A PRIMER ON THE FINANCIAL ACCOUNTING
FEDERAL INCOME TAX RULES FOR
CONSOLIDATION

by

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Abstract

This research is an examination of generally accepted accounting principles (GAAP) and tax law for reporting a common but complex set of business transactions known collectively as consolidation transactions. Consolidation transactions and their effects on a business are reported to the general public through published financial statements which must be prepared in accordance with GAAP. In addition, these same transactions are also reported to the federal government on the firm's income tax return according to the rules established by tax regulations. While there are definite similarities in these two sets of "rules", there are also significant differences.

The prevailing model, for both accounting and tax purposes, for dealing with a group of related entities is generally to view the group as a single entity rather than as a group of individual corporations that retain their separate identity. Despite this overall similarity, many of the specific rules and required procedures differ. The purpose of this article is to present a comparison of the accounting and tax rules currently in effect, as well as proposals under current consideration, pertaining to the consolidation of related entities. The resulting comparison will be useful to those on both the GAAP and tax sides of the transactions.

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I. Introduction

The world today is full of complexity, and the rules governing the consolidation of entities for financial accounting and tax purposes provide no shelter from this ever evolving paradigm. Since the explosion of the use of the corporate form following the passage of the Sherman Act in 1890, accounting and tax rulemakers have struggled to keep pace with creative accountants and attorneys to ensure that the presentation of the financial statements or the calculation of the tax liability of a group of commonly owned corporations (and in some cases, nonincorporated entities) is appropriate.

With growing acceptance, the prevailing accounting and tax model for dealing with a group of related entities is to generally view the group as a single entity with divisions, and not as a group of individual corporations that retain their separate identity. The purpose of this article is to present a comparison of the accounting and tax rules currently in effect, as well as proposals under current consideration, pertaining to the consolidation of related entities. While many other topics for discussion may be found within this general area, the authors have attempted to address some of the more significant transactions and accounting processes that compare and contrast these two unique disciplines.¹

II. Financial Accounting

A. In General

Consolidated financial statements embody the notion that, from a financial perspective, a group of companies, which are connected through common ownership should be viewed as a single entity with divisions. Stated another way, a holistic view of related entities would dictate that it is important to see the forest, and not just the trees.

The specific procedures to be followed in preparing consolidated financial statements depend on the circumstances of the combination. If the acquiring company is the only

¹ One of the most frustrating tasks encountered in completing this article was the difficulty experienced by the authors in attempting to find a common accounting and tax lexicon of terms. For example, we have generally used the term “basis” to refer to both “net book value” and “tax basis” with respect to the amount that an asset is carried on the financial or tax records of an entity. In addition, commonly understood acronyms, such as an “ELA”, shorthand for an “excess loss account” in tax circles, can most easily be described as “negative basis” with respect to stock of a consolidated subsidiary.
surviving legal entity, the primary accounting task is simply to record the initial acquisition of a target’s net assets on the acquiring company’s books. Once the initial acquisition is recorded, the combination is complete, and the “consolidation” occurs automatically. No unique accounting issues should subsequently arise. However, when both companies survive and continue to operate their respective businesses, the accounting procedures are more complex because the assets and liabilities of the subsidiary are not recorded on the separate financial statements of the parent, but remain on the subsidiary’s own financial statements. Instead, the parent simply records the investment in the common stock of the subsidiary as a long-term investment on its separate financial statements. Subsequently, the parent generally accounts for this investment using the equity method.

The preparation of consolidated financial statements consists of combining the separate accounting records of the parent and its subsidiaries and eliminating the effects of all intercompany transactions, including the parent’s investment in the stock of each subsidiary. The resulting financial statements thus represent the individual legal entities as if they were one economic unit. The combination of the separate sets of accounting records and the associated adjustments and eliminations generally take place on a worksheet or in supplemental records, not in the formal accounting system of either the parent or the subsidiaries. Thus, the consolidation process effectively creates a super “consolidated entity” which exists for reporting purposes only. Because the consolidation takes place outside the formal accounting system, the adjustments made in one year must generally be repeated during each subsequent year’s consolidation process.

Note that the requirement that consolidated financial statements be used as the primary reporting vehicle does not preclude the presentation of separate subsidiary financial statements as supplementary financial information. Indeed, minority shareholders of a subsidiary may find such statements to be more useful than the consolidated statements of the entire group.
B. Entities Included in Consolidated Financial Statements

Prevailing accounting theory has long recognized that when one corporation (the parent company) obtains control over another corporation (a subsidiary) in a business combination, the legal entities have become one economic unit. Therefore, under generally accepted accounting principles (GAAP), consolidated financial statements, rather than separate company financial statements, must be presented when one company controls another.²

The purpose of consolidated financial statements is to present the results of operations and the financial position of a parent company and its subsidiaries as if the group were a single company with one or more divisions.³ Thus, consolidated financial statements are, inter alia, intended to prevent the omission of unprofitable subsidiaries, which depress the group’s overall financial picture.

Consolidated financial statements are generally required for the parent company and for all majority-owned subsidiaries.⁴

² However, separate financial statements are also permitted. Separate statements are generally presented for a subsidiary if the presentation of financial information concerning the particular activities of the subsidiary would be more informative to shareholders or creditors of the parent company or the subsidiary. Accounting Research Bulletin No. 51, Consolidated Financial Statements (August 1959) (“ARB 51”), at ¶ 3.

Note that the current tax rules permit the federal income tax return of an affiliated group to be prepared on a separate or consolidated basis at the option of the taxpayer. See section 1501 and Reg. §1.1502-75(a)(1). However, once consolidated filing is elected, the affiliated group must continue to file on a consolidated basis until permission to discontinue consolidated filing is obtained from the Service, or the affiliated group is terminated. See Reg. §1.1502-75(a)(2) and (d). However, separate financial statements are also permitted. Separate statements are generally presented for a subsidiary if the presentation of financial information concerning the particular activities of the subsidiary would be more informative to shareholders or creditors of the parent company or the subsidiary. Accounting Research Bulletin No. 51, Consolidated Financial Statements (August 1959) (“ARB 51”), at ¶ 3.

³ ARB 51, ¶ 1.

1. **Types of entities included.** Generally, the operations of all majority-owned entities must be included in the group’s consolidated financial statements. This includes corporations, both foreign and domestic, partnerships, trusts, other unincorporated entities, as well as nonhomogeneous operations, such as banks and insurance companies.6

2. **The More-Than-50-Percent Stock Ownership Test.** ARB 51, ¶ 1 requires consolidated financial statements when one of the companies in the group directly or indirectly has a “controlling financial interest” in the other companies. A controlling financial interest generally consists of ownership by one company, directly or indirectly, of over 50 percent of the outstanding voting shares of another company.7 Both common and preferred stock which possesses the right to vote must be taken into account in determining whether the more-than-50 percent threshold is met. SFAS 94, ¶ 13 permits two exceptions to the general consolidation rule for majority-owned subsidiaries. Consolidation is not required (1) if control is likely to be temporary; or (2) if control does not rest with the majority owner (for example, if the subsidiary is in legal reorganization or in bankruptcy.)8

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5 ARB 51, ¶ 2 permitted the exclusion of majority-owned foreign subsidiaries. This exclusion appears to have encompassed both subsidiaries incorporated under the laws of a foreign country with foreign operations, as well as subsidiaries incorporated in the United States with foreign operations. SFAS 94, ¶ 13 amended ARB 51 to only permit exclusion from the group’s consolidated financial statements those subsidiaries which operate under foreign exchange restrictions, controls or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent’s ability to control the subsidiary.

6 SFAS 94 ¶ 13 and Proposed Statement of Financial Accounting Standards, Consolidated Financial Statements: Policy and Procedures (October 1995) (the “Consolidated Exposure Draft”), at ¶ 1. See also Accounting Principles Board Opinion No. 16, Business Combinations (August 1970) (“APB 16”), at ¶ 5, which provides that the accounting rules for business combinations (generally a prelude to consolidated financial statements) apply equally to combinations of corporations and one or more unincorporated businesses. Previously, ARB 51, ¶ 3 permitted certain nonhomogenous operations to be excluded from the group’s consolidated financial statements. Subsidiaries most commonly excluded from consolidation under this exception were finance, insurance, real estate and leasing subsidiaries of manufacturing and merchandising enterprises. See SFAS 94, ¶ 6. The exclusion for nonhomogeneous operations was repealed because the exclusion resulted in the omission of significant amounts of assets, liabilities, revenues and expenses from the consolidated statements of many enterprises. Further, the omission of large amounts of liabilities, particularly with respect to finance subsidiaries, has promoted the notion of “off-balance-sheet financing.” See SFAS 94, ¶ 7.

7 ARB 51, ¶ 2. This rule is also adopted and restated in SFAS 94, ¶ 13. Presumably, the “voting” power referred to in SFAS 94, ¶ 13, refers to the right to participate in the election of the board of directors. (cf. Rev. Rul. 69-126, 1969-1 C.B. 218, which defines a similar standard for tax purposes.

8 ARB 51, ¶ 2 also provided similar exceptions. See the previous discussion regarding a further exception for certain foreign subsidiaries.
Example 1: P, a domestic corporation, owns all of the stock of S, a domestic corporation, and F, a foreign corporation. F owns all of the stock of T, a domestic corporation, and a 60 percent capital and profit interest in the UV partnership. P’s consolidated financial statements must include the operations of P, S, F, T and the UV partnership. Note that T must be included in P’s consolidated financial statements even though its stock is owned by F, a foreign corporation.
3. **Combined Financial Statements.** Consolidated financial statements are premised upon one corporation (the parent company), directly or indirectly holding a controlling financial interest in the other included subsidiary companies. In certain cases, however, combined financial statements (as distinguished from *consolidated* statements) of commonly controlled companies may provide more meaningful information than separate statements.⁹

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⁹ Combined statements could also be used to present the financial position of a group of unconsolidated subsidiaries, or companies under common management.
Example 2: Mr. A owns all of the stock of B and S. B and S are each engaged in manufacturing widgets and regularly engage in intercompany transactions with each other. Combined financial statements should be prepared which contain the operations of both B and S.

The accounting rules for combined financial statements will be discussed below.

