An Overview Of Consolidated Return Intercompany Transaction Regulations

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A. Background

1. The most important feature of consolidated return regulations is the ability of members to combine their respective items in determining consolidated taxable income ("CTI"). It follows that a group's CTI will be clearly reflected only if the effects of transactions between members are minimized. Consolidated return regulations applicable to taxable years beginning before 1966 generally provided that "unrealized profits and losses" in transactions between members of the group were eliminated. Former Reg. §1.1502-31A(b)(1)(i). This elimination approach avoided the need to examine the bona fides of intercompany transactions, and the result was similar to the treatment of transfers between divisions of a single corporation. But items were required to be recognized if the underlying property was resold outside the group in the same taxable year. Consistent with the elimination, the purchasing member took a carryover basis in the property. Former Reg. §1.1502-38A(b). Thus, if the purchasing member later sold the property outside the group, it
recognized the entire gain or loss (that is, the gain or loss eliminated in the intercompany transaction plus any amount attributable to the period during which it held the property). In conformity with this single-entity approach, all members were required to adopt a consistent method of accounting that clearly reflected the consolidated net income.

2. Although easy to administer, the pre-1966 elimination system became a source of distortion as illustrated by the permanent elimination achieved in some cases. See, e.g., Henry C. Beck Builders, Inc. v. Comm’r, 41 T.C. 616 (1964). Further study identified that pre-1966 consolidated return regulations created a number of distortions: (i) gain on some intercompany transactions might escape tax; (ii) the wrong member might recognize gain or loss at the wrong time; (iii) there might be an improper characterization of gain or loss; and (iv) there could be an incorrect reflection of earnings and profits (“E&P”) of the individual members of the group.

3. To cure the distortions, the regulations were overhauled for taxable years beginning after 1965 to adopt a deferred sale system that requires each member to take into account its items from intercompany transactions rather than shifting the items to another member. See Former Reg. §§1.1502-13, 1.1502-14, 1.1502-17, 1.1502-18, and 1.1502-31. The deferred sale system is a hybrid of single- and separate-entity treatment. Unlike the former elimination and carryover basis system, the deferred sale system requires separate computations by each member and extensive timing adjustments to achieve a form of single-entity treatment. The separate-entity computations are also used by other consolidated return rules, such as the systems for adjusting member stock basis and E&P. See Reg. §§1.1502-19, 1.1502-32, and 1.1502-33.

4. The emphasis of the deferred sale system on preserving location was designed to solve income-elimination problems, as well as the other identified distortions. But later Code amendments led to new problems that eventually compelled further revisions. Beginning in 1990, the mechanical rules of the 1966 regulations were identified as being too rigid for the rapidly changing environment, and they were supplemented by narrowly focused, temporary principles that responded to specific concerns. See, e.g., Former Reg. §§1.1502-13(l) through (o), and 1.1502-14(g); I.R.S. Notice 94-49, 1994-1 C.B. 358. These were stopgap measures, and the government undertook a more complete overhaul of the intercompany accounting system that culminated in the current regulations that operate through uniform principles that focus on the purposes of intercompany accounting. Notwithstanding the benefits of uniformity and principles, the current regulations are abstract and can be difficult to apply without careful study. Inevitably, tax accounting presents inherently difficult problems, and many of the intercompany difficulties are similar to the more general struggles for certainty under the separate return “clear reflection of income” standards under the Code. To reduce the uncertainty, the current regulations include an unusually large number of examples. Less common transactions that are not illustrated must be analyzed in light of the purposes of intercompany accounting, much like the analysis required under other accounting rules. See, e.g., section 446(b). Although the increasing emphasis on single-entity treatment does not simplify intercompany accounting, the current regulations reflect a conclusion that administrability will never be simple under any rational regime. The current regulations were proposed in 1994 and finalized in 1995. See T.D. 8597, 1995-2 C.B. 147 (final regulations); CO-11-91, 1994-1 C.B. 724 (proposed regulations); I.R.S. Notice 94-49, 1994-1 C.B. 358 (notice of hearing that accompanied proposed regulations). The final regulations are substantially unchanged.

5. The basic policy of preserving the location of intercompany transaction items continues to be compelled by Code and consolidated return rules that depend on the location of items within a group, particularly the 1986 Act repeal of the General Utilities doctrine (Pub.L. No. 99-514, §§631-33) and the investment adjustment system (Reg. §§1.1502-19, 1.1502-32, and 1.1502-33). Consequently, the current regulations retain the deferred sale approach of the 1966 regulations, but with enhanced single-entity treatment to more clearly reflect CTI.

6. The principal approaches of the former and current regulations are as follows:

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B. Intercompany Transaction Regulations

1. In General

a. Purpose. Intercompany transaction regulations state that the purpose of intercompany accounting 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 CTI or consolidated tax liability (“CTL”). Reg. §1.1502-13(a). The 1966 regulations had no statement of purpose, and an example of “creative” interpretation by the government is Rev.Rul. 89-85, 1989-2 C.B. 218 (response to “corporate CPR” transactions).

i. The amount and location of intercompany items are determined on a separate-entity basis.

ii. The timing, character, source, and other attributes of the intercompany items, although initially determined on a separate-entity basis, are redetermined under these regulations to produce the effect of transactions between divisions of a single corporation, rather than separate entities in a consolidated group.

