*SWFT 2018 Corporations, Partnerships, Estates and Trusts*

Chapter 8: Consolidated Tax Returns

End-of-Chapter Question, Exercise, and Problem Correlations

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Corporations,**  **Partnerships,**  **Estates and**  **Trusts 40e (2017)** | **Corporations,**  **Partnerships,**  **Estates and Trusts**  **41e (2018)** | **Corporations, Partnerships, Estates and Trusts 41e (2018) Learning Objectives** | **Exact Same** | **Revised** | **Brand**  **New** |
| **Discussion Questions (DQ)** | |  |  |  |  |
| DQ1 | DQ1 | LO1 | **x** |  |  |
| DQ2 | DQ2 | LO1 | **x** |  |  |
| DQ3 | DQ3 | LO2 | **x** |  |  |
| DQ4 | DQ4 | LO2,3 | **x** |  |  |
| DQ5 | DQ5 | LO3 |  | **x** |  |
| DQ6 | DQ6 | LO3,4,5 | **x** |  |  |
| DQ7 | DQ7 | LO3,10 | **x** |  |  |
| DQ8 | DQ8 | LO3,10 | **x** |  |  |
| DQ9 | DQ9 | LO3,9,10 | **x** |  |  |
| DQ10 | DQ10 | LO3,5,10 | **x** |  |  |
| DQ11 | DQ11 | LO4 | **x** |  |  |
| DQ12 | DQ12 | LO5 |  | **x** |  |
| DQ13 | DQ13 | LO5 | **x** |  |  |
| DQ14 | DQ14 | LO6 |  | **x** |  |
| DQ15 | DQ15 | LO6 | **x** |  |  |
| DQ16 | DQ16 | LO6 | **x** |  |  |
| DQ17 | DQ17 | LO6 | **x** |  |  |
| DQ18 | DQ18 | LO8 | **x** |  |  |
| DQ19 | DQ19 | LO8 |  | **x** |  |
| DQ20 | DQ20 | LO9 | **x** |  |  |
| DQ21 | DQ21 | LO9,10 |  | **x** |  |
| DQ22 | DQ22 | LO9 | **x** |  |  |
| DQ23 | DQ23 | LO9 | **x** |  |  |
| **Computational Exercises (EX)** | |  |  |  |  |
| EX24 | EX24 | LO5 | **x** |  |  |
| EX25 | EX25 | LO6 | **x** |  |  |
| EX26 | EX26 | LO8 | **x** |  |  |
| EX27 | EX27 | LO8 | **x** |  |  |
| EX28 | EX28 | LO9 | **x** |  |  |
| **Problems (PR)** | |  |  |  |  |
| PR29 | PR29 | LO3,7 | **x** |  |  |
| PR30 | PR30 | LO3 |  | **x** |  |
| PR31 | PR31 | LO5 |  | **x** |  |

# EOC 8-1

South-Western Federal Taxation 2018 Edition Series End-of-Chapter Question, Exercise, and Problem Correlations: *Corporations, Partnerships, Estates and Trusts (Volume 2)*

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Corporations,**  **Partnerships,**  **Estates and**  **Trusts 40e (2017)** | **Corporations,**  **Partnerships,**  **Estates and Trusts**  **41e (2018)** | **Corporations, Partnerships, Estates and Trusts 41e (2018) Learning Objectives** | **Exact Same** | **Revised** | **Brand**  **New** |
| PR32 | PR32 | LO5 | **x** |  |  |
| PR33 | PR33 | LO5 | **x** |  |  |
| PR34 | PR34 | LO5 | **x** |  |  |
| PR35 | PR35 | LO6 |  | **x** |  |
| PR36 | PR36 | LO6 | **x** |  |  |
| PR37 | PR37 | LO6 | **x** |  |  |
| PR38 | PR38 | LO7 | **x** |  |  |
| PR39 | PR39 | LO7,8 | **x** |  |  |
| PR40 | PR40 | LO8 | **x** |  |  |
| PR41 | PR41 | LO8 | **x** |  |  |
| PR42 | PR42 | LO8 | **x** |  |  |
| PR43 | PR43 | LO9 | **x** |  |  |
| **Cumulative (Tax Return) Problems (CP)** | | |  |  |  |
| N/A |  |  |  |  |  |
| **Research Problems (RP)** | |  |  |  |  |
| RP1 | RP1 |  | **x** |  |  |
| RP2 | RP2 |  | **x** |  |  |
| RP3 | RP3 |  |  | **x** |  |
| RP4 | RP4 |  | **x** |  |  |
| RP5 | RP5 |  | **x** |  |  |
| **Roger CPA Review Questions (RCPA)** | | |  |  |  |
| RCPA1 | RCPA1 |  | **x** |  |  |
| RCPA2 | RCPA2 |  | **x** |  |  |
| RCPA3 | RCPA3 |  | **x** |  |  |
| RCPA4 | RCPA4 |  |  | **x** |  |
| RCPA5 | RCPA5 |  | **x** |  |  |

