CHAPTER 13 – COMBINING TAX ATTRIBUTES: NET OPERATING LOSSES AND AFFILIATED CORPORATIONS

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13-5. This problem focuses on the definition of an affiliated group under §1504(a). If a consolidated return can be filed, then the parent's losses can offset the subsidiary's profits with the unrelated third-party purchasers ending up with most of the stock (by value) in a corporation not subject to tax.

However, §1504(a) (a requirement for consolidated reporting under §1501) uses a voting and value test. By looking at value, the provision would prohibit consolidated reporting in the example in the previous paragraph, unless the preferred stock is described in §1504(a)(4). Preferred stock often is disregarded in measuring affiliation, allowing group's to raise capital by having a subsidiary sell excepted preferred stock. See §1504(a)(4). In the problem, the preferred stock may not qualify under § 1504(a)(4) for two reasons. First, the dividends are not limited since they can fluctuate with the U.S. Treasury obligation yields. §1504(a)(4)(B). Second, the stock is convertible. §1504(a)(4)(D). Arguably, since the dividend rate does not relate to corporate performance, it may qualify under § 1504(a)(4)(B) if it is not materially in excess of a market rate when issued. Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, p. 172 (1985). Since it is convertible into similar stock, the preferred stock may not run afoul of §1504(a)(4)(D) if the new preferred is not "another class of stock."

13-6. First, the separate taxable income of each corporation is determined. Treas. Regs. §1.1502-12. This computation is similar to the §1366 computation of "nonseparately computed income or loss" of a S corporation. Here, the ordinary business income of each corporation is its separate taxable income. Next, the consolidated taxable income is then computed under Treas. Regs. §1.1502-11(a). The net $80 of §1231 gain is treated as a capital gain and is combined with the aggregate $40 capital loss to produce a net $40 capital gain. This gain is combined with the $260 of the aggregate separate taxable income to produce $300 of taxable income. The charitable contribution is deductible under §170(b)(2) only to the extent of 10 percent of the taxable income. Therefore, $30 is deductible, leaving $270 of consolidated taxable income.

13-7. This problem deals with intercompany transactions.

13-7a. The lease of software from P to X is an "intercompany transaction," with P as the "selling member" and X as the "buying member." Treas. Regs. §1.1502-13(b)(1). Under the matching rule of Treas. Regs. §1.1502-13(c)(2), X takes its rental deduction into account under its accounting method, and P takes its rental income into account at the same time. Consequently, X and P take an offsetting income and deduction into account. P deducts $300 while X includes $300.

13-7b. As in problem 13-7a, under a similar analysis, P's $60 deduction and Y's $60 income inclusion offset.

13-7c. The sale of land by P to Z in Year 1 is an intercompany transaction, with P as the selling member and Z as the buying member. P recognizes a $100 gain on the sale, but does not take that gain into account until Z has income, gain, deduction, or loss from the land (Z's corresponding item). Note that Z takes a $400 basis in the land. §1012. Thus, when Z sells the land to an unrelated party in Year 2 for $650, it recognizes a $250 gain. If P and Z had been divisions of a single corporation, however, Z would have taken a $300 basis in the land and recognized a $350 gain on its sale of the land. Under the matching rule of Treas. Regs. §1.1502-13(c), in Year 2, P takes its $100 gain into account, matching the difference between the $350 (Z's recomputed corresponding item) and $250 (Z's corresponding item).

13-7d. On an installment sale, there is parallel reporting of the deferred gain. P takes its gain into account as Z recognizes its gain. Treas. Regs. §1.1502-13(c)(7)(ii) (*ex. 5*) (illustrating an installment sale).

13-7e. P defers its gain and takes it into account over the depreciation period. Treas. Regs. §1.1502-13(d)(1). P takes into account $10 of deferred gain annually. Treas. Regs. §1.1502-13(c)(7)(ii) (*ex. 4*) (illustrating depreciation deductions).

13-8. This problem focuses on intercompany distributions, investment basis adjustments, and excess loss accounts.

13-8a. This problem deals with the investment adjustments on subsidiary stock, intended to prevent a subsidiary's income or loss from being taken into account a second time on the group's disposition of the subsidiary stock. *See* Treas. Regs. §1.1502-32(a). Disregarding tax paid by the group, in year 1, P increases its basis in its X stock by $30 to account for X's $30 of taxable income. Treas. Regs. §1.1502-32(b)(2)(i) and (b)(3)(i). Note that X and P each increase its earnings and profits by $30. Treas. Regs. §1.1502-33(b)(1) (providing for the tiering up of earnings and profits). In year 2, before taking the distribution into account, X increases its earnings and profits by $20 to $50. (P correspondingly increases its earnings and profits by $20 under the "tier-up" rule.) X's distribution to P is treated entirely as a dividend. §301(c)(1). Under Treas. Regs. §1.1502-32(b)(2) and (b)(3), P reduces its basis in its X stock by $30 ($20 positive adjustment for X's earnings minus a $50 negative adjustment for the distribution). Because the $50 distribution is fully reflected in P's X stock basis, P includes no amount in its gross income for the distribution. Treas. Regs. §1.1502-13(f)(2)(ii). Note that X reduces its earnings and profits to $0 to account for the distribution.

13-8b. P's $100 basis in the X Corp. stock is decreased by the $160 loss of X Corp. in year 1, assuming that the group absorbs the loss in that year. Treas. Regs. §1.1502-32(b)(2)(i) and (b)(3)(i)(A). The $60 negative basis is called an "excess loss account" (ELA), and it is treated for all Federal income tax purposes as basis that is a negative amount. Treas. Regs. §1.1502-19(a)(2)(ii). In year 2, the basis is reduced again to the extent that the loss is absorbed by the group in that year. Assume that the group absorbs $100 of X's $140 loss.

Thus, P's ELA in its X stock increases by $100, from $60 to $160. On its sale of the X stock, P Corp. recognizes a gain of $240 ($80 amount realized plus $160 ELA). Note that X should be allocated its $40 loss when it leaves the group. *See* Treas. Regs. §1.1502-21(b)(2)(iv).