the liquidation of a subsidiary into a parent company involved neither taxable

gain nor deductible loss. This appears sound, since the liquidation would certainly be an inter-company transaction. But where the stock of the subsidiary was sold to an outsider, the board and the commissioner parted company. Certainly, there is a transaction here with the outside world at arm's length, and the bureau of internal revenue has seemingly had the better of the argument in holding that profit or loss is realized by such transactions. The board held in the *Crocker* case that there was no profit or loss realized. The United States supreme court refused certiorari on this case October 21, 1929 (*U. S. Supreme Court Dockets* 377 and 378). The trouble arose from the methods adopted by the bureau in determining the gain or loss. Apparently the bureau failed to see that more ingredients than cost and sale-price enter into the determining of profit and loss on the sale of subsidiary corporations' capital stock. It failed to see how easily the sale of the stock can be supplanted by the sale of the assets or vice versa—two actions having the same effect but achieved by quite different methods.

Affiliated corporations and the net-loss provisions have been fruitful of many controversies. The problem is elusive, especially as it applies to the application of a net loss sustained before affiliation and the final application of a net loss sustained during affiliation but carried beyond severance of affiliation. The *Walton Tax Service* feels that the commissioner has been more equitable since regulations 75 were issued. Prior to 1928, it seems safe to say that the commissioner and the board and the courts have been largely at loggerheads. The commissioner, basing his argument largely on the *Swift & Co.* case, prior to 1928 held that for purposes of deducting statutory losses the entity of the individual corporations became paramount. The court of claims made the decision in the *Swift & Co.* case. The board and the circuit court of appeals felt that statutory losses might be carried along by the affiliated group as a unit. Since 1929, *Walton Tax Service* feels that the commissioner has leaned toward the board's view.

Under the revenue act of 1921, G. C. M. 3266, vii–16–3684, it was held that:

"A net loss sustained by a subsidiary for a taxable year prior to affiliation can not be applied against the net income of the affiliated group for subsequent years in an amount greater than the portion of the consolidated net income directly attributable to the subsidiary."

One is forced to accept this at first glance as an equitable ruling for the government and the taxpayer. However, it has not

taken into consideration that after affiliation the matter of income or loss that may be attributed to the individual subsidiary is more or less arbitrary in many cases. Inter-company transactions are susceptible to considerable "window dressing." The ruling seems to invite such shifting of income as may be advantageous to the affiliated group.

It appears that the question of indirect control versus direct control as a condition for affiliated corporations under the revenue acts came up early to plague the department. Here the commissioner seemed to favor the legalistic concept, at the beginning, with a tendency to change in later years. For example, in G. C. M. 2780, vii–15–3674, it was held that "there is no authority for considering the so-called 'indirect' ownership of stock under the consolidated return provisions of the revenue act of 1924." This position was stated in the first half of 1928. I was interested to find that in G. C. M. 8982, x–5–4920, rendered in the first half of 1931, the general counsel stated that "in the cases before the courts the bureau has advanced beneficial ownership as the fundamental test of whether affiliation should or should not be granted. In other words, if the stock ownership, either direct or indirect, is such that the ultimate burden of the tax would fall upon the same persons, regardless of whether the corporations filed consolidated return or separate returns, affiliation should be conceded. . . . Clearly the foregoing position of the bureau before the courts is inconsistent with the above quoted language from G. C. M. 2780. . . ."

The general counsel went on in the memorandum to render the opinion that affiliated status belonged to corporations where the ownership was indirect. The particular case was that A owned all the stock of company X and 35 per cent. of the stock of company Y, but company X held 60 per cent. of the stock of company Y also. Apparently such developments should encourage those who feel that the economic concept should be given more recognition in solving the problems which arise in this troublesome field of income taxation.

However, the United States circuit court of appeals for the second circuit, court decision 339, x–21–5076, on January 5, 1931, upheld the board of tax appeals (17 B. T. A. 980) in a more complicated case of indirect ownership and held that the conditions for affiliated status under the revenue act of 1918 did not prevail.

Doubtless one of the chief reasons why the government has held to 95 per cent. as a condition meeting the requirements of affiliated groups is that if less than that is considered, the matter of minority interests becomes significant. In theory, and doubtless in law, the minority interests are entitled to their profit that may be reflected in inter-company transactions. Doubtless the accounting technique could rise to the occasion, but the waters would be muddier than they are.

Another example of the difficulty of interpreting the phrase "the same interest," as it was used until the 1928 act, may be seen in the following findings of the United States circuit court of appeals for the second circuit on December 7, 1931. The court in this case reversed the board of tax appeals.