# EOC 8-2

**CHAPTER 8**

**CONSOLIDATED TAX RETURNS**

**SOLUTIONS TO PROBLEM MATERIALS**

# DISCUSSION QUESTIONS

1. (LO 1) There are significant nontax reasons for creating corporate conglomerates, including:
   * The isolation of the assets of one corporation from the liabilities of another.
   * The execution of estate planning objectives.
   * A perceived value of retaining the separate identities of the acquired corporation.
   * A need to shield the identities of a subsidiary’s true owners from the public.
   * A desire to move an affiliate from control of its activities in a “business unfriendly” state to that of its new parent entity, which is resident in a “business friendly” jurisdiction.
2. (LO 1) A consolidation election may be available as a result of various tax and nontax motivated business decisions.
   * A merger, acquisition, or other corporate combination.
   * A structural change in the capital of a corporation due to regulatory requirements, competitive pressures, or economizing of operations.
   * A desire to gain tax or other financial advantages.
3. (LO 2)
   1. The length and details of the rules associated with consolidated returns make them poorly suited for placement in the Code. Moreover, as corporate structures and transactions become more complex every year, development of the expertise that the Treasury staffers (and the tax professionals that assist them) use to draft the Regulations is critical. Thus, the delegation of such rule-writing responsibilities may be appropriate.
   2. Unelected individuals should not be charged with writing tax law. The public review process for the consolidated return Regulations must remain thorough, to protect against abuses and unintended consequences.

**8-1**

1. (LO 2, 3) Some of the more important differences between the book and tax treatments of conglomerates include the following.

|  |  |  |
| --- | --- | --- |
| **Event or**  **Requirement** | **Financial Accounting Effects (generally required when ownership levels are met)** | **Tax Effects**  **(upon taxpayer election)** |
| Acquiror takes over Target | The transaction is treated as a purchase, with cost amounts marked up or down to fair market value (FMV). | Depends upon the structure of the deal. Nontaxable with carryover basis if a qualifying reorganization (see Chapter 7) or a stock purchase. If an asset purchase, a FMV tax basis is taken. |
| Purchase price exceeds the sum of the net assets acquired | Goodwill is created. No scheduled amortization. Impairments or restorations of goodwill are recorded on the income statement and balance sheet. | Goodwill is created. Purchased goodwill usually is amortized against taxable income over 15 years. |
| Building the consolidated report | Non-U.S. corporations and noncorporate entities can be included in a consolidated financial statement. | Only U.S. C corporations can be included in a consolidated tax return. |
| Affiliates to be included | A greater than 50% ownership threshold is used. | An 80% or greater ownership threshold is used. |

1. (LO 3) SPEECH OUTLINE

November 1, 2017

# WHEN TO USE CONSOLIDATED RETURNS Potential Advantages of Filing Consolidated Returns

* Use the operating and capital loss carryovers of one group member to shelter the corresponding income of other group members.
* Eliminate taxation of all intercompany dividends.
* Defer recognition of income from certain intercompany transactions, an advantage as to the time value of money.
* Optimize certain deductions and credits, by using consolidated amounts in computing pertinent limitations.
* Increase the tax basis of investments in the stock of subsidiaries by the amount of positive subsidiary taxable income.
* Use the alternative minimum tax (AMT) attributes of all group members in deriving consolidated alternative minimum taxable income (AMTI), thereby reducing the magnitude of the adjustment for adjusted current earnings (ACE) and of other AMT preferences and adjustments.
* Use the current-year operating losses of one group member to defer or reduce the (regular or AMT) estimated tax payments of the entire group.
* The shareholdings of all group members can be used in meeting other statutory requirements.

# Potential Disadvantages of Filing Consolidated Returns

* Binding nature of the election on all subsequent tax years of the group members, unless either the makeup of the affiliated group changes, or the IRS consents to revocation of the election.
* Apply the capital and operating losses of one group member against the corresponding income of the other group members when assignment of such losses to separate return years would produce a greater tax reduction therefrom.
* Defer recognition of losses from certain intercompany transactions, a detriment as to the time value of money.
* Decrease the amounts of certain deductions and credits, by using consolidated amounts in computing pertinent limitations.
* Decrease the tax basis of investments in the stock of subsidiaries by the amount of negative subsidiary taxable income, and by distributions therefrom.
* Creation of short taxable years of subsidiaries, in meeting the requirement that all group members use the parent’s tax year, thereby bunching income and expending one of the years of the subsidiary’s charitable contribution and loss carryforward period.
* Return elections made by the parent are binding on all members of the filing group for the year.
* Recognition of legal and other rights of minority shareholders in the context of a consolidated group.
* Incurring of additional administrative costs in complying with the consolidated return regulations.

