

CONSOLIDATED RETURNS IN THE FEDERAL TAX SYSTEM

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Introduction

THE "affiliated group"¹ of corporations reporting taxable income or excess profits on a consolidated return has long been a hybrid in the Federal tax system. Never completely accepted as a single tax entity, this type of intercorporate association has been recognized to the extent of being permitted to file a consolidated return provided all member corporations subscribe in advance to regulations designed to restrict rigidly any windfalls or double deductions arising out of switching in and out of the consolidated accounting basis. Since 1934, exercise of the privilege of filing a consolidated return has been conditional on an increase in the applicable surtax rate by 2-percentage

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Author's Note: The opinions expressed in this article are strictly those of the author and in no way represent the views of the Internal Revenue Service.

¹ Section 1504 (a) of the Internal Revenue Code of 1954 reduced the intercorporate stock ownership requirement for affiliation from 95 per cent to 80 per cent. In all other respects, the definition of an "affiliated group" has not been changed. An "affiliated group" is defined as one or more chains of corporations connected through stock ownership with a common parent if (1) stock possessing at least 80 per cent of the voting power of all classes of stock (other than preferred stock) and at least 80 per cent of each class of the nonvoting stock of each corporation except the common parent is owned directly by one or more of the includible corporations, and (2) the common parent corporation owns directly stock possessing at least 80 per cent of the voting power of all classes of stock (other than preferred stock) and 80 per cent of each class of the nonvoting stock of at least one of the other includible corporations.

points, except for Western Hemisphere trade corporations. Under section 1503 (a) of the Internal Revenue Code of 1954, the 2-per cent addition has also been waived with respect to regulated public utility corporations.²

The additional tax for the privilege of filing consolidated returns has evoked continuous protests from businessmen and accountants since its imposition under the Revenue Act of 1932 and, in particular, ever since the 2-per cent rate was adopted under the Revenue Act of 1934. Hopes for the repeal of the tax were raised when, in his tax message of January 21, 1954, the President specifically recommended its elimination as a "penalty tax." But the bill reported by the Ways and Means Committee, H.R. 8300 (the Internal Revenue Code of 1954) continued the special tax on affiliated groups with the two exceptions mentioned.

This study briefly reviews the principal issues involved in the imposition of a tax for the use of consolidated returns. It contains background information in the form of a legislative synopsis of the consolidated returns provision and it compares, statistically, the position of

² Section 1503 (c) contains the definition of a regulated public utility for purposes of the tax on consolidated returns. A regulated public utility is defined to include electric, gas, water and sewage disposal companies; common carriers by rail, air, and water; intrastate, suburban, municipal or interurban railroads, trackless trolleys or bus systems; and finally certain lessor railroads and common parent corporations which are common carriers subject to part 1 of the Interstate Commerce Act.

such returns in the Federal tax system before and after the imposition of the special tax. It then examines the chief tax reasons for the decline in the use of consolidated returns and summarily touches upon the rationale of the tax.

By way of preliminary comment, it should be explained that income tax consolidation differs from consolidated accounting for ordinary business purposes. Generally speaking, income tax consolidation does not obliterate the separate taxable status of the member of an affiliated group but merely holds it in suspense over the period in which consolidated returns are filed. During this period, various adjustments are required in acknowledgment of the common ownership which invests the corporate group. In computing consolidated taxable income, certain income or loss items of the group are aggregated algebraically, but the member accounts are never combined directly as if they represented separate departments of a single enterprise. Certain deductions—net operating losses and carry-overs, capital gains and losses and carry-overs, charitable deductions, etc.,—which are eliminated in computing each member's taxable income are combined on a consolidated basis and are added to or subtracted from the consolidated taxable income of the group. The substance of consolidated accounting is preserved in determining the group's taxable income or net loss by eliminating profits and losses which have not been realized by transactions with outsiders and by disregarding intercompany dividends.