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\(^{10}\) ARB 51, ¶ 22-23. The Consolidated Exposure Draft at ¶ 34-35, would continue the use of combined financial statements.
C. Initial Basis in the Stock and Assets of a Subsidiary

GAAP provides special rules to account for the formation or acquisition of a subsidiary. Principally, these rules are described under the broad heading of “Business Combinations.” Since a “one size fits all” rule will produce a suboptimal result in most cases, different regimes have evolved over the years to tailor the proper accounting to the form used to effect the acquisition of a subsidiary.

In its simplest form, a business combination concerns the fusion (i.e. mergers) of one legal entity into another. Since only one entity continues thereafter, consolidated financial statements are not necessary, and specific adjustments may be made to the carrying value of the assets on the acquiring corporation’s books. In more complex situations, multiple entities may be used to effect the acquisition, and as a result, special accounting rules must be employed.

Two mutually exclusive methods are generally used in accounting for business combinations: (1) the pooling of interests method (the “pooling method”), and (2) the purchase method.\(^{11}\)

1. **The pooling method.** The pooling method treats a business combination as the uniting of the ownership interests of two or more companies through the exchange of stock. Under this method, no acquisition is generally recognized for accounting purposes, the ownership interests continue, and the former bases of accounting are retained. For example, the assets and liabilities of the acquiring company and the target are carried forward at their pre-acquisition recorded amounts. The reported income of the acquiring company and the target is combined for the year of acquisition, as well as for prior periods.\(^{12}\)

Twelve specific criteria must be met before the pooling method may be applied to a business combination. (These criteria are discussed in Appendix A and were developed in an attempt to limit the application of the pooling method to those business combinations which represent a complete fusion of two independent companies formed through the exchange of voting common stock.\(^{13}\) Indeed, perhaps the most significant criteria requires that substantially all (90 percent or more) of the voting common stock of one company (the issuing company) be exchanged for either all of the net assets or at least 90 percent or more of the voting common stock of another company.\(^{14}\) If stock is acquired through the transfer of cash or other assets, the pooling method may not be used.

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\(^{11}\) These methods are prescribed by APB 16.

\(^{12}\) APB 16, ¶ 12.

\(^{13}\) APB 16, ¶ 45-48.

\(^{14}\) APB 16, ¶ 47.b.
If a business combination does not meet all twelve requirements of the pooling method, the purchase method must be used.\textsuperscript{15}

2. **The purchase method.** The purchase method accounts for a business combination as the acquisition of one company by another. If the acquiring company directly acquires the target's assets, the target's assets less any liabilities assumed are recorded on the acquiring company's books at cost.\textsuperscript{16} The excess of the amount paid by the acquiring company, in excess of the fair market value of the tangible and identifiable intangible assets less liabilities assumed, is recorded as goodwill.\textsuperscript{17} The reported income of the acquiring company includes the post-acquisition operations of the target.

If the target remains a separate legal entity after the acquisition, no adjustments are made to the assets and liabilities on the target's separate accounting records. Rather, the above adjustments are only made at the consolidated level when consolidated financial statements are prepared.

The purchase method is used to account for all acquisitions that do not qualify for the pooling method. Thus, cash, stock of the acquiring company or other securities may be used to effect the acquisition.\textsuperscript{18} The purchase method, however, does not apply to acquisitions and exchanges of companies under common control.\textsuperscript{19}

\textsuperscript{15} APB 16, ¶ 8. Further, a single method must be used for the entire combination. A part-pooling, part-purchase approach is not permitted. ARB 16, ¶ 43.

\textsuperscript{16} APB 16, ¶ 11.

\textsuperscript{17} If the fair value of the net assets exceeds the amount paid by the acquiring company, the excess amount is used to reduce the carrying amount of all noncurrent, nonmonetary assets acquired, and any remaining excess is recorded as a deferred credit. APB 16, ¶ 87.

\textsuperscript{18} APB 16, ¶ 8.

\textsuperscript{19} APB 16, ¶ 5. For this purpose, common control is defined by reference to ARB 51, ¶ 2 (generally a direct or indirect ownership of 50 percent or more of the outstanding voting shares of an entity.)
3. **Formation of a subsidiary.** As discussed above, the purchase method does not apply to acquisitions and exchanges of companies under common control.\(^{20}\) If a subsidiary ("S") is formed by the parent company, the basis of the stock of S in the hands of the transferor should be equal to the basis of the assets transferred, less any liabilities assumed by S or to which the transferred assets are subject. S’s basis in the assets received should generally be equal to the transferor’s basis in the assets transferred to \(S.\)\(^{21}\)

**Example 1:** P forms S by transferring $100 in cash and a machine with a net book value of $40 and fair market value of $100 to S in exchange for S common stock.

P’s basis in the S stock is $140, and S has a basis of $140 in its assets.

4. **Acquisition of subsidiary’s stock.** If the acquiring corporation ("P") acquires the stock of a target ("S") from an unrelated party, the acquisition will be treated as a business combination and be reported under the pooling method or the purchase method (but not both) as discussed above.\(^{22}\) P’s basis in the S stock will be equal to the book value of S’s assets less recorded liabilities (i.e. S’s equity on a book value basis) under the pooling method or equal to the amount paid by P under the purchase method. The basis of S’s assets will not be adjusted on S’s separate company books under either method of business combination. However, consolidated adjustments will be made to reflect the amount paid by P to acquire S’s stock in the group’s consolidated financial statements if the transaction is accounted for under the purchase method.

5. **Acquisition of subsidiary’s assets.** If P (or a subsidiary of P) acquires the assets of S, (an unrelated company), the form of the transaction will dictate the P group’s basis in such assets. As stated previously, the basis of S’s assets will not be adjusted if the acquisition qualifies under the pooling method. If the purchase method must be used, the basis of the assets will be adjusted to equal the amount paid by the acquiring company.

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\(^{20}\) APB 16, ¶ 5.

\(^{21}\) AICPA Accounting Interpretation No. 39, *Transfers and Exchanges Between Companies Under Common Control* (March 1973) ("Interpretation 39") states that the "assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting." See also Emerging Issues Task Force ("EITF") Summary No. 90-5, "Exchanges of Ownership Interests Between Entities Under Common Control," (March 8, 1990) and EITF Summary No. 90-13, "Accounting for Simultaneous Common Control Mergers," (June 22, 1990).

\(^{22}\) APB 16.
D. Intercompany Transactions and Distributions

The three basic types of intercompany transactions which require adjustment for consolidation are intercompany asset transfers, intercompany debt and intercompany distributions. In each of these cases, the objective of consolidation is to present financial statements for the group as a whole, as if the group were a single business enterprise.

Intercompany balances and transactions are generally eliminated in the preparation of consolidated financial statements. Thus, intercompany profit or loss on assets remaining with the group are eliminated.

1. Intercompany asset transfers. Intercompany transfers of both depreciable and nondepreciable assets are common transactions. In either case, the goal of consolidation is to report the transferred asset on the consolidated financial statements at historical cost (cost to the member which originally acquired it), and to defer income recognition until the asset is sold to an entity outside the consolidated group or is consumed by the group.

One of the most common types of intercompany asset transfers is the transfer of inventory. When one member of the group sells inventory to another, each member records the sale (purchase) on its separate financial statements. One member records revenue (and the related expense, Cost of Goods Sold) and the other records the purchase of the asset. However, viewing the group as a single entity, no transaction has actually occurred, and no profit should be recorded until the inventory is either consumed or ultimately sold outside the group. The consolidation process eliminates the recorded gross profit and adjusts the inventory balance back to original cost on the consolidated financial statements. This will ensure that the deferred gross profit will ultimately be recognized when the inventory is sold outside the group. The elimination should occur only for that portion of inventory which is still on hand at year end. Profit on inventory which has since been either consumed or sold to an unrelated party should correctly be included in consolidated income.

Another common intercompany asset transfer is the intercompany sale of land. As with inventory transfers, any gain or loss should be recognized for consolidation purposes only when or if the land is ultimately transferred out of the group. If the land is held indefinitely, the gain or loss will be deferred indefinitely as well, and the land must remain on the consolidated balance sheet at its historical cost.

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23 ARB 51, ¶ 6. This elimination rule applies to intercompany open account balances, security holdings, sales and purchases, interests, dividends, etc.
The consolidation objectives for the transfer of depreciable assets are the same as for transfers of nondepreciable assets: (1) report historical cost balances, and (2) achieve appropriate income recognition in the consolidated financial statements. Any gain or loss on these transfers is initially deferred. Gain will be recognized as depreciation is taken on the transferred asset. When the transfer occurs, the purchaser records the asset at its fair market value (which includes the deferred gain) and therefore, subsequently depreciates this stepped up amount (assuming the asset was appreciated at the time of the sale). During the consolidation process, the excess depreciation expense recorded by the purchaser offsets the gain recorded by the seller. Over the life of the asset, the depreciation process eliminates all effects of the asset transfer from the consolidated asset and retained earnings balances.24

Example: P owns all of the stock of S. P sells equipment to S for $20,000. P originally paid $10,000 for the equipment. At the time of the sale, the equipment has a book value of $8,000 and a remaining useful life of 8 years. P will record a gain of $12,000, and S will record the equipment at $20,000 and will claim annual depreciation expense of $2,500. If P had not sold the equipment to S, P would have recorded annual depreciation of $1,000. Thus, from a consolidated perspective, depreciation is overstated by $1,500, and gain is overstated by $12,000. This excess depreciation expense recorded by S offsets the gain recorded by P when the two sets of financial statements are consolidated. After the appropriate eliminations and adjustments are made, the consolidated financial statements will reflect the equipment at $7,000 (P’s year-end book value had no sale occurred), will not reflect the gain, and will report only $1,000 of depreciation expense. In other words, the consolidated financial statements will not reflect any effects of the intercompany sale of equipment.

24 These rules are very similar to the tax intercompany transaction rules under Reg. §1.1502-13, discussed infra.
2. **Obligations of members.** In the case of direct loans between members of the group, consolidation procedures are relatively straightforward. In order to account for the group as if it were a single economic entity, the reciprocal receivable and payable balances are eliminated as are any balances related to accrued interest. A more complex intercompany debt scenario occurs when one member purchases the other member’s debt from an outside third party. In this situation, the debt remains on the issuer’s books as a liability and on the purchaser’s books as an investment. In addition, cash interest payments are made between members of the group. However, from a consolidated perspective, the debt has been retired. Because the price paid to purchase the debt will invariably be different than the book value of the debt, the difference represents a gain or loss on the retirement of debt to the consolidated entity. This gain or loss must be recognized immediately as an extraordinary item in consolidated net income.\(^{25}\) In addition, all intercompany balances such as the investment account, liability account, premium or discount accounts and interest accruals must also be eliminated.