1. (LO 3, 4, 5) Before a consolidation election can be made under the tax law, three major requirements first must be met.
   * Affiliated group status Stock ownership tests

Identifiable parent corporation

* + Eligible corporation to join Statutory definitions consolidated group

* + Compliance requirementsForms 851, 1122

Conformity to parent’s tax year

1. (LO 3, 10) Pertinent tax issues include the following.
   * How accurate are the income and loss projections of the group members?
   * Will Black’s NOLs be available for deduction against future group taxable income?
   * Will Black’s NOLs be available for immediate carryback, producing a tax refund in the near future?
   * Will Red produce net taxable income at levels that will accelerate the use of Black’s NOLs?
   * Will Red begin to produce new NOLs in the future?
   * Will Red’s new NOLs be deductible against group taxable income?
2. (LO 3, 10) Additional pertinent tax issues include the following.
   * How will the group charitable contribution deduction be computed in the future?
   * Will all of Brown’s charitable gifts be deductible against group taxable income (i.e., considering the 10% floor on a group basis)?
   * How will the group’s § 1231 gain or loss be computed in the future?
   * How will Brown’s realized gain and loss affect the group’s § 1231 netting and computation in the future?

1. (LO 3, 9, 10) Finding good consolidated return partners often means that contrary tax effects are matched together, resulting in a lower total Federal income tax.
   1. Probably a good match. Intercompany gains are deferred until a sale is made to a taxpayer outside of the consolidated group.
   2. Probably not a good match. The parties want to accelerate recognition of the realized losses, and consolidation results in the deferral of those losses.
   3. No effect. Tax return elections made by the parent of a consolidated group can differ from those made by other members of the filing group for the tax year.
   4. Probably not a good match. SubTwo must convert to a calendar tax year upon joining the ParentCo consolidated group, and this may result for the group in a bunching of more than twelve months of taxable income into the calendar year of the election.
2. (LO 3, 5, 10) Finding good consolidated return partners often, but not always, means that contrary tax effects are matched together, resulting in a lower total Federal income tax.
   1. Perhaps not a good match. The election to consolidate cannot be “turned on and off.” The election is binding on all future tax years, and this may not be a desirable result if both affiliates generate a positive taxable income. If an election is made and approved to “deconsolidate,” the same group cannot re-elect consolidated status for five years.
   2. Probably a good match, depending on the current marginal tax rates of the group members. If consolidation occurs, ShortCo’s foreign-source income could be used to free up the foreign tax credit carryforwards, resulting in immediate tax reductions. But also consider the currentyear effects on new foreign tax liabilities.
   3. Probably not a good match. An attractive consolidated return partner would allow ParentCo to shelter some of its Federal taxable income, and Small will produce such losses for only one tax year. Moreover, after a de-consolidation, the group probably could not re-elect to form a group again for five tax years, so planning flexibility would be lost.
   4. Probably not a good match, for purposes only of the charitable gift deduction. The consolidated ceiling on charitable contribution deductions will be lower than that of the unaffiliated parent, so some of the charitable gift deduction may be suspended and carried forward.

1. (LO 4) The consolidated return rules generally produce these results.

|  |  |  |
| --- | --- | --- |
| **Group of Entities** | **Eligible to Join a**  **Consolidated Group?** | **Why Not Eligible?** |
| a. Lima City Choral Artists Co-op | No | Exempt entities are ineligible to join a consolidated group |
| b. Columbus United  Health Insurance, Ltd. | No | Insurance companies are ineligible to join a consolidated group |
| 1. Bethke Services, Inc. 2. Tequila Telefono, organized in El   Salvador | Yes  No | Non-U.S. entities are ineligible to join a consolidated group |
| e. Vermont, South Carolina, and Utah Barber Shops, Inc. | Yes |  |
| f. Capital Management Partnership | No | Noncorporate entities are ineligible to join a consolidated group |
| g. Henry Pontiac Trust | No | Noncorporate entities are ineligible to join a consolidated group |

1. (LO 5) In most cases, the decision to consolidate must be made no later than the extended due date of the parent’s return for the year. Here, that date is September 15, 2019, when the forms 1120, 851, and 1122 must be submitted.
2. (LO 5)
   1. Under the *relative taxable income* method, the consolidated tax liability is allocated among the members based on the amounts of their separate taxable income. This might be preferred for cash flow purposes by a subsidiary that reports an operating loss for the tax year.
   2. When the *relative tax liability* method is used, the allocation is based on the hypothetical separate tax liabilities of the affiliates. This might be preferred for cash flow reasons by a subsidiary that is the source of large tax credits for the year.

1. (LO 6) TAX FILE MEMORANDUM

November 1, 2017

To: Tax File, Jeri Byers

From: Mandy Michael

Re: Adjustments to subsidiary stock basis

Adjustments to stock basis are made for the subsidiary’s allocable share of each of the following.

***Positive Adjustments***

* + Consolidated taxable income
  + Unused operating or capital loss

***Negative Adjustments***

* + Consolidated taxable loss
  + Operating and capital losses, used or carried back this year, if not previously deducted from basis
  + Dividends paid to parent out of the subsidiary’s E & P

1. (LO 6) A parent’s stock basis in a consolidated subsidiary never can go below zero. But when negative adjustments exceed the stock basis in the subsidiary, an *excess loss account* is created, in the amount of the negative adjustments. This means that annual operating and other losses of the subsidiary can continue to be deducted on the consolidated return; their use is not suspended as would be the case with partnerships and S corporations (see Chapters 10 and 12, respectively).

If the subsidiary stock is sold or redeemed by the parent when an excess loss account exists, the parent typically recognizes the balance of the account as capital gain.

