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CORPORATIONS

Back to Basics: Consolidated Tax Returns

By Amie T. Whittington

Consolidated tax returns can often become quite complex and confusing. That's why it is important to get back to basics and understand the big picture of consolidated tax returns before tackling all of the intricate details. This article will outline the advantages and disadvantages of consolidated tax returns while covering the basic ideas behind these returns.

Who Files?

According to Internal Revenue Code Section ("Code Sec.") 1501, an affiliated group of corporations may file a consolidated return, as long as the members of the group consent to all the consolidated return regulations under Code Sec. 1502, prior to the filing of the return. An affiliated group is one or more includable corporations connected through stock ownership and having a common parent, as outlined in Code Sec. 1504(a)(1). The common parent directly owns stock in at least one of the other includable corporations.

Stock Ownership Requirement

The stock ownership requirement is a two-part requirement. A corporation must meet both the voting-control requirement and the value requirement. Under the voting-control requirement, the

controlling corporation must control at least 80 percent of the total voting power of the stock of the controlled corporation. And, to meet the value requirement, this 80 percent of stock must also have a value equal to at least 80 percent of the total value of all stock of the controlled corporation.

For the purposes of this two-part requirement, under Code Sec. 1504(a)(4), this stock does *not* include any stock that:

- is nonvoting;
- is limited and preferred as to dividends and does not participate in corporate growth to any significant extent;
- has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium); and
- is nonconvertible.

It is important to note that an includable corporation is defined as any corporation *other than*:

- corporations exempt from taxation under Code Sec. 501;
- insurance companies subject to taxation under Code Sec. 801;
- foreign corporations;
- corporations with respect to which a possession tax credit election under Code Sec. 936 is in effect for the tax year;

- regulated investment companies (RICs) and real estate investment trusts (REITs); or
- an S corporation.

Affiliated corporations that meet the includable corporation criteria and stock ownership requirements can elect to file a consolidated tax return. By doing so, the corporations become known as a "consolidated group." Consolidated groups must file Form 1122, *Authorization and Consent of Subsidiary Corporation To Be Included in a Consolidated Income Tax Return*, in the first year of the election to be treated as such, and file Form 851, *Affiliations Schedule*, for each year a consolidated return is filed.

Advantages

The most notable advantage of filing a consolidated return is that the loss from one member can be used to offset the income of the other members of the consolidated group. Another advantage relates to intercompany transactions, specifically gains on intercompany sales. A sale of property between members of a consolidated group generally has no immediate tax effect for either corporation. Any gain is deferred until certain events occur, usually the property's transfer to a nonmember. This is advantageous because the tax on this

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gain is deferred until this event occurs. In addition, the capital gains of one member can be used to offset the capital losses of another member in the current tax year.

Filing a consolidated return can be beneficial to corporations whose profit sharing plan contributions are limited due to insufficient earnings and profits. This is because affiliated group members can make contributions to the group's profit-sharing plan on behalf of these corporations, and this amount is not limited, if a consolidated return is filed.

Disadvantages

The most notable disadvantage is that the consolidated group must adhere to the consolidated return regulations, which are viewed as some of the most complex and detailed federal tax regulations. The deferral of gain on intercompany transactions can also be viewed as disadvantage, under certain circumstances. It may increase the group's present-value tax cost if tax rates increase, and it may cause a loss carryover to expire unused.

Another disadvantage is that any loss a group member realizes from the disposition of stock of a subsidiary member is generally disallowed. Certain deductions and credits are subject to limitations on a consolidated basis. These limitations can reduce the amount of deductions for dividends received, charitable contributions deductions and the foreign tax credit, among other deductions and credits.

A consolidated group is also subject to certain other consolidated loss limitations. These include separate return limitation year (SRLY) rules and Code Sec. 382 rules. Again, these rules can be quite complex and difficult to maneuver through.

Another big disadvantage is that many states do not permit the filing of consolidated state income tax returns. Some states require that each corporation file a separate tax return for state purposes. Also, even if a state does require or allow consolidated returns, not all states follow the federal consolidated return rules. So, an affiliated group that files a consolidated federal tax return may be subject to very different rules for state purposes. This disadvantage can be amplified if the group files in several different states, each with different consolidation rules.

Once an affiliated group decides to file on a consolidated basis for federal purposes, it generally must file a consolidated return for the duration of the group's existence. The group *can* elect to cease filing federal consolidated returns, if the IRS grants permission. Generally, the IRS will grant permission when federal tax law changes have a substantial adverse effect on a group's consolidated tax liability.

Conclusion

On paper, it seems that the sheer number of disadvantages, in comparison to advantages, would keep an affiliated group from filing a consolidated return; however, each group must weigh the advantages and disadvantages of its particular situation. Some of these disadvantages may not apply to every corporation, and for many affiliated groups, the ability to offset one member's income with another member's loss is of a greater importance than any of the potential disadvantages of consolidation.

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