3. **Intercompany distributions.** Intercompany dividends are eliminated from the consolidated financial statements.\(^{26}\) With respect to the distributing member, gain or loss will generally be recognized upon a distribution of property, other than cash, as if the property were sold at its fair market value. Such gain or loss is deferred and taken into account under the rules discussed above for intercompany asset transfers.


\(^{26}\) ARB 51, ¶ 6.
II. Federal Income Tax

A. In General

1. History of the consolidated return regulations. The concept of a consolidated return dates back as far as 1917, when regulations compelled affiliated corporations to file on a consolidated basis in calculating the World War I excess profits tax. These first rules were an attempt by the Service to prevent taxpayers from lowering their excess profits tax rate through the use of multiple corporations. Because each corporation was eligible for its own set of graduated tax rate brackets, the government perceived that an undue advantage existed for multiple corporations over a single entity with divisions.

Beginning in 1918, consolidated returns were required by statute.\(^{27}\) Consolidated filing was extended to include the income tax as well as the excess profits tax.

Taxpayers and the consolidated return regulations coexisted in relative tranquillity thereafter until the 1960s. Following a significant defeat for the government in *Henry C. Beck Builders, Inc.*,\(^ {28}\) a completely new consolidated return system was adopted for taxable years beginning after 1965. The chief components of this new regime, principally the deferred accounting system for intercompany transactions and the stock basis adjustment system, continue even today.

Significant changes have recently been made to the rules to keep pace with the Congressional appetite for enacting new tax legislation. Many of these new provisions are discussed below.

\(^{27}\) Revenue Act of 1918, §240(a). The legislative history of this provision gives an insight into Congressional thinking as to how related corporations should be taxed:

As far as its immediate effect is concerned, consolidation increases the tax in some cases and reduces it in other cases, but its general and permanent effect is to prevent evasion which cannot be successfully blocked in any other way.

While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operated to prevent evasion of taxes or because of its effect upon the revenue, but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the government. See S. Rep. No. 617, 65th Cong., 3d Sess. 8-9 (1918).

\(^{28}\) 41 T.C. 616 (1964). The taxpayer in this case took advantage of the rules then in effect, which in combination permitted the basis of a subsidiary’s assets to be stepped up to fair market value with no negative tax consequences.
2. **Consolidated vs. separate returns.** Every corporation subject to taxation is required to file a federal income tax return, regardless of income level. Members of an affiliated group as defined under section 1504 may elect to file federal income tax returns on a separate or consolidated basis. Once an affiliated group has elected to file consolidated federal income tax returns, the group must continue to file on a consolidated basis until the group terminates, or until the group obtains permission from the Service to discontinue its consolidated return election.

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29 Section 6012(a)(2). Form 1120, U.S. Corporation Income Tax Return, is generally used for this purpose.

30 Section 1501 and Reg. §1.1502-75(a)(1). The election to file a consolidated return in lieu of separate filing is a privilege which is conditioned upon each corporation that has been a member of the affiliated group during any part of the taxable year consenting to the consolidated return regulations under section 1502. Form 1122, Authorization and Consent of Subsidiary Corporation to be Included in a Consolidated Income Tax Return, must be executed by each subsidiary to evidence such consent. Reg. §1.1502-75(h)(2). Consolidated filing is only permitted for federal income tax purposes. Payroll and excise taxes must be calculated and reported on a separate return basis. In addition, many states have not adopted the federal consolidated return system. See, e.g., *In the Matter of the Approval of Rapid-American Corporation*, No. 94A-0284, Lexis 97 STN 84-9 (Oct. 10, 1996).

31 Reg. §1.1502-75(a)(2) and 1.1502-75(d). The Service may grant permission to discontinue filing consolidated returns to a single affiliated group, a particular class of taxpayers, or all affiliated groups. See Rev. Proc. 95-39, 1995-2 C.B. 399 and Rev. Proc. 95-11, 1995-1 C.B. 505, in which blanket permission to discontinue consolidated filing was granted to all taxpayers as a result of the adoption of new consolidated return rules.
Considerable differences exist between the consolidated and separate return reporting systems. Some of the most significant differences are illustrated below:

<table>
<thead>
<tr>
<th>Item</th>
<th>Consolidated</th>
<th>Separate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercompany gains</td>
<td>Deferred</td>
<td>Reported currently</td>
</tr>
<tr>
<td>Intercompany dividends</td>
<td>Eliminated</td>
<td>80% or 100% dividend-received deductions</td>
</tr>
<tr>
<td>Adjustments to stock basis of subsidiaries</td>
<td>Increase for earnings; decrease for subsidiary’s losses and distributions to shareholders</td>
<td>Decrease for certain dividend distributions (if section 1059 applies) or for distributions in excess of earnings and profits</td>
</tr>
<tr>
<td>Ability to deduct loss on sale of subsidiary stock</td>
<td>Generally disallowed</td>
<td>Yes</td>
</tr>
<tr>
<td>Earnings and profits</td>
<td>Tier-up to higher-tier members even if not distributed</td>
<td>Only tier-up if actual distributions are made</td>
</tr>
<tr>
<td>Ability to offset income and losses of members</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

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32 Special rules are provided for intercompany losses. See Reg. §1.1502-13 for consolidated return filers and Reg. §1.267(f)-1 if the group files separate returns.

33 See Reg. §1.1502-20, the loss disallowance rules.
3. **Single and separate entity theories.** The consolidated return regulations principally embody two competing theories. Under the “single entity” theory, an affiliated group of corporations filing a consolidated return is treated as a single corporation.\(^{34}\) Alternatively, the “separate entity” theory would respect the identity of each entity within the consolidated return. Historically, the Service has tended to favor the separate entity approach in promulgating its regulations.\(^{35}\) Since the 1980s, however, new regulations have tended to drift toward the single entity theory.\(^{36}\)

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\(^{34}\) For an excellent discussion of these theories, see Dubroff and Broadbent, *Consolidated Returns: Evolving Single and Separate Entity Themes*, 72 Taxes 743 (Dec. 1994).

\(^{35}\) See, e.g., Reg. §1.1502-17 (each member elects its own method of accounting); Reg. §1.1502-21(c) (separate return limitation year (SRLY) rules have historically been applied on a member-by-member basis); and Reg. §1.1502-33 (each member has its own earnings and profits account).

\(^{36}\) See, e.g., Reg. §§1.1502-90T through -99T (section 382 applied on a consolidated basis); Reg. §1.1502-13 (members treated as divisions of a single corporation), and Reg. §1.1502-20 (loss disallowance rules).
B. Initial Basis in the Stock and Assets of a Subsidiary

The U.S. system of taxation provides a sophisticated set of rules that determine the tax basis of the stock of a subsidiary and the subsidiary’s tax basis in its assets. These amounts may vary greatly based on the form chosen to effect the acquisition. In addition, Congress has enacted statutes which permit taxpayers to elect particular tax consequences which do not necessarily follow the form of the acquisition which actually occurred.

1. **Formation of a subsidiary.** If a subsidiary is formed by a member of a consolidated group in a tax-free incorporation qualifying under section 351, the owning member’s (P’s) basis in the stock of the subsidiary (S) will generally be equal to the basis of the assets transferred to S, less any liabilities assumed by S or to which the transferred assets are subject.\(^{37}\) S’s basis in the assets received from P will generally be equal to P’s basis in the assets, increased by any gain recognized by P on the transfer.\(^{38}\)

Example 1: P forms S by transferring $100 in cash and a machine with a tax basis of $40 and fair market value of $100 to S in exchange for S common stock.

P’s basis in the S stock is $140, and S has a basis of $140 in its assets.

2. **Acquisition of subsidiary’s stock.** If P acquires the stock of S from an unrelated party in a taxable or tax-free transaction, S’s basis in its assets will generally not change as a result of the acquisition. P’s basis in the S stock will vary based on the manner in which the acquisition is effected. For example, P’s initial basis in the S stock will be equal to (1) fair market value,\(^{39}\) (2) the former S shareholders’ basis,\(^{40}\) or (3) S’s basis in its net assets.\(^{41}\) S’s tax attributes, such as its net operating loss carryovers, should continue to exist following the acquisition.\(^{42}\)

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\(^{37}\) Section 358(a)(1). If the transaction fails to qualify as tax-free under section 351, P’s initial basis in the S stock will be equal to the fair market value of the net assets transferred to S.

\(^{38}\) Section 362(a). If the transaction fails to qualify as tax-free under section 351, S’s initial basis in the transferred assets will be equal to the fair market value of such assets at the time of the transfer.

\(^{39}\) Section 1012, in the case of a taxable stock acquisition.

\(^{40}\) Section 362(b), in the case of a section 368(a)(1)(B) reorganization.

\(^{41}\) Reg. §§1.358-6(c) and 1.1502-30, in the case of a triangular reorganization described in section 368(a)(1)(A) and (a)(2)(E).

\(^{42}\) Such attributes may, however, be subject to limitation by the SRLY rules, sections 269, 382, 383, or 384.
3. **Acquisition of subsidiary’s assets.** If P (or a subsidiary of P) acquires the assets of S, the form of the transaction will dictate the P group’s basis in such assets. If the assets are acquired in a tax-free reorganization, the acquiring corporation’s basis in the assets will generally be equal to S’s basis before the acquisition, plus any gain recognized by S.\(^{43}\) In most cases, the acquiring corporation will inherit S’s tax attributes, such as its net operating loss carryovers.\(^{44}\)

4. **Elections under sections 338(g) or 338(h)(10).** In certain cases, the taxable acquisition of stock of a corporation from an unrelated party may be electively treated as a taxable acquisition of the corporation’s assets.\(^{45}\) These rules thus permit the basis of the assets of a target corporation to be stepped up to fair market value, thus generating future tax deductions in the form of depreciation and enhanced basis recovery, even though the acquisition was actually structured as a purchase of stock.