* 1. The stock basis is zero. Friar now holds a $1 million excess loss account for Abbey.
  2. Such a disposition would trigger a $1 million capital gain for Friar.

1. (LO 6) There is no such concept as consolidated earnings and profits (E & P) in the Federal income tax law.

The subsidiaries keep track of their respective E & P balances on a pre-consolidated basis, as does the parent. A subsidiary’s E & P records its own operating results, and it makes E & P adjustments for its agreed-upon share of the consolidated Federal income tax liability. E & P of the subsidiary also reflects any gain/loss on intercompany transactions with other affiliates.

Likely’s operating profit increases Certain’s basis in the Lively stock. The related E & P adjustment occurs on Likely’s tax records.

1. (LO 6) Consolidated taxable income is derived using the following step-wise computational method.
   * Compute taxable income for each affiliate on a separate basis, applying the usual rules of Subchapter C and the rest of the Code.
   * Remove from each affiliate’s separate taxable income any *group items*. • Remove from each affiliate’s separate taxable income the tax effects of any *intercompany transactions*.
   * Account for any intercompany distributions and permanent eliminations from consolidated taxable income.
   * Use the combined amounts from all affiliates to compute the effects on consolidated taxable income of each of the identified group items. Add these positive or negative amounts back to taxable income (or the amount of the AMT base).
   * Isolate the effects of intercompany transactions on consolidated taxable income.
   * Combine all of the pertinent amounts into consolidated taxable income.
2. (LO 8) Perhaps not. At most, only $2 million of Mini’s NOL carryforward can be used in the first tax year, which is that entity’s cumulative contribution to consolidated taxable income, as the SRLY rules require. Then, § 382 further may reduce that deduction.
3. (LO 8) The separate return limitation year (SRLY) rules defer the deduction for the net operating losses of an affiliate until that corporation contributes positively to consolidated taxable income. The SRLY rules are intended to prevent a “trafficking” in the net operating losses of unsuccessful corporations, which might be acquired merely to obtain the NOL deductions. The SRLY rules attempt to keep an existing group from reducing consolidated taxable income by using current loss deductions that are traceable to an affiliate’s operations prior to its joining the consolidated group. The new affiliate’s NOLs are allowed, but only after that affiliate makes positive contributions to the taxable income of the group.
4. (LO 9) A consolidated group computes the following items on a group basis when filing its tax return, among others.
   * Net capital gain/loss
   * § 1231 gain/loss
   * § 199 domestic production activities deduction
   * Casualty/theft gain/loss
   * Charitable contributions
   * Dividends received deduction
   * Net operating loss
   * The foreign tax credit and other business tax credits and their recapture
   * Percentage depletion deduction
   * AMT exemption, preferences, and adjustments
5. (LO 9, 10)
   1. The matching rule generally defers gain/loss recognition until an asset is sold outside of the consolidated group. The matching rule applies a “one company with multiple divisions” approach to intercompany transactions. The acceleration rule applies when the matching rule is inappropriate, triggering immediate recognition of the gain/loss. The rules are mandatory; they apply whenever the transaction is structured to trigger the acceleration or deferral. With effective tax planning relative to the transactions, the entities can achieve the desired tax results.
   2. Taking into account the time value of money, tax advisers often recommend that taxable gains be deferred and deductible losses be accelerated. Thus, most taxpayers prefer to apply the matching rule to gains and the acceleration rule to losses.
6. (LO 9) The only reflection of these transactions in consolidated taxable income is in year 4, when the total $260 gain is recognized. The matching rule defers the year 3 realized gain, as though it were a sale between divisions of one corporation.
7. (LO 9) The only reflection of these transactions in consolidated taxable income is in year 4, when the total $160 loss is recognized. The matching rule defers the year 3 realized loss, as though it were a sale between divisions of one corporation. The matching rule is designed to prevent group members from accelerating loss deductions that are realized within the group.

# COMPUTATIONAL EXERCISES

1. (LO 5) The most commonly used tax sharing agreements are the relative taxable income and relative tax liability methods. Under the relative taxable income method, the consolidated tax liability is allocated among the members based on their relative amounts of separate taxable income. When the relative tax liability method is used, the consolidated tax liability is allocated based on the relative hypothetical separate tax liabilities of the members. IRS permission is required for the group to change from one allocation method to another.
   1. The consolidated taxable income is $14,500 ($10,000 − $1,500 + $4,000 + $2,000). The consolidated tax liability (assuming a 35% rate) is $5,075 ($14,500 × 35%).

b.

|  |  |  |  |
| --- | --- | --- | --- |
| **Entity** | **Separate Taxable Income** | **Allocation Ratio** | **Allocated Tax Due** |
| Parent | $10,000 | ($10,000/$16,000) × $5,075 | $3,172 |
| Sub1 | –0– | –0– | –0– |
| Sub2 | 4,000 | ($4,000/$16,000) × $5,075 | 1,269 |
| Sub3 | 2,000 | ($2,000/$16,000) × $5,075 | 634 |
| Total | $16,000 |  | $5,075 |

1. (LO 6) Upon acquiring a subsidiary, the parent corporation records a stock basis on its tax balance sheet equal to the acquisition price. At the end of every consolidated return year, the parent records one or more adjustments to this stock basis, as in the financial accounting “equity” method. This treatment prevents double taxation.