"Where the S corporation owning 70% of the capital stock of the K corporation, holds an option to purchase 25% of the shares of the latter corporation owned by W, which provides that if the S corporation should elect to exercise its option, then W should have the right for 30 days thereafter to purchase from the S corporation all its shares of the K corporation—the S corporation does not own or control within meaning of section 240 (c) of the revenue act of 1921, W's 25% of the stock of the K corporation so as to authorize an affiliation of the two corporations under that clause."

On May 16, 1932, Justice Cardozo wrote two or more decisions on the deductibility of losses in cases involving affiliated corporations. In the *Woolford Realty Company* vs. *J. T. Rose, Collector*, the court held:

"A net loss, as defined by section 206 of the revenue act of 1926, sustained in 1925 and 1926 by a corporation without an affiliated status in those years, which, without the application of any part of the net loss of either year, had no net income in 1927 when it was affiliated with another corporation within the meaning of section 240 of that act, may not be deducted in determining the consolidated net income of the corporations for the latter year."

In the *Planters Cotton Oil Company* vs. *George C. Hopkins, Collector*, the court held to this theory although applied to a quite different set of facts. The court held as follows:

"A net loss as defined under section 206 of the revenue act of 1926, sustained by a corporation in a year when it is unaffiliated, may not be deducted under that section in a subsequent year, in which it is affiliated with another corporation, and in which without the application of the net loss it has no net income, in determining the consolidated net income of the corporations for the subsequent year, even though one person is the owner in the first year of substantially all the stock of the corporation sustaining the net loss and the owner in the subsequent year of substantially all the stock of the two corporations."

The internal revenue bulletin for July 11, 1932, carries a transcript of the *Athol Manfacturing Company* vs. *Commissioner*

case as heard by the United States circuit court of appeals for the first circuit, which decided, among other issues, the following:

"Where a new corporation acquires the business and the assets of an old corporation, a net loss sustained by the old corporation may not be deducted under section 206 of the revenue act of 1924 in computing the net income of the new corporation."

One is led to believe that the courts have practically put a stop to the carrying forward of statutory net losses when a change takes place in the corporate form. From the economic point of view such rulings may seem unjust in many cases. However, it can hardly be doubted that tax avoidance has been effected by abuses of the carrying forward of losses into an affiliation that has large profits to offset. To bar the carrying forward of the losses, the courts have been forced to take, in general, the legalistic view of the separate entity of the corporations, i.e., that after a merger or consolidation there came into existence a new taxpayer entirely. And, as has been suggested, perhaps the knowledge of the abuses which have grown up together with the necessity of the times with regard to taxes have had indirect influence on the rulings. At least it is interesting to note in the *Woolford Realty Company* case, the learned and liberal justice observes: "Expediency may tip the scales when arguments are nicely balanced."

## Conclusion

So the controversy about the consolidated return goes on. It goes on because the real problem is one of economic phenomena in relation to taxation. The consolidated return is not the problem but the attempted solution to the problem of taxing income of consolidations and affiliations. It is the same problem that brought consolidated financial statements into accounting technique. To abolish the consolidated return will not solve the problems, as has been pointed out by Professor Jones. Some of us may believe with him that the success of the "consolidated return will depend ultimately upon the extension of the techniques of the consolidated balance-sheet to the consolidated return."

Undoubtedly, three factors are largely to blame for the present confusion:

(a) The tremendous growth of consolidations and affiliations in the last decade.

(b) The changes that were effected in the laws in regulations 75, now aggravated by the 1932 rates.

(c) The complex pattern of the problem which has been a fertile field for the use of technicalities by all parties involved.

While it is true that regulations 75 are liberalizing and progressive, yet the very fact that the laws suffered a change at a crucial stage, i.e., when consolidations were being effected in almost every conceivable way, apparently has added to the litigation.

No doubt, the commissioner's regulations under the revenue act of 1932 will again take a forward step in clearing up the confusion. The assessment of higher rates on the consolidated return may lead many affiliations back to individual returns. (This may be done by obtaining the permission of the commissioner.) To an accountant this would seem a backward step. The manipulations which are possible are many and devious. Transactions within a group do not have the test of "arm's length." Income and losses may be shifted to the advantage of the affiliation. Perhaps convenience and other advantages of the consolidated return, mentioned at the beginning of this paper, will be sufficient to cause the continuance of its use. One can imagine what will go on in accounting offices as the options are discussed. That may give accountants and lawyers work; it may sharpen wits—but what of the canons of simplicity in tax laws? Can the consolidated return be made simpler? Perhaps, but not simple. Little of that quality remains in life.