b. Matching And Acceleration Rules. Two principal rules govern how intercompany transactions are taken into account and their consequences within the consolidated group. Reg. §1.1502-13(c) and (d).
i. 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.

ii. Under the acceleration rule, additional guidelines are provided for taking the items from an intercompany transaction into account if the effect of treating the consolidated members as divisions cannot be achieved.

c. Intercompany Transactions. An intercompany transaction is defined broadly as any transaction between corporations that are members of the same consolidated group immediately after the transaction. Reg. §1.1502-13(b)(1).

i. 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; S’s licensing of technology, rental of property, or loan of money to B, and B’s payment or accrual of its expenditures; and S’s distribution to B with respect to S stock. See, e.g., Tech.Adv.Mem. 2003-02-002; ILM 2006-17-036; ILM 2007-29-035.

ii. Each intercompany transaction is analyzed separately. For example, if S simultaneously sells two properties to B, one at a gain and the other at a loss, each property is treated as sold in a separate transaction. Similarly, each payment or accrual of interest with respect to a loan is considered a separate transaction. If two members exchange property, each member is S with respect to the property it transfers, and B with respect to the property it receives. Reg. §1.1502-13(b)(1)(iii).

iii. It is possible for an intercompany transaction to be rescinded under the generally applicable common law, separate-return principles. See, e.g., Rev.Rul. 80-58, 1980-1 C.B. 181; Reg. §1.1502-13(d)(3), Ex. 4(c). A special, practical consolidated return rescission applies to certain intercompany gain from member stock, by redetermining the gain to be excluded from gross income. See Reg. §1.1502-13T(c)(6)(ii)(C) (2008).

d. Items. Each party to an intercompany transaction can have items of income, gain, deduction, and loss from the 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).

i. For example, S’s gain from the sale of property to B is intercompany gain. If the sale results in both ordinary income and capital gain, each is treated as a separate intercompany item of S. An item is an intercompany item whether it directly or indirectly arises from an intercompany transaction. Reg. §1.1502-13(b)(2).

ii. Conversely, if B pays rent to S, B’s deduction for the rent is a corresponding deduction. If B buys property from S and resells it to a nonmember, B’s gain or loss from the resale is a corresponding gain or loss. If, instead, B recovers the cost of the property purchased from S through depreciation, B’s depreciation deductions are corresponding deductions. An item is a corresponding item whether it directly or indirectly arises from an intercompany transaction. Reg. §1.1502-13(b)(3).
iii. B’s corresponding items include amounts that are permanently disallowed or permanently eliminated whether directly or indirectly. Reg. §1.1502-13(b)(3)(ii).

iv. The treatment of costs and expenses related to an intercompany transaction have always been unclear, as well as how S computes the deferral (or acceleration) of its intercompany profit or loss not yet recognized by the time that B takes into account its corresponding item. An interesting example of the scope and manipulation of items is Reg. §1.1502-80(g)(6), Ex. 3:

(1) Example. X’s stock is owned 80 percent by M1 and 20 percent by M2. X operates two divisions, each generating prepaid subscription income that is deferred under a section 455 election. X distributes all of its assets in complete liquidation, with M1 receiving Division 1 (including its prepaid subscription income) and assuming the related subscription liability, and M2 receiving Division 2 (including its prepaid subscription income) and assuming the related subscription liability. For purposes of determining whether X’s deferred income attributable to Division 2 is taken into account from X’s liquidation, the distribution of property to M2 is not treated as a section 381(a) transaction because M2 is not an actual 80 percent distributee. Therefore, X’s Division 2 deferred income is taken into account in determining its items from the liquidation. Further, section 332 does not apply in determining any M2 income from consideration for assumption of X’s liabilities to deliver periodicals. If Division 2 originally generated $100 of prepayment income that was deferred under section 455, X expected to incur $70 of future performance expense, so that X expected to generate a $30 future profit, and X negotiated to split its $30 future profit equally with M2. By transferring $85 to M2 (who also expects to incur $70 of performance expense), X’s liquidation accelerates its $100 of section 455 deferred income but also its $85 deduction for payment to M2. These items net to $15 of X profit that is reflected in the group’s CTI. M2 therefore needs to take into account $15 of its future $70 of deductions (and none of its $85 of income) currently to offset this result and preserve the neutrality for the group. M2’s prepayment from X and its future expenses generating that intercompany income are both intercompany items. M2 takes into account its $85 payment from X and remaining $55 (its original $70, minus $15) of expenses over the remaining life of the underlying agreements.

e. Accounting Method. The intercompany transaction regulations are an accounting method to the extent they affect the timing of items. Reg. §§1.446-1(c)(2)(iii) and 1.1502-13(a)(3). Each member separately applies the rules, but application of the rules clearly reflects income only if CTI is clearly reflected. Treating intercompany accounting as an accounting method has significant consequences. For example, the Commissioner has broad discretion under section 446 to make adjustments to clearly reflect income. Moreover, changes in application of the current rules generally require consent of the Commissioner and possibly a section 481 adjustment. See Form 3115. Former intercompany transaction rules were generally considered by the courts to be a “method of reporting,” rather than a method of accounting, although the Service disagrees under the 1966 regulations. Compare General Motors Corp. v. Commissioner, 112 T.C. 270 (1999) (method of reporting) with Tech. Adv.Mem. 94-29-001 (method of accounting). See also ILM 2008-29-028 (Section 1382 timing for intercompany patronage dividend by cooperative overridden by the matching rule).