The adjustments are recorded on the last day of the consolidated return year or on the (earlier) date of the disposal of the shares. In this regard, positive adjustments to stock basis include the following.

* + An allocable share of consolidated taxable income for the year.
  + An allocable share of the consolidated operating or capital loss of a subsidiary that could not utilize the loss through a carryback to a prior year.

Negative adjustments to stock basis include the following.

* + An allocable share of a consolidated taxable loss for the year.
  + An allocable share of any carryover operating or capital losses that are deducted on the consolidated return and have not previously reduced stock basis.
  + Dividends paid by the subsidiary to the parent out of the subsidiary’s E & P.

Clifton’s basis at the end of each year is computed as follows.

* 1. Year 1: $2,400,000 − $250,000 = $2,150,000
  2. Year 2: $2,150,000 + $400,000 − $100,000 = $2,450,000
  3. Year 3: $2,450,000 + $180,000 − $300,000 = $2,330,000

1. (LO 8) In computing a consolidated NOL, remove any charitable contribution deductions and capital gain/loss, as those items have their own carryover periods. Any dividends received deduction remains in the NOL.

Operating loss $2,500,000

Charitable contributions +600,000 Net capital gain –1,100,000 Consolidated NOL $2,000,000

1. (LO 8) When a member leaves a consolidated return group, it takes with it the net operating loss carryforwards that are apportioned to it. Thus, assuming that SRLY and § 382 limitations do not restrict the deduction, Call reports a zero taxable income on its first two separate Forms 1120, and reports $100,000 on the third.

NOLs carried out of the Put group $2,000,000

Used in year 1 after leaving the group $ 700,000

Used in year 2 700,000 Used in year 3 600,000

Total NOL used after leaving the group $2,000,000

The NOL carryforwards apportioned to Put remain with the parent and any newly formed consolidated group.

1. (LO 9) Specifically, the following items are computed on a group basis with the usual C corporation tax effects applied to the combined group amounts.

* + Net capital gain/loss.
  + Section 1231 gain/loss.
  + Domestic production activities deduction.
  + Casualty/theft gain/loss.
  + Charitable contributions.
  + Dividends received deduction.
  + Net operating loss.
  + AMT adjustments and preferences.

Following the computational procedure, all of the group basis items are removed from each member’s separate taxable income. Then, using the consolidated taxable income figure to that point, statutory limitations are applied to determine group-basis gains, losses, income, and deductions.

Computing these items on a group basis does not always result in a reduction of aggregate group taxable income. Nevertheless, the possibility of using the group basis computations may affect transactions by group members late in the tax year when it becomes apparent that planning opportunities may be available. It also may encourage the taxpayer to seek out fellow group members that bring complementary tax attributes to the consolidated return.

* 1. Parent’s separate taxable income is $105,000 computed as follows.

Income from operations $100,000 + Capital gain income $10,000 − Charitable contributions $5,000 = Taxable income $105,000

* 1. SubCo’s separate taxable income is $45,000. Corporations are not allowed a deduction for capital losses; the losses may only offset capital gains.

* 1. Using the worksheet approach presented in text Exhibit 8.3, the $148,000 consolidated taxable income is computed as follows.

**Consolidated Taxable Income Worksheet**

# Separate Taxable Income Adjustments Post-Adjustment Amounts

Parent information $105,000 −$10,000

(capital gain)

+$5,000 $100,000

(contribution)

Subsidiary information 45,000 45,000

Group-basis transactions –0– +$8,000\*

|  |  |
| --- | --- |
|  | (capital gain) |
|  | −$5,000 3,000 |
|  | (contribution) |
| Intercompany events –0– | –0– |
| Consolidated taxable income | $148,000 |

\*The consolidated group can use the $2,000 capital loss to offset part of the $10,000 capital gain. Therefore, the net effect is $8,000.

# PROBLEMS

1. (LO 3, 7) Tax and book treatment of intercompany transactions are similar but not identical.

|  |  |  |
| --- | --- | --- |
| **Transaction** | **Financial Accounting Treatment** | **Consolidated Tax Return Treatment** |
| a. LittleCo pays a $1 million dividend to Big | Consolidated eliminating entry—No effect on book income | Consolidated eliminating entry—No effect on taxable income |
| b. LittleCo sells an asset at a gain to Big | No effect | No effect |
| c. Big sells the intercompanysale asset to an outsider | Big reports $550,000 gain | LittleCo recognizes $400,000 gain. Big recognizes $150,000 gain |

1. (LO 3) When an affiliated group exists, Federal income tax treatment often changes for the group members.