Apart from these adjustments of specified accounts required by the regulations, income tax consolidation is a somewhat tentative procedure, with one eye, so to speak, constantly cocked at

the separate taxable status of the corporations included in the group. But the adjustments made in connection with such consolidation may, nonetheless, produce a substantial difference in tax liability from that which would have resulted without consolidation.

Legislative Synopsis of Additional Tax on Consolidated Returns

From its inception, the use of consolidated returns was favored by revenue authorities as an instrument of administrative control in deterring tax avoidance by closely-related corporations. This problem in corporate tax administration first arose in the 1917 excess profits tax, the first corporate tax in the United States to apply a schedule of graduated, progressive rates. Anticipating complex enforcement difficulties if the numerous controlled corporations were not restrained from allocating income, credits, deductions and other items to minimize taxes, the Commissioner of Internal Revenue prescribed the use of consolidated returns by affiliated groups for excess profits tax purposes.³ Under the Revenue Act

³ Regulation 41, Article 631, explained the reasoning underlying this requirement as follows: "The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. . . . Where such branches or units of a business are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing,

(continued next page)

of 1918, such returns became mandatory for income tax purposes.⁴

Naturally, a chief reason for prescribing consolidated returns seemed to disappear when, under the Revenue Act of 1921, the corporate income tax reverted to a uniform, low, flat-rate levy. While consolidation was not eliminated by this Act, its use was made permissive, the option being reserved to any affiliated group.⁵

The 1930 depression intervened to alter abruptly the career of the consolidated return as a special accounting technique in Federal taxation. Emphasizing its adverse social effects, several senators and congressmen charged the consolidated return with fostering the rapid growth of holding companies. These integrated enterprises, it was alleged, gained tax advantages over independent business competitors by being permitted to offset the losses of some subsidiaries against the earnings of others. Substantial tax savings were also said to accrue from such loss offsets and from the indefinite postponement

charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group." *Regulations 43* (1920 edition).

⁴ The Commissioner's authority to prescribe regulations was validated retroactively in the Revenue Act of 1921.

⁵ In recommending an optional basis, the Senate Finance Committee stated: "Under existing law affiliated corporations are required to make consolidated returns. Owing to the complexity of the consolidated return in certain instances, the corporations affected would prefer not to make such consolidated returns, although it benefits affiliated corporations when one or more of them sustain a loss. The consolidated return is necessary to prevent evasion under the excess profits tax, but this necessity will disappear when the excess profits tax is repealed." Senate Finance Committee, *Internal Revenue Bill of 1921*, 67th Cong., 1st sess., Report No. 275, p. 20.

of tax on intercorporate transactions.

The tax-savings feature, however, was, to some extent, the product of a coincidental statutory development. In order to conserve shrinking revenues as the depression deepened, Congress, in the Revenue Act of 1932, reduced the carry-forward of net operating losses from two years to a single year, and in the subsequent National Industrial Recovery Act of 1933, it entirely abolished the loss carryover. When independent corporations were denied the right to average income, a valuable technical advantage ensued in the use of consolidated returns.

Partly to compensate for the tax savings allegedly obtained by holding companies through offsetting losses and partly to discourage holding companies, Congress levied an additional tax at the rate of $\frac{1}{4}$ of 1 percent on affiliated groups filing consolidated returns in 1932 and 1933.⁶ In 1934 and 1935, the additional rate was raised to 2 percent.⁷

Legislative pressure to abolish consolidated returns reached its peak in 1933-34. Late in 1933, the Ways and Means Committee, ostensibly seeking new sources of revenue, appointed a subcommittee to investigate methods of preventing avoidance and evasion of the Internal Revenue laws. The subcommittee agenda included the subject of consolidated returns. When the sub-

⁶ Originally, the rate of tax was viewed as roughly equivalent to the tax savings from consolidation. With subsequent revisions and complications in the corporate tax, the relationship has become haphazard and quite uncertain.