If section 338(g) is elected, the seller must recognize gain or loss (to the extent permitted under the Code) on the actual sale of stock. In addition, the target corporation must also recognize gain or loss on the deemed sale of its assets.\(^{46}\) Due to this double-tax scenario, an election under section 338(g) is generally made for domestic target corporations only if the target has sufficient unrestricted losses to offset the gain on the deemed sale of the target’s assets.

The ability to make a section 338(h)(10) election is more restrictive. A section 338(h)(10) election is only available if the target corporation is a subsidiary (and not the common parent) of a U.S. affiliated group (whether or not a consolidated federal income tax return is filed) or an S corporation.\(^{47}\)

\(^{43}\) Section 362(b). If the acquisition is structured as a tax-free triangular acquisition in which the assets are acquired by a subsidiary of P in exchange for P stock, P’s basis in the acquiring subsidiary is generally equal to the target corporation’s basis in its net assets. Reg. §§1.358-6(c) and 1.1502-30.

\(^{44}\) Section 381(a)(2) provides for the transfer of tax attributes to the acquiring corporation in the case of certain nondissolving reorganizations described in section 368(a)(1)(A), (C), (D), (F), and (G). Such attributes may be subject to limitation under the SRLY rules or sections 269, 382, 383, or 384.

\(^{45}\) Section 338(g) and 338(h)(10). To elect the provisions of section 338(g) or 338(h)(10), Form 8023-A must be filed by the 15th day of the month following the month in which the acquisition date occurs. Reg. §§1.338-1(d) and 1.338(h)(10)-1(d)(2).

\(^{46}\) The target corporation is treated as a newly formed entity in the hands of the acquiring corporation. As a result, the target’s tax attributes, such as its NOL carryovers, are extinguished if a section 338(g) election is made.

\(^{47}\) Reg. §1.338(h)(10)-1(a), (c).
Under Section 338(h)(10), the target corporation is treated as first, selling its assets in a taxable transaction and, then, distributing the sale proceeds in liquidation. Because the liquidation would generally qualify as tax-free to the former T shareholders, the target’s assets will be stepped up to fair market value in the hands of the P group at the cost of a single level of taxation.

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48 Reg. §1.338(h)(10)-1(e).
C. Entities Included in the Consolidated Return

An affiliated group may elect to file a consolidated return. An affiliated group consists of one or more chains of includible corporations connected through stock ownership with a common parent corporation which is also an includible corporation, provided that the common parent owns directly stock possessing at least 80 percent of the total voting power and 80 percent of the value (the 80 percent stock ownership test) of at least one of the other includible corporations. In addition, the affiliated group includes other includible corporations of which at least 80 percent of the total voting power and 80 percent of the value of such corporations is owned directly by one or more of the other includible corporations.

Because affiliation must be determined by direct ownership, the insertion of a nonincludible corporation between members of an affiliated group will exclude one or more members from the group.

Example 1: P owns all of the stock of S and T. P transfers 50 percent of the stock of T to partnership PX, in which P has a 40 percent capital and profits interest. Because the 80 percent stock ownership test is no longer met, T ceases to be a member of the affiliated group.

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49 An affiliated group which elects to file a consolidated return is known as a consolidated group. Reg. §1.1502-1(h).

50 Section 1504(a). The standard for affiliation is based on direct ownership of stock. To qualify as direct ownership the holders of the stock must possess beneficial ownership (i.e., the right which the owners have in the management, profits, and ultimate assets of the corporation). Rev. Rul. 69-591, 1969-2 C.B. 171. Possession of naked legal title, without more, is not sufficient to constitute beneficial ownership. See, e.g., Macon, Dublin and Savannah Railroad v. Commissioner, 40 B.T.A. 1266 (1939), acq. 1940-1 C.B. 3. Accordingly, no constructive ownership rules apply in making this determination. Cf. sections 267, 318, and 1563.

51 Section 1504(a)(3)(A) contains an anti-avoidance rule which prevents a corporation which ceases to be a member of a consolidated group from rejoining in the group's consolidated return for the 60-month period following the deconsolidation. The Service may waive this period if the purpose of the disaffiliation and reconsolidation was not to achieve favorable tax consequences. Section 1504(a)(3)(B) and Rev. Proc. 91-71, 1991-2 C.B. 900.

52 Affiliation for purposes of section 1504 is a mechanical standard. See TAM 9206005 (Oct. 24, 1991), in which the Service ruled that a transfer of 25 percent of the stock of a domestic subsidiary by the U.S. common parent to its foreign parent was sufficient to break affiliation, even though the transfer was to secure tax benefits. The Service treats a partnership as an entity for affiliation purposes. See, e.g., Rev. Rul. 75-19, 1975-1 C.B. 382, Rev. Rul. 83-156, 1983-2 C.B. 66, and PLR 9645015 (Aug. 9, 1996).
Includible corporations which are not commonly owned by an includible corporation will not constitute an affiliated group.

Example 2: F, a foreign corporation, owns all of the stock of D1 and D2 (two U.S. corporations). D1 and D2 do not compose an affiliated group.

If F contributes the stock of D2 to D1, an affiliated group consisting of D1 and D2 will now exist.

1. **Includible corporations.** Only an "includible corporation" may be a member of an affiliated group and, thus, join in the filing of a consolidated federal income tax return. An includible corporation is generally any domestic corporation, with certain statutory exceptions. The following entities are specifically excluded from the definition of an includible corporation:

   a. Corporations exempt from taxation under section 501;

   b. Life insurance companies subject to taxation under section 801;

   c. Foreign corporations;

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53 Section 1504(b). A "domestic" corporation means a corporation created or organized in the U.S. or under the laws of the U.S. or any state or the District of Columbia. Section 7701(a)(4) and (10). In PLR 9321039 (Feb. 24, 1993), the Service ruled that a corporation which had been incorporated in a foreign country and later domesticated in the U.S. was treated as an includible corporation. A corporation in bankruptcy remains an includible corporation. Rev. Rul. 63-104, 1963-1 C.B. 172.

54 Section 1504(b)(1). However, two or more organizations exempt from taxation under section 501 may file their own consolidated return provided that at least one of such organizations is described under section 501(c)(2) and the remaining entities derive income from the section 501(c)(2) organization. Section 1504(e).

55 Section 1504(b)(2). However, two or more life insurance companies may file their own consolidated return. Section 1504(c)(1). In addition, after 1980, life insurance companies subject to taxation under section 801 may elect to join in a consolidated return with nonlife includible corporations after a five-year ownership period has run. Section 1504(c)(2). Other insurance companies subject to taxation under section 831 (e.g., property and casualty insurance companies) are includible corporations and are not subject to section 1504(b)(2).

56 Section 1504(b)(3). Note that a corporation organized in the U.S. which only conducts business outside the U.S. is nevertheless treated as an includible corporation. A foreign sales corporation ("FSC") is, by definition, a foreign corporation and is not an includible corporation. Certain Canadian or Mexican corporations which are formed to comply with foreign law and certain foreign insurance companies may elect to be treated as includible corporations. Sections 1504(d) and 953(d).
d. Corporations doing business in Puerto Rico or in a possession of the U.S. which have elected under section 936;\textsuperscript{57}

e. Regulated investment companies and real estate investment trusts;\textsuperscript{58}

f. Domestic international sales corporations (DISCs);\textsuperscript{59}

g. S corporations;\textsuperscript{60} and

h. Taxable mortgage pools.\textsuperscript{61}

Other entities which are treated as domestic corporations for federal income tax purposes may also qualify as includible corporations.\textsuperscript{62}

2. The 80 percent stock ownership test. The 80 percent stock ownership test requires the ownership of stock which possesses at least 80 percent of the total voting power (the voting test) and has a value equal to at least 80 percent of the total value of the stock (the value test) of such corporation.\textsuperscript{63} Both common and preferred stock must be taken into account in determining whether the requisite 80 percent stock ownership threshold is met.\textsuperscript{64}

However, certain preferred stock ("plain vanilla" preferred stock) is not taken into account in determining whether the 80 percent stock ownership test is met. In determining affiliation, the term "stock" does not include stock which:

\textsuperscript{57} Section 1504(b)(4). Section 936 was generally repealed for taxable years beginning after 1995, subject to certain transition rules. Section 936(j). Corporations which lose their section 936 election should become includible corporations.

\textsuperscript{58} Section 1504(b)(6).

\textsuperscript{59} Section 1504(b)(7).

\textsuperscript{60} Section 1504(b)(8). Note that an S corporation may have C corporation subsidiaries, and the C corporations may constitute an affiliated group and file a consolidated return. An S corporation may also own S corporation subsidiaries (known as qualified subchapter S subsidiaries or QSSS). Section 1361(b)(3).

\textsuperscript{61} Section 7701(i)(1).

\textsuperscript{62} An association taxed as a corporation is an includible corporation. \textit{California Brewing Assn. v. Commissioner}, 5 B.T.A. 347 (1926), \textit{nonacq.} VII-1 C.B. 36. In addition, a limited liability company which elects to be taxed as a corporation is an includible corporation. See Reg. \$301.7701-2(a).

\textsuperscript{63} Section 1504(a)(2).

\textsuperscript{64} Rev. Rul. 69-126, 1969-1 C.B. 218.
a. is not entitled to vote;

b. is limited and preferred as to dividends and does not participate in corporate growth to any significant extent;

c. has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption premium); and

d. is not convertible into another class of stock.65

For purposes of the voting test, voting power generally means the right to participate in the election of the board of directors.66 However, in instances in which substantial restrictions are placed on the authority of the board of directors to exercise control over the corporation, the Service has ruled that other factors must be considered in determining whether the voting test is met.67

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65 Section 1504(a)(4).
67 See TAM 9452002 (Aug. 26, 1994).
The value test was enacted by the Tax Reform Act of 1984 over Congress’s concerns that affiliation could be achieved in form, even though less than 80 percent of a corporation’s actual equity was owned by members of the affiliated group. Section 1504 does not provide definitive guidance on how to determine whether the requisite 80 percent threshold has been met. However, the legislative history of the changes to section 1504 by the Tax Reform Act of 1984 suggests that the purpose of the value test is to determine whether there is an economic unity between a corporation and a subsidiary.68 In the absence of further guidance, the value test is necessarily based on the underlying facts and circumstances. With respect to rules that have been issued by the Service thus far, all shares of stock within a single class are treated as having the same value. Thus, control premiums and minority discounts within a single class are not taken into account.69

To further police the affiliation provisions, Congress granted the Service broad authority to issue regulations.70 The only set of regulations issued to date concerns the treatment of options, warrants, and similar instruments.