|  |  |  |
| --- | --- | --- |
| **Item** | **If Consolidated Return Is Filed** | **If Separate Returns Are Filed** |
| a.      b.          c.        d. | The payment is eliminated in dividend computing consolidated taxable income, so no tax liability results.  Only one 15% tax bracket is allowed to the *affiliated* group, so total Federal income tax is $22,250. An allocation method is used to determine the payment of each member.  Both corporations are fully liable for the $170,000 income tax liability. An allocation method is used to determine the payment of each member.  No restriction. A parent and subsidiary are allowed to use different tax accounting methods. | Boulder reports $1 million in income, then claims a $1 million (100%) dividends received deduction.  Only one 15% tax bracket is allowed to the *controlled* group, so total Federal income tax is $22,250.      Boulder is liable only for its $95,000 liability, and PebbleCo for its $75,000.      No restriction. A parent and subsidiary are allowed to use different tax accounting methods. |

1. (LO 5) Grand must pay the $2.5 million for Junior’s Federal income taxes, as consolidated return partners have joint and several liability as to income taxes due. The bankruptcy receiver will determine the ultimate disposition of the $1 million owed to the supplier, but Grand is not likely to have any responsibility for paying that obligation.
2. (LO 5) Consolidated tax liabilities are shared in the following manner. SubThree’s taxable income is negative, so its separate tax liability is zero.

|  |  |  |  |
| --- | --- | --- | --- |
| **Separate**  **Taxable Income** | **Allocation Ratio Allocated Tax Due** | | |
| Parent$ 850 | | 850/1,200 | $220 |
| SubOne 200 | | 200/1,200 | 52 |
| SubTwo 150 | | 150/1,200 | 38 |
| SubThree –0– | | 0 | –0– |
| Totals $1,200 | |  | $310 |

1. (LO 5) Consolidated tax liabilities are shared in the following manner.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Separate Taxable Income** | **Separate Tax Liability** | **Allocation Ratio** | **Allocated Tax Due** |
| Parent | $ 850 | $297.5 | 297.5/350 | $264 |
| SubOne | 200 | $0, after  applying energy  tax credit | 0/350 | –0– |
| SubTwo | 150 | 52.5 | 52.5/350 | 46 |
| SubThree | –0– | –0– | 0 | –0– |
| Totals | $1,200 | $350.0 |  | $310 |

1. (LO 5) ACE Adjustment = .75(ACE – Pre-ACE AMTI)

**Without consolidation** ParentCo .75($600,000) = $450,000

DaughterCo $0 {Negative $112,500 [.75($150,000)]

adjustment is wasted} Group $450,000

**As consolidated** Group .75($450,000) = $337,500

The unused “negative” ACE adjustment of $112,500 generated by DaughterCo is used by the group when a consolidation election is in force.

# AMT Exemption

The affiliates share one exemption, but because of the phaseout percentages, the exemption becomes zero whether or not a consolidation election is made.

Thus, the election to consolidate benefits the group overall by reducing the group liability by $22,500 ($112,500 reduction in aggregate ACE adjustment × 20% AMT), in a manner traceable to the computation of the ACE adjustment.

1. (LO 6)

|  |  |  |  |
| --- | --- | --- | --- |
| **Stock Basis at**  **End of Tax**  **Year** | **(a)** | **(b)** | **(c)** |
| 1 | $34 million | $34 million | $34 million |
| 2 | $37 million | $19 million | $0 stock basis, $15 million Excess Loss Account |
| 3 | $52 million | $34 million | $0 stock basis, $0 Excess Loss Account |

If a subsidiary is sold while its parent holds an Excess Loss Account, capital gain income is created to the extent of the account balance.

d. Year 1 ELA = (MAX 0,(– (Purchase price + Year 1 operating gain/(loss) – Year 1 dividend paid)))

Year 2 ELA = (MAX 0,(– (Purchase price + Year 1 operating gain/(loss) – Year 1 dividend paid + Year 2 operating gain/(loss) – Year 2 dividend paid)))

Year 3 ELA = (MAX 0,(– (Purchase price + Year 1 operating gain/(loss) – Year 1 dividend paid + Year 2 operating gain/(loss) – Year 2 dividend paid + Year 3 operating gain/(loss) – Year 3 dividend paid)))

1. (LO 6) The stock basis in a subsidiary is adjusted at the end of every tax year in a manner similar to that of the financial accounting “equity” method. Stock basis cannot go below zero, so an excess loss account is created when negative adjustments exceed the beginning-of-year stock basis.

|  |  |  |
| --- | --- | --- |
| **Tax Year** | **Operating Gain/(Loss)** | **Stock Basis** |
| 1 | $100,000 | $900,000 + $100,000 = $1,000,000 |
| 2 | ($800,000) | $1,000,000 – $800,000 = $200,000 |
| 3 | ($600,000) | $0 with a $400,000 excess loss account ($200,000 – $600,000) |

1. (LO 6) If subsidiary stock is sold while its parent holds an excess loss account, capital gain income is created equal to the extent of the account balance.

Amount realized from stock sale $250,000

– WhaleCo basis in MinnowCo stock (–0–) + Excess loss account 400,000

Capital gain income $650,000

1. (LO 7) Consolidated taxable income equals the following amounts.

**Year 1** $180,000 **Year 2** 220,000 **Year 3** 10,000 **Year 4** 335,000

The Orange losses offset the Blue income dollar for dollar, but they never become large enough to produce a consolidated taxable loss. Because both corporations produce ordinary income, there are no adjustments to make using the format of text Exhibit 8.3. There are no consolidated NOL carryforwards in any of the specified years.