⁷ The National Industrial Recovery Act of 1933 provided for a rate of 1 per cent applicable in 1934 and 1935. Before this rate could take effect in these years, the Revenue Act of 1934 was enacted with a provision making the rate 2 per cent in 1934 and 1935.

committee reported in December of 1933, it recommended the complete elimination of consolidated returns which, it stated, had proved "of substantial benefit to the large groups of corporations in existence in this country."⁸ The subcommittee supported its recommendation by reaffirming the tax savings charge and by pointing out the additional benefits from tax postponement.

Before acting on the subcommittee's report, the Treasury Department was invited to comment on this proposal. A statement was accordingly submitted by the Acting Secretary of the Treasury in which the proposed elimination of consolidated returns was characterized as "a backward step."⁹ Many sound and legitimate business reasons were

found to exist for multiple incorporation of businesses. Furthermore, the normal operations of a multiple corporate group entailed arrangements for business contracts, property transfers, intercompany loans and services, and shifts of income from one corporation to another. The Secretary then suggested:

If the arrangement is a palpable evasion of the tax law, it can and should be disregarded, but many contracts which do shift income from one subsidiary to another or to the parent, are perfectly reasonable in themselves and cannot be proved to be evasions.¹⁰

In another part of his statement, the traditional Treasury Department position on the principle of consolidated returns was again expounded:

Businessmen and their professional advisers, the lawyers and accountants, have long recognized that the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, including therein the income and deductions of the parent and every subsidiary, with all intercompany transactions eliminated. Such a consolidated statement is simply a recognition of the actual fact that the separate corporations, though technically distinct legal entities, are, for all practical business purposes, branches or departments of one enterprise. This fact has been so thoroughly established for many years that many affiliated corporations today would find it a practical impossibility to determine the income and deductions of any one number of the group. . . . The principal reason given in the subcommittee's report for the abolition of the consolidated return is that this would prevent the loss of one subsidiary from being absorbed by the income of another or of the parent. For reasons already stated, this result is not likely to follow as a

⁸ The subcommittee indictment consisted of two paragraphs as follows:

"It cannot be denied that the privilege of filing consolidated returns is of substantial benefit to the large groups of corporations in existence in this country. This is especially true in depression years, for the effect of the consolidated return is to allow the loss of one corporation to reduce the net income and tax of another, and during a depression more losses occur. Another effect of the consolidated return is to postpone tax. This is because there is no profit recognized for tax purposes on intercompany transactions, and profits on a product of the consolidated group, passing through the hands of the different members of the group, are not taxed until the product is disposed of to persons outside the group.

"In the past, when any corporation could carry forward a net loss from one year to another, the consolidated group did not have such a great advantage over the separate corporation. Now that this net loss carryover has been denied, the advantage of the consolidated return is much greater on a comparative basis." *Prevention of Tax Avoidance, Preliminary Report of a Subcommittee of the Committee on Ways and Means Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws Together with Suggestions for the Simplification and Improvement Thereof*, 73rd Cong., 2d sess., December 1933, p. 10.

⁹ Statement of the Acting Secretary of the Treasury regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means, December 1933, p. 12.

¹⁰ *Ibid.*

practical matter. Subsidiary corporations now showing losses in separate statements, could arrange by intercompany contracts and by a readjustment of accounting methods, to obtain a fair share of the profits of the affiliated group. There is no way to prevent the bulk of such contracts because the Treasury cannot hold that a contract which enables a company to make a profit is necessarily unfair or evasive. Moreover, full recognition of intercompany transactions would often result in deductible losses as well as taxable gains. The fact that consolidated returns have been regarded as absolutely essential to check these practices in the past is sufficient basis for the belief that these evils will recur in the future. . . . The present law permits a return in accord with business practice, and gives the Treasury broad powers to make the necessary rules and regulations to prevent escape from the tax. . . .¹¹

Deferring to the Treasury Department's plea for the retention of consolidated returns, the Ways and Means Committee set aside the recommendation of its subcommittee and moved to retain the consolidated return. The Senate, however, stood firm in its position that consolidated returns should be discontinued. In Conference, the Senate's view prevailed and the general privilege of filing consolidated returns was abolished. An exception was made for railroads because they were frequently required by State law to incorporate their properties separately in each State in which such properties were located.