Under these rules, options and the like are treated as exercised if (1) the issuance or transfer of the option, in lieu of the underlying stock, will result in the elimination of a substantial amount of federal income tax liability, and (2) it is reasonably certain that the option will be exercised.71 The rules provide that the deemed exercise of options is only for purposes of the value test and not the voting test. Thus, these rules, if applicable, will tend to break, and not create, affiliation.

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68 See H. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 831 (1984) (amendment to prevent corporations from being included in the consolidated return even though the corresponding economics were owned by nonmembers).

69 Reg. §1.1504-4(b)(2)(iv). This rule, however, does not appear to apply with respect to multiple classes of stock, e.g., common and preferred.

70 Section 1504(a)(3).

71 Reg. §1.1504-4.
D. Intercompany Transactions and Distributions

In general, the consolidated return regulations applicable to taxable years beginning before 1966 provided that "unrealized profits and losses" in transactions between members of the group were to be eliminated.\textsuperscript{72} Gains and losses were required to be recognized, however, if the property was resold outside the group in the same taxable year. In an intercompany sale of property, the purchasing member took a carryover basis in the property.\textsuperscript{73} If, in a year subsequent to the year of the intercompany sale, the purchasing member sold the property at a gain outside the group, it recognized the entire gain, i.e., the gain that was eliminated in the intercompany transaction plus any gain attributable to the period during which the property was held by it.

This approach taken under the pre-1966 consolidated return regulations created a number of problems, such as: (1) gain on some intercompany transactions might escape tax, (2) the wrong member might recognize gain or loss at the wrong time, (3) there might be an improper characterization of gain or loss, and (4) there could be an incorrect reflection of earnings and profits of the individual members of the group.

As a result of these conceptual shortcomings, the consolidated return regulations were substantially revised.\textsuperscript{74} For taxable years beginning after 1965, gains or losses on intercompany transactions are no longer eliminated. Such gain or loss, once recognized, is generally deferred until one of a series of restoration or triggering events occurs.\textsuperscript{75}

However, by the 1980s this system, too, was in need of revision. After some tinkering by the Service to fix some targeted problems, a completely new system was adopted on

\textsuperscript{72} Former Reg. §1.1502-31A(b)(1)(i).

\textsuperscript{73} Former Reg. §1.1502-38A(b).

\textsuperscript{74} Former Reg. §1.1502-13.

\textsuperscript{75} T.D. 8597. The new regulations apply with respect to transactions occurring in years beginning on or after July 12, 1995. Reg. §1.1502-13(1)(1).

If a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of the new regulations applicable to transactions occurring in years beginning on or after July 12, 1995, and instead apply prior law, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, or elimination of any item (or tax liability). Reg. §1.1502-13(1)(2).

Taxpayers could have elected the early application of certain aspects of new Reg. §1.1502-13 with regard to the triggering of deferred gains with respect to stock where such gains were originally deferred before the effective date of the new regulations otherwise triggered on or after July 12, 1995. Reg. §1.1502-13(1)(3). Taxpayer's seeking an extension of this filing date should request permission under Reg. §301.9100-1.
July 12, 1995. The purpose of the intercompany transaction rules is to provide guidance to clearly reflect the taxable income and tax liability of a consolidated group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income or consolidated tax liability.

Two principal rules govern the treatment of intercompany transactions and their consequences within the consolidated group. Under the matching rule, the parties to an intercompany transaction are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. The acceleration rule provides additional guidelines for taking the items of an intercompany transaction into account if the effect of treating the consolidated members as divisions cannot be achieved. Each of these rules will be discussed in greater detail below.

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76 See former Reg. §1.1502-13(b) and (c).

77 Reg. §1.1502-13(a)(1). To accomplish this purpose, the amount and location of intercompany items are determined on a separate-entity basis. However, the timing, character, source, and other attributes of the intercompany items, although initially determined on a separate-entity basis, are redetermined under the regulations to produce the effect of transactions between divisions of a single corporation, rather than as separate entities in a consolidated group. Reg. §1.1502-13(a)(2).

78 An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. Reg. §1.1502-13(b)(1)(i). For purposes of illustration, S is the member transferring property or providing services, and B is the member receiving the property or services. Intercompany transactions include S’s sale of property or other transfers such as an exchange or contribution to B, whether or not gain or loss is recognized; S’s performance of services for B; and B’s payment or accrual of its expenditures for S’s performance. Other examples of intercompany transactions include S’s loan of money to B, B’s payment or accrual of its expenditures, and S’s distribution to B with respect to S stock.

Each party to an intercompany transaction can have items of income, gain, deduction, and loss from an intercompany transaction. S’s items are referred to as “intercompany items” and B’s items are referred to as “corresponding items.” Reg. §1.1502-13(b)(2) and (3). For example, S’s gain from the sale of property to B is an intercompany item. Alternately, if B pays rent to S, B’s deduction for the rent is a corresponding item. If B buys property from S and resells it to a nonmember, B’s gain or loss from the resale is also a corresponding item. Further, if B recovers the cost of the property purchased from S through depreciation, B’s depreciation deductions are corresponding items.

79 Reg. §1.1502-13(c).

80 Reg. §1.1502-13(d).
1. **The matching rule.** The matching rule provides that the attributes of S’s intercompany items and B’s corresponding items are predetermined to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation and the intercompany transaction were a transaction between divisions. Thus, the activities of both S and B affect the attributes of both intercompany items and corresponding items.\[^{81}\]

S takes its intercompany items into account to reflect the difference for the year between B’s related corresponding items taken into account and B’s related recomputed corresponding items.\[^{82}\] The recomputed corresponding items are those items which B would take into account for the year if S and B were divisions of a single corporation. For example, if S sells property with a $70 basis to B for $100 and B later resells the property to a nonmember for $90, B’s corresponding item taken into account is its $10 loss; B’s recomputed corresponding item is a $20 recomputed gain (the deemed $70 carryover basis from S subtracted from the $90 of proceeds from the nonmember) and the $30 difference is the amount of S’s intercompany gain that is taken into account for the year of the resale.

Example 1: On January 1 of Year 1, S buys ten-year property for $100 and depreciates it under the straight-line method. On January 1, of Year 3, S sells the property to B for $130. Under section 168(i)(7), B steps into S’s shoes for purposes of section 168 to the extent B’s $130 basis does not exceed S’s adjusted basis at the time of the sale. B’s additional basis is treated as new ten-year recovery property for which B elects the straight-line method of recovery.

S claims $10 of depreciation for each of Years 1 and 2 and has an $80 basis in the property at the time of the sale to B. Thus, S has a $50 intercompany gain from its sale to B. For Year 3, B has $10 of depreciation with respect to $80 of its basis (i.e., the basis of the asset in S’s hands). In addition, B has $5 of depreciation with respect to the $50 of its additional basis that exceeds S’s adjusted basis.

\[^{81}\] Reg. §1.1502-13(c)(1).
\[^{82}\] Reg. §1.1502-13(c)(2)(ii).
S’s $50 gain is taken into account to reflect the difference for each consolidated return year between B’s depreciation taken into account with respect to the property and the recomputed depreciation. For Year 3, B takes $15 of depreciation into account. If the intercompany transaction were a transfer between divisions of a single corporation, B would succeed to S’s adjusted basis in the property and take into account only $10 of depreciation for Year 3. Thus, S takes $5 of gain into account in Year 3. In each subsequent year that B takes into account $15 of depreciation with respect to the property, S must also take $5 of gain into account.

2. The acceleration rule. The acceleration rule backstops the matching rule discussed above. S’s intercompany items and B’s corresponding items are taken into account under the acceleration rule to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation.\(^{83}\)

Example 2: S owns land with a basis of $70. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, P sells 60% of S’s stock to X for $60; and as a result, S becomes a nonmember.

Under the matching rule, none of S’s $30 gain is taken into account in Years 1 through 3 because there is no difference between B’s gain or loss taken into account and its recomputed gain or loss (i.e., the land is not subject to depreciation). However, acceleration of S’s intercompany items takes place because under the acceleration rule, S’s $30 gain is taken into account in computing consolidated taxable income immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once S becomes a nonmember, S takes its $30 gain into account in Year 3 immediately before becoming a nonmember.

The results under this example would be the same had P sold the stock of B. In that instance, S and B again cannot produce the same effect as if they were divisions of a single corporation once B becomes a nonmember. Therefore, S

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83 Reg. §1.1502-13(d). The acceleration rule applies (1) to the extent an intercompany item or corresponding item will not be taken into account in determining the group’s consolidated taxable income or consolidated tax liability under the matching rule of Reg. §1.1502-13(c) (e.g., if S or B becomes a nonmember); or (2) to the extent a nonmember reflects directly or indirectly any aspect of the intercompany transaction (e.g., if B’s cost basis in property purchased from S is reflected by a nonmember under section 362 following a section 351 transaction). Reg. §1.1502-13(d)(1)(i). Note that the acceleration rule will require restoration of any remaining deferred gains upon a transfer of the property to a partnership which is partially or wholly owned by members of the consolidated group. See PLR 8135075 (June 5, 1981) and PLR 8449019 (Aug. 30, 1984).
takes its $30 gain into account under the acceleration rule immediately before B becomes a nonmember.

Additional rules are provided with respect to transactions involving stock of members of the consolidated group.\textsuperscript{84}

An intercompany distribution (whether treated as a dividend or not) is not included in the gross income of the distributee member.\textsuperscript{85} With respect to the distributing member, gain or loss will generally be recognized upon a distribution of property as if the property was sold at its fair market value.\textsuperscript{86} Such gain or loss is deferred and is taken into account under the general rules of Reg. §1.1502-13, such as the matching and acceleration rules.

\textsuperscript{84} Special rules are also provided with respect to the obligations of members. See Reg. §1.1502-13(g).

\textsuperscript{85} Reg. §1.1502-13(f)(2)(ii). However, this exclusion applies to a distribution from a subsidiary only to the extent that there is a corresponding negative adjustment reflected under Reg. §1.1502-52 in B's basis in the stock of the distributing member.