1. (LO 7, 8) Consolidated taxable income equals the following amounts. [It is assumed that the group does not elect to forgo the carryback of the year 3 consolidated net operating loss.]

**Year 1** $520,000

**Year 2**  140,000

**Year 3**  0 ($150,000) NOL carryback. This generates a partial refund of the year 1 group tax liability. The year 3 NOL is fully used.

**Year 4** 525,000

1. (LO 8) In years when a group member files a separate return (e.g., due to a de-consolidation of the member from the group), each member can carry over only its apportioned segment of the group NOL. Thus, Ocelot can use its $1.5 million share of the group NOL carryforward on its separate return.
2. (LO 8) The NOL deduction is limited to $500,000, the annual § 382 amount.
3. (LO 8) Under the SRLY rules, the group cannot carry back the losses that Child brings into the group. Subsequent deductions are limited to the cumulative positive contributions toward group taxable income that are traceable to Child. Child’s NOL can be deducted by the Thrust group as follows.

**Year 1** $ 0 **Year 2** 1,500,000

**Year 3** 500,000 (exhausted)

1. (LO 9)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Separate**  **Taxable**  **Income** |  | **Adjustments** |  | **Post-**  **Adjustment Amounts** |

* 1. This intercompany transaction is subject to the matching rule. Realized gain is deferred, through an elimination in the computation of consolidated taxable income. B.I.G.’s $60,000 gain is recognized when SubCo later sells the land to Outsider.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| B.I.G. information | $190,000 |  |  | $190,000 |
| SubCo information | (20,000) |  |  | (20,000) |
| Group-basis transactions intercompany events |  | – $60,000 gain on |  | (60,000) |
|  |  | intercompany sale to SubCo† |  |  |
| **Consolidated** |  |  |  |  |
| **Taxable Income**    NOTES  † Matching Rule |  |  |  | **$110,000** |

* 1. The group result includes the $30,000 post-acquisition gain realized and recognized by SubCo on the land.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Separate**  **Taxable**  **Income** | | | | **Adjustments** | | **Post-**  **Adjustment Amounts** | |
| B.I.G. information | $90,000 |  | |  | $ 90,000 |
| SubCo information | 50,000 |  | |  | 50,000 |
| Group-basis transactions intercompany events |  | – $60,000 gain on | |  | 60,000 |
|  |  | intercompany sale to SubCo† | |  |  |
| **Consolidated** |  |  | |  |  |
| **Taxable Income**    NOTES  † Matching Rule |  |  | |  | **$200,000** |

* 1. Present value of the tax on the sale of the land, as deferred for 5 years = $60,000 deferred gain × 35% tax rate = $21,000 tax liability × .822 PV factor = $17,262.

Tax benefit to the group from the deferral of the gain = $21,000 tax if due for year 1 – $17,262 tax if due for year 5 = $3,738.

# RESEARCH PROBLEMS

1. TAX FILE MEMORANDUM

November 3, 2018

To: Lynne E. Schoenfeldt

Tax Director, Heron Group

Subject: Consolidated return, status of extension for election of affiliates

All members of a new consolidated group must consent to an election to file a consolidated tax return by filing a Form 1122 with the first consolidated return of the new group. Lacking such consents, the entities must file separate returns. Reg. §§ 1.1502–75(a)(1), –75(b)(3), –75(h)(2).

The Regulations allow the Commissioner to consider an election to have been made if, given all the facts and circumstances, a member of an affiliated group has joined in the making of a consolidated return (i.e., by properly including its income and deductions in a consolidated return and not filing a separate return [Reg § 1.1502–75(b)(2)] or if the failure to file Form 1122 was inadvertent [Reg. § 1.1502–75(b)(3)]. Further, the IRS can grant an extension of this filing requirement for up to six months, where the taxpayer has acted reasonably and in good faith. Reg. §§ 301.9100–1 and –3.

In PLR 9837020 (9/11/98), the taxpayer was in a position similar to that of the Heron Group. It recognized and admitted its mistake in applying for an extension of the election date. The IRS recognized that the group had acted in good faith in applying for the extension, but more importantly, it had acted as though a consolidated election already were in place, by computing consolidated taxable income in an appropriate manner.

A 30-day extension was granted, from the issuance date of the letter ruling, to execute a belated set of consents to document the creation of the new consolidated group.

Similar relief was granted by the IRS in PLR 200435014 (8/27/04), where the subsidiaries’ tax directors were confused as to the dates upon which the affiliated group rules were met. In PLR 200418033 (4/29/04), IRS relief was granted regarding an LLC that elected to be treated as a corporation so that it could join the consolidated group. The IRS granted relief in PLR 201220018 (5/18/2012), where membership changes occurred and a Form 1122 did not accompany the short-year Form 1120 for the new group’s first tax year. In PLR 201232015 (8/10/2012), the taxpayer did not even provide a rationale for why the Form 1122 had not been included, it just asked for (and received) IRS relief.

