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I. Introduction

A. The continued existence of an affiliated group that is filing consolidated returns (a consolidated group) is important in many respects. The tax consequences associated with the termination of a consolidated group include:

1. Gain or loss on intercompany transactions may be accelerated and taken into income. § 1.1502-13.2

2. Excess loss accounts may be included in income. § 1.1502-19.

3. Tax years of members of the terminated group will be separate return limitation years (SRLY). § 1.1502-1(f)(3). Thus, any unused investment tax credits, net operating losses, capital loss carryovers, or other tax attributes of such members will be subject to the SRLY limitations if the overlap rule of § 382 is inapplicable. § 1.1502-3(c), -21(c), -22(c) (see discussion of overlap rule in Section V.E., infra). Losses of the continuing group’s common parent generally will not be subject to the SRLY rules as a result of the “lonely parent” exception to such limitations. §§ 1.1502-1(f)(2)(i), -1(f)(3), and –75(d)(2)(ii) (second sentence). But see CCA 2004-1026 (June 25, 2004), discussed in section V.E.2.A below, which limits the applicability of the “lonely parent” exception to certain separate return years of the continuing group’s common parent.

4. With certain exceptions, the requirement of continued filing of consolidated returns is ended. § 1.1502-75(a).

5. The taxable years of the subsidiaries are terminated if the group is terminated during a taxable year. This may accelerate return filing deadlines. § 1.1502-76.

6. Life insurance members of a life-nonlife consolidated return may be prohibited from joining in a consolidated return with the nonlife members for five years.

7. The sole surviving corporation from a series of intragroup mergers may elect to be taxed immediately as an S corporation upon the termination of the consolidated group.

8. Certain elections previously made by the consolidated group that is terminated will be terminated. See, e.g., Priv. Ltr. Rul. 200003012 (Oct. 20, 1999) (ruling that a target corporation’s election under § 1.1502-13(l)(3), which applied § 1.1502-13 to stock elimination transactions to which prior law would otherwise apply, was terminated as a result of the target corporation group’s termination on its acquisition by an unrelated consolidated group).

9. If a consolidated group terminates, its members may be precluded for five years from joining in the filing of a consolidated return with another affiliated group with the...
same common parent (or a successor of such common parent). See section 1504(a)(3).

10. In general, § 965 (relating to the temporary deduction for dividends received from controlled foreign corporations) applies to a consolidated group as though it is a single taxpayer. Special rules apply to members that join or depart from a group, including a departure caused by the termination of the group. To the extent that subsidiaries enter and leave consolidated groups, eligible dividends received by such subsidiaries may qualify for the § 965 dividends received deduction in multiple groups. See Notice 2005-38 (May 31, 2005) for detailed guidance on the application of § 965 in these situations.

B. The rules in § 1.1502-75(d), which provide when a group continues or terminates, are essentially “group accounting rules.” The requirements that a group continue despite a change in the common parent and that only one of multiple combining groups survives necessarily derive from the continued filing requirement, among other things. See Andrew J. Dubroff et al., Federal Income Taxation of Corporations Filing Consolidated Returns § 12.01, at 12-2 (2d ed. 1997).