\textsuperscript{86} Section 311(b) and Reg. §1.1502-13(f)(2)(iii). Thus, S may not shift the inherent gain or loss in the property to another member as a result of an intercompany distribution. For example, if S is a subsidiary of B and distributes property to B which creates a loss to S of $10, the $10 loss is a deferred intercompany item. If B sells the property for its value and recognizes no gain or loss, the intercompany deferred transaction loss of S will be allowed in the year of the sale.

However, if B distributes the property to P which then distributes the property to nonmember shareholders, the loss at the S level will be triggered, but such loss will not be allowed to reduce consolidated taxable income. S's gain would, nevertheless, be required to be recognized.
E. Post-Acquisition Adjustments to Stock Basis

Historically, an owning member, P, has been required to reduce its basis in the stock of a subsidiary, S, upon the use of S’s net operating losses in a consolidated return if these losses were used to offset the income of members of the group. In 1966, the Service promulgated regulations which embodied concepts of the equity method of accounting for investments in subsidiaries. The purpose of these adjustments was to prevent the double deduction of loss or double taxation of a subsidiary’s earnings. The quantity chosen for the annual adjustment was S’s undistributed current earnings and profits (“E&P”) or deficit therein. The Service felt that E&P represented a better measure of economic gain or loss and, therefore, was preferable to taxable income as the yardstick for adjusting stock basis.

While E&P generally took into account the economic increase or decrease in wealth of a subsidiary, the system of creating parallel adjustments to basis and E&P created several anomalies. After the enactment of section 312(k) in the Tax Reform Act of 1969, a further anomaly was created by the use of E&P instead of taxable income in calculating investment adjustments. Section 312(k) required the use of straight-line depreciation for taxable years beginning after June 30, 1972, while accelerated depreciation could be used in determining taxable income. Thus, S’s E&P was not reduced by the excess of accelerated depreciation over the straight-line amount. Correspondingly, P’s basis in the S stock was reduced by a lesser amount even though a tax deduction for the full accelerated depreciation had been obtained. Therefore, on disposition of S’s stock, P could realize a tax advantage in the form of less gain (or more loss) if the excess depreciation was not

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87 See Ifeld Co. v. Hernandez, 292 U.S. 62 (1934), Reg. §1.1016-6(a) and former Reg. §1.1502-34A (effective for taxable years beginning before 1966).

88 For example, assume that P owns all of the stock of S, and the P group files a consolidated return. S incurs losses which are used to offset P’s income in consolidation. If P is not required to reduce its basis in the S stock, P could effectively get a double deduction: once when S’s losses are used, and again when P sells the S stock. Conversely, if S has earnings, these earnings could be taxed again upon a sale of the S stock if P’s basis in the S stock was not increased when S’s earnings were produced.

89 One of the most celebrated anomalies produced under the 1966 regulations was “phantom E&P.” Phantom E&P was created as a result of S’s unused losses. For example, in Year 1, assume that S incurred an NOL of $100, but produced a deficit in E&P of only $80 due to the special E&P rules, such as for the difference between accelerated and straight-line depreciation. Under the rules then in effect, P’s basis in the S stock would be increased by $100 for S’s unused NOL, but decreased by $80 for S’s E&P deficit, producing a net positive adjustment of $20. Former Reg. §1.1502-32(b)(1)(ii), -32(b)(2)(i), and -32(e)(2). A correlative E&P adjustment was also made, which created $20 of phantom E&P at the P level. Reg. §1.1502-33(c)(4)(ii)(a). Thus, this rule would incorrectly characterize some portion of a distribution to P’s shareholders as a dividend.
taken into account in calculating P's basis in the S stock. Despite challenge by the Service, the Tax Court affirmed this application of the rules in *Woods Investment Company*.90

In 1987, the Congress enacted section 1503(e)(1)(A) to overrule the decision in *Woods Investment Company* and to reverse the effects of section 312(k) and other special adjustments under section 312(n) [(other than section 312(n)(7)] on the stock basis adjustment. Under section 1503(e)(1)(A), stock basis adjustments must generally be determined without regard to section 312(k) and (n) for purposes of determining gain or loss on dispositions of subsidiary stock after December 15, 1987. However, section 1503(e)(1)(A) is not otherwise applicable for purposes of computing and tiering up S's E&P. As a result, a separate accounting system was required under the pre-1995 regulations in determining P's E&P with respect to S's earnings or losses.

On August 12, 1994, the Service issued new rules to address many of the technical problems which existed in this area.91 The new rules conform the consolidated stock basis rules to take into account section 1503(e), discussed above.

The adjustment to P's basis in the S stock is the net amount (treating income and gain items as increases and losses, deductions and distributions as decreases) of S's —

a. Taxable income or loss;

b. Tax-exempt income;

c. Noncapital, nondeductible expenses; and
d. Distributions with respect to S's stock.92

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91 T.D. 8560. The new rules are generally applicable to determinations of stock basis in consolidated return years beginning on or after January 1, 1995. If the final rules apply, basis generally must be determined or redetermined as if the new rules were in effect for all consolidated return years of the group. Reg. §1.1502-32(h)(1).

However, if P disposes of S's stock in a consolidated return year beginning before January 1, 1995, P's income, gain, deduction, or loss and the basis reflected in that amount are not redetermined. Nevertheless, if determinations or adjustments to P's basis in S's stock reflect determinations or adjustments with respect to stock of a lower-tier member, the determinations or adjustments are redetermined if S later disposes of the lower-tier member's stock under the final rules, even though they were previously taken into account in P's disposition of S's stock. Reg. §1.1502-32(h)(2).

92 Reg. §1.1502-32(b)(2). Basis adjustments are made as of the close of each consolidated return year, and as of any other time if a determination at that time is necessary to determine a tax liability of any person. For example, adjustments are made as of P's sale of S's stock, in order to measure P's
Each of the items is discussed in greater detail below.

1. **Taxable income or loss.** S’s taxable income or loss is consolidated taxable income determined by taking into account only S’s items of income, gain, deduction, and loss. By referring to consolidated taxable income, the rules take into account such provisions as the deferral of intercompany items and the elimination of intercompany dividends under Reg. §1.1502-13.93

Example 1: During Year 1, the P group has $100 of consolidated taxable income when determined by taking into account only S’s items of income, gain, deduction, and loss. P has a $100 positive adjustment with respect to S’s stock for Year 1, which increases P’s basis in S’s stock by $100 as of the close of Year 1.

The facts are the same as above, except that during Year 1, S sells property to P and recognizes a $25 gain, which is deferred under Reg. §1.1502-13 and taken into account in Year 3, when P resells the property. The deferred gain is not additional taxable income for Year 1 because it is not taken into account in determining the P group’s consolidated taxable income for that year. Thus, the deferred gain does not result in a basis adjustment until Year 3, when it is taken into account in determining the P group’s consolidated taxable income.

income, gain, or loss from the sale. Similarly, if S liquidates during a consolidated return year, adjustments must be made as of the liquidation (even if the liquidation is tax-free under section 332). Reg. §1.1502-32(b)(1)(i).

Adjustments are made to the basis of S’s common and preferred stock held by members of the consolidated group. The negative adjustment for distributions is allocated to the shares of S’s stock to which the distribution relates. Thus, distributions may reduce the basis of common or preferred stock of a subsidiary owned by members of the group. The remainder of the adjustment with respect to S’s stock [the portion described in Reg. 1.1502-32(b)(2)(i) to (iii)] is allocated among the shares of S’s stock, including shares owned by nonmembers. However, the allocation to nonmembers has no effect on their basis in the S stock. Reg. §1.1502-32(c)(1). If the adjustment under Reg. §1.1502-32(b)(2) (without taking distributions into account) is positive, it is allocated first to any preferred stock to cover distributions and arrearages and then to common stock. If it is negative, it is allocated only to common stock.

Anti-abuse rules are also provided to ensure that these provisions are applied in a manner which is consistent with their intended purpose. Reg. §1.1502-32(e).

93 Reg. §1.1502-32(b)(3)(i).
Assume instead that P sells S's stock on December 31 of Year 2. Under Reg. §1.1502-13, S takes the $25 deferred gain into account immediately before the sale. Thus, P increases its basis in S's stock by the $25 immediately before the stock sale.

In determining consolidated taxable income (or loss), S's deductions and losses are taken into account to the extent that they are absorbed by S or any other member.94

Example 2: During year 2, the P group has a $50 consolidated net operating loss when determined by taking into account only S's items of income, gain, deduction, and loss. S's loss is absorbed by the P group in Year 2, offsetting P's income for that year. Because S's loss is absorbed in the year it arises, the loss is treated as a $50 tax loss for Year 2, and P has a $50 negative adjustment with respect to S's stock. This negative adjustment decreases P's basis in S's stock by $50.

Assume instead that P has no income of loss for Year 2 and S's tax loss is carried forward and absorbed by the P group in Year 3 (offsetting the income of P or S). The loss is not treated as a tax loss until Year 3.

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94 Id. To the extent that S's deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (e.g., under sections 172, 465, or 1212), the deduction or loss is taken into account in the year in which it is absorbed. Reg. §1.1502-32(b)(3)(i)(A). To the extent that S's deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the loss is treated as a tax loss for purposes of these rules in the year in which it arises and not in the year in which it is absorbed. Reg. §1.1502-32(b)(3)(i)(B).
2. **Tax-exempt income.** S’s tax-exempt income is its income and gain that is taken into account but is permanently excluded from S’s gross income under applicable law and which increases, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S’s dividend income to which Reg. §1.1502-13(f)(2)(ii) applies and interest excluded from gross income under section 103 are tax-exempt income. This prevents S’s tax-exempt income from being indirectly taxed as gain on P’s disposition of the S stock.

An item of income or gain is also treated as tax-exempt income for purposes of P’s stock basis adjustments if it is permanently offset by a deduction or loss and the offsetting item does not reduce, directly or indirectly, the basis of S’s assets (or an equivalent amount).

**Example 3:** S receives a $100 dividend with respect to which a $70 dividends-received deduction is allowed under section 243. Both the $100 dividend and the $70 deduction are taken into account in computing taxable income. In addition, $70 of the dividend is treated as tax-exempt income. As a result, P’s basis in S’s stock increases by $100, $30 because of S’s taxable income and $70 because of its tax-exempt income.

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95 Reg. §1.1502-32(b)(3)(ii)(A). Income realized but not recognized under section 1031 is not treated as tax-exempt income for this purpose.