In each of the above cases, the parent computed the consolidated tax and taxable income correctly, and it included a correct Form 851 Affiliations Schedule with the return.

As the Heron Group appropriately included the income and deductions of Cardinal and Swallow in a timely-filed consolidated return, the Regulations under § 1502 allow the IRS to consider Form 1120 filed. Similarly, Reg. §§ 301.9100–1 and –3 allow the IRS to grant an extension of the filing requirement. Based on prior rulings, it would seem that the IRS may be willing to consider the election made, or to grant the extension, given the circumstances

2. LETTER TO CLIENT

November 16, 2017

Mary Ellen Rogers

Cutlinger Corporation

1101 Office Strip Lane, Suite 3 Hudson, OH 44237 Dear Mary Ellen:

It was good to see you at our firm’s golf outing last week. I wish your company continued success. Thank you for asking me about your issue as to the deduction for cleaning up the environmental damage during the EarthTones years.

My analysis of your situation follows that of the IRS, as confirmed in *Thrifty Oil Co*., 139 TC 198 (2012). I believe that you cannot claim a deduction for the environmental remediation costs.

The Tax Court agreed with the IRS’s interpretation that the taxpayer in *Thrifty Oil* should not be able to deduct the same loss twice. Under your facts, the IRS would take the position that the capital loss deduction and the environmental clean-up expenditures represented the same economic loss (i.e., traceable to the damages that EarthTones caused in its fields). That loss of value, here of about $30 million, already was the cause of the drop in the EarthTones stock price. It was claimed in computing Cutlinger’s earlier capital loss, so it should not be allowed “again” as to the remediation costs, now that the clean-up actually has occurred.

*Thrifty Oil* involved a more complex set of facts, including some related party transactions and a bankruptcy proceeding. However, the underlying argument of “one deduction per loss” was firmly stated by the Tax Court in the decision.

I’m happy to hear that issues related to the EarthTones investment are finally behind Cutlinger, and that the future of Golden West appears to be bright. I look forward to working with you going forward.

My comments are based on the information that you provided me concerning this tax matter. If those facts change in any material way, my comments may need to be revised. My tax advice for you is regulated by IRS Circular 230.

Sincerely,

Wally Biever, Tax Partner Biever and Beall, CPAs

3. The joint-and-several rule allows the U.S. Treasury to collect the outstanding income taxes of one member of an electing Federal consolidated group from any other group member, when necessary [Reg. § 1.1502–6(a)]. This rule applies to interest and penalties imposed as a result of IRS audits, as well as to the underlying tax liabilities.

However, the rule does not appear to apply to employment taxes. Chief Counsel Advice (CCA) 200913052 (3/09) acknowledged that a member’s employment tax obligations are its own, with no contribution required by any other affiliate. It should be noted, however, that the CCA addressed only a Federal unemployment tax obligation of a subsidiary. Graeter should determine whether similar protection is in place for the pertinent state.

# Research Problems 4 and 5

*These research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.*

# CHECK FIGURES

1. Consolidated TI $14,500. Sub3 liability $634.
2. Year 2: $2,450,000.
3. Consolidated NOL $2,000,000.
4. NOL used in year 1 $700,000. Reaches $0 after year 3.
   1. $45,000.
   2. $148,000.
   3. LittleCo, no effect.
   4. Big, $150,000 taxable gain.

30.a. Separate, $1 million DRD is allowed.

30.c. Consolidated, Boulder and PebbleCo are both fully liable for $170,000 of tax.

1. Grand is liable for $2.5 million.
2. $220 allocated to Parent.

1. $264 allocated to Parent.
2. Consolidation reduces group liability by

$22,500.

35.a. $37 million basis, end of year 2. 35.c. $15 million ELA, end of year 2.

1. $200,000 stock basis end of year 2.
2. $400,000 excess loss account.
3. $220,000 for year 2.
4. $520,000 for year 1; $140,000 for year 2.
5. $1.5 million NOL carryforward is used.
6. $500,000.
7. NOL deduction in year 2 = $1,500,000. 43.a. Consolidated taxable income $110,000. 43.b. Consolidated taxable income $200,000.

43.c. PV factor = .822.

# SOLUTION TO ETHICS & EQUITY FEATURE

**Delegating Authority to the Nonelected** **(p. 8-4).** Most observers find the delegation of control over consolidated return regulations to the Treasury to work well. Given the complex nature of capital structures and the tax effects needed to keep a competitive balance in a world economy, special expertise clearly is needed. The Treasury generally has been sensitive to the corporate community’s concerns about the law and compliance issues related to consolidated returns. Typically, it calls upon experienced Treasury staff, and occasionally noted attorneys and accountants, to take the lead in drafting the Regulations.

In addition, when a change in law is needed (e.g., as with respect to the recent change in the computations of the parent’s basis in a subsidiary’s stock), the Regulation process likely is more responsive to special needs and faster than is a legislative approach.

# SOLUTIONS TO ROGER CPA REVIEW QUESTIONS

Detailed answer feedback for Roger CPA Review questions is available on the instructor companion site (www.cengage.com/login).

1. a 4. a
2. b 5. c
3. d