C. Due to a conflict in judicial precedents applying the consolidated return regulations, it is uncertain whether the rules governing the continuation of a group will be applied literally or consistent with their somewhat uncertain purposes. Compare CSI Hydrostatic Testers, Inc. v. Commissioner, 103 T.C. 398 (1994) (no published administrative authority supporting taxpayer position; literal application of the consolidated return regulations despite contrary policies), aff’d, 63 F.3d 136 (5th Cir. 1995), and Woods Inv. Inc. v. Commissioner, 85 T.C. 274 (1985) (application of the consolidated return regulations as written; policy decision at issue did not have a clear resolution as evidenced by Treasury/IRS inability to promulgate regulations) with The Falconwood Corporation v. United States, 2004 U.S. Claims LEXIS 95 (Apr. 6, 2004) (regulation applied based on overall substance of transaction and the purpose of the regulation); Wyman-Gordon Co. and Rome Indus., Inc. v. Commissioner, 89 T.C. 207 (1987) (disregard for the literal language of the consolidated return regulations in light of the policies of the regulations). See also Walt Disney Inc. v. Commissioner, 97 T.C. 221 (1991) (deference to the IRS in interpreting consolidated return regulations), rev’d, 4 F.3d 735 (9th Cir. 1993); Salomon Inc. v. United States, 976 F.2d 837 (2d Cir. 1992) (same); Aeroquip-Vickers, Inc. v. Commissioner, 347 F.3d 173 (6th Cir. 2003) (same). The bright line rules set forth in the regulation for determining when a group continues indicate that the IRS might interpret the rules in accord with their literal language. However, the apparent substance-over-form inquiry required by the regulation militates in favor of interpreting the rules in accord with their purposes. At least in the case of certain transactions analogous to the downstream exception under § 1.1502-75(d)(2)(ii), the IRS has chosen to interpret the regulation consistent with the “single economic entity theory” underlying the consolidated return regulations rather than in accordance with the regulations’ literal language. See Rev. Rul. 82-152, 1982-2 C.B. 205, 205-06. More recently, the IRS’ National Office found a reverse acquisition based on the purposes of § 1.1502-75(d)(3), notwithstanding that the literal requirements of the regulation seemingly were not satisfied. See Tech. Adv. Mem. 9806003 (Oct. 1, 1997) (finding a reverse acquisition
even though, at the completion of the transaction, the former shareholder of the acquired corporation did not have any direct stock ownership interest in the acquiring corporation because it contributed the stock in the acquiring corporation to a wholly owned subsidiary).

D. Although the 2002-2003 Priority Guidance Plan indicated that IRS and Treasury would be issuing published guidance regarding “continuation of a consolidated group in certain transactions,” no revisions to the group continuation and termination rules under § 1.1502-75 were published, and this item was dropped from the 2003-2004 and 2004-2005 Priority Guidance Plans. See Treasury Department Office of Tax Policy and Internal Revenue Service, 2004-2005 Priority Guidance Plan (July 26, 2004); Treasury Department Office of Tax Policy and Internal Revenue Service, 2003-2004 Priority Guidance Plan (July 24, 2003); Treasury Department Office of Tax Policy and Internal Revenue Service, 2002-2003 Priority Guidance Plan (July 10, 2002).

II. Section 1.1502-75(d): When a Group Remains in Existence.

A. Section 1.1502-75(d) sets forth the rules that govern when a group remains in existence or terminates. Although the general rule provides that the common parent must continue as the common parent for the group to remain in existence, exceptions are provided.

B. The rules employ a “substance-over-form” approach intended to prevent the termination of a group as the result of a restructuring of its members. In addition, in the case of a combination transaction, the rules use a similar approach to identify which of the combining groups continues. Because the regulation, itself, is mechanical in nature, the rules may be manipulated in many instances to produce different results for transactions that are economically similar (if not identical) and, in certain cases, to produce results presumably not contemplated by the drafters.

C. The determination of whether a group continues or terminates is made based upon a corporate-level inquiry. Where a change in a group is merely a restructuring of its form, the continuation of that group is generally not affected. See § 1.1502-75(d)(2) and Rev. Rul. 82-152. In contrast, where two groups combine, the rules attempt to identify the larger of the two groups, determined by reference to the relative net equity capitalization of the two groups, as the surviving group. See § 1.1502-75(d)(3).

D. The focus on changes at the corporate level, rather than the shareholder level, should make irrelevant issues relating to whether the transaction in question is taxable or whether there is continuity of shareholder interest.

E. Regulations under § 1.1502-77, regarding the agent for the consolidated group, contain several provisions relating to the termination of the consolidated group under § 1.1502-75(d).

1. Under § 1.1502-77(a)(4)(i), the common parent for the consolidated return year remains the agent for the group with respect to that year until the common parent’s existence terminates regardless of whether the group terminates or continues with a new common parent.