96 Reg. §1.1502-32(b)(3)(ii)(B). In addition, a discharge of S’s indebtedness that is excluded from gross income under section 108(a) is treated as tax-exempt income to the extent the discharged amount is applied to reduce tax attributes (e.g., section 108(b) or 1017) and the attribute reduction is taken into account as a noncapital, nondeductible expense under Reg. §1.1502-32(b)(3)(iii). Discharge of S’s indebtedness that is excluded from gross income but is not applied to reduce tax attributes is not treated as tax-exempt income. Reg. §1.1502-32(b)(3)(ii)(C)(1).
3. **Noncapital, nondeductible expenses.** P’s basis in the S stock is also decreased by the amount of S’s noncapital, nondeductible expenses, to prevent the expenses from being indirectly recovered on the disposition of S’s stock. A noncapital, nondeductible expense is a deduction or loss that is taken into account but permanently disallowed or eliminated under applicable law in determining S’s taxable income or loss and that decreases, directly or indirectly, the basis of its assets (or an equivalent amount).97

Likewise, if S’s net operating or net capital loss carryovers expire or are reduced under section 108(b) upon a discharge of S’s indebtedness, such expiration or reduction becomes a noncapital, nondeductible expense at the close of the year of expiration or reduction.98

Example 4: P acquired all of the stock of S at the close of 1995 from an individual for $10 million in a taxable purchase transaction. At the time of acquisition, S had a $10 million NOL carryforward, which will expire in 2002 and which is subject to an annual section 382 limitation of $600,000 (assumed long-term tax-exempt rate of 6% x $10,000,000).

Under the regulations, P must reduce its basis in the S stock in 2002 by the amount of the NOL which expires unused. Upon expiration and assuming no other adjustments, P’s basis in the S stock will be reduced to zero at that time.99 The reduction of P’s stock basis because of the expiration of S’s losses is one of the most controversial provisions in the new stock basis regulations.

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97 Reg. §1.1502-32(b)(3)(iii)(A). For example, federal income taxes, officers’ life insurance premiums and disallowed meal and entertainment expenses are noncapital, nondeductible expenses.

Rules are provided to allocate the consolidated tax liability to each of the members of the group. These provisions treat the consolidated group as having a tax-sharing agreement in effect which provides for the deemed payment from one member to another for the use of the latter’s tax attributes (e.g., NOLs) if such use results in a decreased tax liability for the consolidated group. Reg. §1.1502-32(b)(3)(iv)(D).

98 *Id.*

99 This result occurs even though the P group could never have used all of S’s NOL due to the limitations imposed by section 382.

To mitigate the harsh results illustrated above, the final regulations permit the acquiring group to elect to treat all or any portion of a loss carryover of S which arose in a separate return limitation year as expiring for all federal income tax purposes immediately before S becomes a member of the group. If S was a member of another group immediately before it became a member of the acquiring group, the expiration is also treated as occurring immediately after it ceases to be a member of the prior group. Reg. §1.1502-32(b)(4). This election, however, is not available with respect to S’s losses which arose in the P consolidated group.
4. **Distributions.** P's basis in the S stock is reduced by all of S's distributions to P to which section 301 applies and to all other distributions treated as dividends [e.g., under section 356(a)(2)], without regard to when the E&P was accumulated.\(^{100}\)

The adjustments to S's stock are taken into account in determining adjustments to higher-tier stock. The adjustments are applied in the order of the tiers, from the lowest to the highest.\(^{101}\) For example, if P is a subsidiary whose stock is owned by another member, P's adjustment to S's stock is taken into account in determining the adjustments to stock of P owned by other members.

**Example 5:** M owns all of P's stock, and P owns all of S's stock. During Year 1, the M group has $100 of consolidated taxable income when determined by taking into account only S's items of income, gain, deduction, and loss, and $50 of consolidated taxable income when determined by taking into account only P's items. P increases its basis in S's stock by $100. This $100 basis adjustment is taken into account in determining M's basis in P's stock. Thus, M increases its basis in P's stock by $150.

\(^{100}\) Reg. §1.1502-32(b)(3)(v). Note that these new regulations represent a significant departure from the former rules with respect to E&P accumulated in years for which the group files separate returns. Although a basis increase was not obtained when this E&P was accumulated, P must nevertheless reduce its basis in the S stock when this E&P is distributed. This change puts consolidated groups at a disadvantage vis-à-vis separate return filers, since groups filing separate returns could obtain a 100% dividends-received deduction under section 243(b) and would not be required to reduce the basis of the stock of the distributing company (unless section 1059 applied).

Note that a distribution by S which is in excess of its earnings and profits will also reduce P's basis in the S stock to the extent thereof. If the distribution (whether or not in excess of S's earnings and profits) exceeds P's basis in the S stock, no gain is recognized by P under section 301(e)(3). Reg. §1.1502-13(f)(2)(ii). Instead, P takes a "negative basis" in the S stock, which is described in the regulations as an excess loss account. See the discussion below.

\(^{101}\) Reg. §1.1502-32(a)(3)(iii).
5. **Excess loss accounts.** Special rules are also provided which permit P to reduce its basis in the S stock below zero. This consolidated return phenomena is known as an excess loss account (ELA). P’s basis in the S stock is reduced as the group absorbs S’s losses and as S makes distributions to P. The reductions are not limited to the group’s basis in S’s stock and, to the extent reductions exceed stock basis, they result in an ELA with respect to the S stock owned by P.102 P’s ELA is included in its income when P disposes of the stock, and the income is generally treated as gain from the sale of the stock.

An ELA ordinarily arises with respect to a share of S’s stock only if S’s losses and distributions are funded with capital not reflected in the basis of the share. The reductions may be funded by creditors or by other shareholders, including other members.

Generally, an ELA is treated as “negative basis” for computational purposes, which eliminates the need for special ELA rules paralleling the basis rules of the Code.103 Similarly, the rules of the Code are generally used to determine the timing for inclusion of an ELA in the owning member’s income.104

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102 Cf. Sections 705(a) for partnerships and 1367(a) for S corporations, which do not permit the partners or shareholders, as the case may be, from reducing the basis of their ownership interest below zero. The only comparable Code provision is found in section 1059(a)(2) with respect to stock basis adjustments required upon the receipt of an extraordinary dividend.

103 Reg. §1.1502-19(a)(2)(i).

104 P’s ELA income from a disposition of a share is subject to any nonrecognition or deferral rules applicable to the disposition. Reg. §1.1502-19(b)(2)(i). For example, if P’s stock in S is redeemed in a liquidation to which section 332 applies or P transfers all of its assets (including S’s stock) to S in a reorganization to which section 361(a) applies, P’s income or gain from the ELA is not recognized.

If stock of more than one subsidiary is disposed of in the same transaction, the ELA income is taken into account in the order of the tiers, from the lowest to the highest. Reg. §1.1502-19(b)(3).

P is treated as disposing of a share of the S stock upon the occurrence of the following:

1. When P transfers or ceases to own the share for federal income tax purposes, even if no gain or loss is taken into account, or P takes into account gain or loss with respect to the share;

2. When P becomes a nonmember, or a nonmember determines its basis in the share (or any other asset) by reference to P’s basis in the share, directly or indirectly, in whole or in part (e.g., under section 362);

3. When S becomes a nonmember, or P’s basis in the share is reflected directly or indirectly, in whole or in part, in the basis of any asset other than member stock;

4. At the time that substantially all of S’s assets are treated as disposed of, abandoned, or destroyed for federal income tax purposes;

5. At the time that an indebtedness of S is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under Reg. §1.1502-32(b)(3)(ii)(C). Reg. §1.1502-19(c)(1).
Example 1: P has a $150 basis in S's stock. During Year 1, P has $500 of ordinary income, and S has a $200 ordinary loss. Due to the absorption of S's loss to offset P's income, P's basis in the S stock is reduced to zero and an excess loss account of $50 is created. P must include its ELA in the S stock in income at the time of the sale. On January 1 of Year 2, P sells S's stock to a nonmember for $60. Consequently, P recognizes a $110 gain from the sale of the S stock, which is taken into account in determining the group's consolidated taxable income.
F. Earnings and Profits

The amount by which a corporate distribution is taxable to a shareholder as a dividend is determined by reference to the distributing corporation's earnings and profits (E&P). The term E&P is synonymous neither with taxable income nor with retained earnings for financial accounting purposes. Principally, the concept of E&P is the vehicle which ensures that the corporation's shareholders are taxed on the realized accretion in wealth of their investment.

Taxable income is frequently used as the starting point in computing E&P. Once taxable income is determined, other adjustments are then made to reflect statutory and judicial rules which have evolved over the years.

The calculation of E&P also has important ramifications in the case of a consolidated group. E&P is determined on a company-by-company basis, and there is, to date, no recognized concept of "consolidated E&P."

The consolidated return regulations effective for taxable years beginning after 1965 did not originally cause the E&P or deficit therein of a subsidiary (S) to be reflected in the E&P of its parent (P). Adjustments were only made in the case of actual (or deemed) dividend distributions. In this situation, a member's E&P computations were similar to those made when separate returns were filed. However, for taxable years beginning after 1965 and before 1976, a consolidated group could elect to adjust its E&P currently to reflect the investment account adjustments to P's basis in the S stock.

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105 For tax purposes, a "dividend" means any distribution of property made by a corporation to its shareholders: (1) out of its E&P accumulated after February 28, 1913; or (2) out of its E&P of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year).

106 See e.g., Rev. Proc. 75-17, 1975-1 C.B. 677. E&P is generally determined by the method of accounting used by the taxpayer in computing taxable income. Reg. §1.312-6(a).

107 Proposed legislation would have treated a consolidated group as a single entity for purposes of determining the existence of E&P (or lack thereof). See Joint Committee on Taxation, Description of Revenue Reconciliation Proposal by Chairman Rostenkowski, (JCX-28-89), July 11, 1989.

108 Former Reg. §1.1502-33(c)(4)(i)(a).

109 Former Reg. §1.1502-33(c)(4)(iii).
For taxable years beginning after 1975, the current adjustment of E&P is mandatory. Thus, a member was required to adjust its E&P to reflect the amount of the net positive and net negative investment adjustments made by it to the basis of the stock of each other member.\textsuperscript{110}

The adjustments required by section 1503(e)(1) are not taken into account in calculating P's E&P due to the investment adjustment system. Thus, P's E&P is increased by the excess of S's accelerated depreciation over the straight-line amount even though this differential was not reflected in P's basis in the S stock.

As part of the revision of the stock basis rules discussed above, the Service also revised the E&P rules for consolidated groups.\textsuperscript{111} These new rules establish a separate system for adjusting and tiering up E&P.\textsuperscript{112}

Under the new rules an allocable part of S's E&P is tiered up and reflected in P's E&P based on P's ownership of S's stock.\textsuperscript{113} P's E&P is adjusted at the close of each consolidated return year and as of any other time when a determination is necessary to ascertain the E&P of any person.\textsuperscript{114}

Example 1: P forms S on January 1 in Year 1 with a $100 capital contribution. S has $100 of E&P during Year 1 and no E&P during Year 2. During Year 2, S

\textsuperscript{110} Former Reg. §1.1502-33(c)(4)(ii)(a).
\textsuperscript{111} The new rules generally apply with respect to determinations of E&P (e.g., for purposes of a distribution to which section 301 applies) in consolidated return years beginning on or after January 1, 1995. If the new rules apply, E&P must be determined or redetermined as if the new rules were in effect for all consolidated return years of the group. Reg. §1.1502-33(j)(1).

However, if P disposes of S's stock in a consolidated return year beginning before January 1, 1995, P's E&P with respect to S are not redetermined. Nevertheless, if determinations or adjustments to P's basis in S's stock reflect determinations or adjustments with respect to stock of a lower-tier member, the determinations or adjustments are redetermined if S later disposes of the lower-tier member's stock under the new rules, even though they were previously taken into account in P's disposition of S's stock. Reg. §1.1502-33(j)(2).

\textsuperscript{112} Consequently, anomalies resulting from the interdependence of stock basis adjustments and E&P adjustments have been eliminated. For example, if S sustained an E&P deficit and a corresponding tax loss, P's basis in S's stock was not reduced to reflect the E&P deficit under the former tax rules until the tax loss was absorbed. This created "phantom E&P" at the P level.

\textsuperscript{113} Reg. §1.1502-33(b)(1). In determining S's E&P for this purpose, S's unabsorbed losses reduce S's E&P in the year such losses arise.

\textsuperscript{114} Reg. §1.1502-33(b)(1)(i). Anti-abuse rules are also provided to ensure that these provisions are applied in a manner which is consistent with their intended purpose. Reg. §1.1502-33(g).
distributes a $50 dividend to P. S’s $100 of E&P for Year 1 also increases P’s E&P for Year 1. P has no additional E&P for Year 2 as a result of the $50 distribution in Year 2, because there is a $50 increase in P’s E&P as a result of the receipt of the dividend and a corresponding $50 decrease in S’s E&P under section 312(a) that is reflected in P’s E&P.

Assume instead that S distributes the $50 dividend at the end of Year 1 rather than during Year 2. P’s E&P are increased by $100 (S’s $50 of undistributed E&P plus P’s receipt of the $50 distribution). Thus, S’s E&P increase by $50 and P’s E&P increase by $100.

Alternatively, assume that after P forms S on January 1 of Year 1 with a $100 capital contribution, S borrows additional funds and has a $150 deficit in E&P during Year 1. S’s $150 deficit in E&P decreases P’s E&P for Year 1 by $150. Note that P’s E&P is decreased for Year 1 whether or not S’s corresponding loss is absorbed by the group or is carried forward.

Example 2: P owns 80 percent of S’s stock throughout Year 1. During Year 1, S has $100 of E&P. $80 of S’s E&P is allocated to S’s stock owned by P. Accordingly, $80 of S’s E&P for Year 1 is reflected in P’s E&P for Year 1.

Immediately before it becomes a nonmember, S’s E&P are eliminated to the extent that they were taken into account by another member under Reg. §1.1502-33. The elimination of S’s E&P does not tier up and eliminate the E&P of a higher-tier member of the group.115 Upon the elimination of S’s E&P, if S makes a distribution to P before earning postconsolidation E&P, P’s basis in the S stock may be reduced or may create capital gain.116

Example 5: Individuals A and B own all of P’s stock, and P owns all the stock of S and T, each with $500 basis. During Year 1, S has $100 of E&P and T has $50 of E&P. The E&P of S and T tier up to P, and P has $150 of E&P for Year 1. On December 31 of Year 1, P sells all of S’s stock for $600.

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115 Reg. §1.1502-33(e)(1). However, no elimination occurs solely by reason of the termination of a group because of the acquisition of the stock, or the tax-free acquisition of the assets, of the common parent, if there is a surviving group that is immediately thereafter a consolidated group. Reg. §1.1502-33(e)(2). These provisions only apply to deconsolidations occurring in consolidated return years beginning after 1994. Reg. §1.1502-33(j)(3). Special rules are also provided to allocate E&P in accordance with section 312(b) if the S stock is distributed in a transaction qualifying under section 355. See Reg. §1.1502-33(e)(3).

116 See section 301(c)(2) and (3).
S's $100 of E&P is eliminated immediately before S becomes a nonmember of the consolidated group because the E&P are taken into account in computing P's E&P. However, no corresponding adjustment is made to P's E&P or to P's basis in S's stock as a result of the elimination. Accordingly, P has no gain or loss on the sale of the S stock, and P's E&P for Year 1 remain $150 following the sale of S's stock.

IV. Summary

This article has addressed a number of significant issues currently present in the area of consolidations. Appendix B contains a table which compares the financial accounting treatment with the tax treatment of some of the primary issues discussed in this article. A review of this table highlights the many similarities and many differences between the two sets of rules. It is our hope that this type of comparison will be helpful to those involved in either side of the consolidation transaction.

As we have illustrated, a number of similar issues are being hotly debated by the FASB, the SEC and the IRS. While the current level of economic activity is likely to produce new derivations of transactions and organizational structures, the accounting and tax rules will remain under constant scrutiny and strain from the daily bombardment of creative minds in today's global economy. It is with some hope, and much skepticism, that the state of the rules keep up with the game that they are intended to regulate.
Appendix A

Twelve criteria for Pooling-of-Interests

APB 16 established twelve criteria for the pooling-of-interests method of accounting for a business combination. The criteria, divided into three categories, must all be met before the use of the pooling-of-interests method is permitted.

A. Attributes of combining companies

1. Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.

2. Each of the combining companies is independent of the other combining companies.

B. Characteristics of the combination

3. The combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.

4. A corporation offers and issues only common stock with rights identical to those of the majority of its outstanding voting common stock in exchange for substantially all of the voting common stock interest of another company at the date the plan of combination is consummated. (Substantially all of the voting common stock means 90 percent or more for this condition.)

5. None of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated or between the dates the combination is initiated and consummated; changes in contemplation of effecting the combination may include distributions to stockholders and additional issuance's, exchanges, and retirements of securities.

6. Each of the combining companies reacquires shares of voting common stock
only for purposes other than business combinations, and no company reacquires more than a normal number of shares between the dates the plan of combination is initiated and consummated.

7. The ratio of the interest of an individual common stockholder to those of other common stockholders in a combining company remains the same as a result of the exchange of stock to effect the combination.

8. The voting rights to which the common stock ownership interest in the resulting combined corporation are entitled are exercisable by the stockholders; the stockholders are neither deprived of nor restricted in exercising those rights for a period.

9. The combination is resolved at the date the plan is consummated and no provisions of the plan relating to the issue of securities or other consideration are pending.

C. Absence of planned transactions

10. The combined corporation does not agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination.

11. The combined corporation does not enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guaranty of loans secured by stock issued in the combinations, which in effect negates the exchange of equity securities.

12. The combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination other than disposals in the ordinary course of business of the formerly separate companies and to eliminate duplicate facilities or excess capacity.
following a disassociation of a subsidiary, no reorganization for 60 months. Options might be treated as exercised:

- Certain special status entities, excludes foreign corporations and generally domestic corporations;
- Preferred stock excluded from rest of the outstanding voting shares of another company of the controlling voting shares of another.
- Direct or indirect ownership of more than 50%.

Tax Treatment

Federal Income

Summary of Financial Accounting and Tax Differences

Appendix B

Bankruptcy (of C.E. subsidiary) is in liquidation or if control does not rest likely. Reorganization is not required if control is not incorporated. Generally all entities are included, whether or not incorporated. Includible corporations. Threshold for affiliation:

Entities included in consolidation.

Attribute
Sections 338(f) or 338(h)(10)

Non-legal asset acquisition

Stock acquisition

Formation by the affiliated group

Initial basis of assets of a subsidiary

Carryover, plus any gain recognized by the transferee on formation

Carryover, plus any gain recognized by the transferee in the reorganization

Carryover, plus any gain recognized by the transferee in the property used

Carryover, plus any gain recognized by the transferee in the property used

Carryover, plus any gain recognized by the transferee in the property used
Nonexemptible to distribute: Gain or Loss

Deferral and not eliminated:
Adj usted to Fair market value

Matching and acceleration rules

Income under Intercompany accounting rules
Deferral at consolidated level and included in
Deferred at consolidated level and included in

Eliminated in consolidation: Gain or Loss on

Company books: Carried in consolidation
Adj usted to Fair market value on separate

Intercompany dividends
Basis of assets transferred
Intercompany Gain or Loss

Financial Accounting Treatment
Federal Income

Tax Treatment
be created. Stock plus net advances.

Adjusted basis when losses are absorbed

Basis reduced for a loss below Parent’s investment in Subsidiary.

Basis reduced immediately, but generally not

Effect of subsidiary’s losses

Distributions to shareholders

Less non-capital, non-accumulative items and

taxable income and tax-exempt income.

Allocateable share of subsidiary’s earnings or

Allocateable share of subsidiary’s earnings or

Tax Treatment

Federal Income

Accounting Treatment

Parent’s post-acquisition adjustments to

Attribution
When it leaves the consolidated group

Sub's consolidated E & P eliminated

its shareholders

determining dividends

remitted in parent's E & P for

current earnings and profits (E & P)

Tax Treatment

Federal Income

Consolidated Financial Statements

No adjustment when subsidiary leaves

under state law

Dividends

For determining parent's ability to pay

current retained earnings

Generally reflected in parent's retained

current retained earnings

Adjustment on disposition

Effect on owning member

Amount of adjustment

Adjustment for the subsidiary's earnings

Attributed