The 2-per cent rate of additional tax, effective in 1934 and 1935, was suspended in 1936 by the Revenue Act of 1936 and reinstated in 1942 by section 159 (a) of the Revenue Act of 1942.¹²

¹¹ *Ibid.*

¹² A tax on intercorporate dividend transfers was enacted under the Revenue Act of 1935, the first to

Not until the passage of the second Revenue Act of 1940 was the use of the consolidated return partially restored to all corporations. This Act permitted the use of consolidated returns for affiliated groups reporting excess profits taxes, but the general option was made available once more for the income tax under the Revenue Act of 1942. With the end of World War II, the option was indefinitely continued for income tax purposes. The Excess Profits Tax Act of 1950 again permitted the election of consolidated returns for excess profits tax purposes.

In reducing the intercorporate stock ownership requirement for affiliation from 95 per cent to 80 per cent and in eliminating the tax with respect to regulated public utilities, the Revenue Act of 1954 apparently reverted to a more liberal approach to consolidated returns. These steps may presage future legislative action to abolish the 2-per cent tax for all affiliated groups regardless of industry classification.

Importance of consolidated returns

Since its restoration to general use in 1942, the consolidated return has failed to regain the commanding position in the Federal tax system it held in the late 1920's and early 1930's. Between 1929 and 1951, the number of corporations using the consolidated return declined significantly, and this method of reporting taxable income lapsed into a position

put into effect a permanent schedule of graduated income tax rates. One of the purposes of the tax on intercorporate dividends was the installation of a tax as a deterrent to holding companies. Up to the time of this Act, dividend transfers among corporations had not been taxed. Now it was seen that corporate rate graduation might prove administratively unfeasible in combination with the absence of a penalty on dividend transfers. However, in its impetus toward corporate simplification, the tax on intercorporate dividends supplemented the tax on consolidated returns.

of minor importance in many industries in which it had previously been predominant.

No doubt the recent reduction in the intercorporate stock ownership requirement by a full 15 per cent and the

the net increase resulting from the liberalized ownership provision is not easy to estimate, since there are so many intricate factors involved in the election of a consolidated return by groups affected by a 20 per cent minority in-

TABLE 1

CONSOLIDATED INCOME TAX RETURNS FILED AND NUMBER OF SUBSIDIARIES INCLUDED, 1928-1950

Year	Consolidated Returns *						Number of Subsidiaries
	Total		With Net Income		With No Net Income		
	Number	Per Cent of Total	Number	Per Cent of Total	Number	Per Cent of Total	
1928	9,300	100.0%	5,870	63.1%	3,430	36.9%	n.a.
1929	8,754	100.0	5,408	61.8	3,346	38.2	30,112
1930	8,951	100.0	4,067	45.4	4,884	54.6	32,209
1931	8,495	100.0	2,698	31.8	5,797	68.2	31,307
1932	7,426	100.0	1,272	17.1	6,154	82.9	29,232
1933	7,101	100.0	1,880	26.5	5,221	73.5	28,589
1934	445	100.0	147	33.0	298	67.0	2,522
1935	63	100.0	9	14.3	54	85.7	464
1936	98	100.0	35	35.7	63	64.3	722
1937	93	100.0	30	32.3	63	67.7	693
1938	102	100.0	22	21.6	80	78.4	690
1939	108	100.0	31	28.7	77	71.3	715
1940	112	100.0	44	39.3	68	60.7	709
1941	107	100.0	65	60.7	42	39.3	706
1942	942	100.0	737	78.2	205	21.8	5,584
1943	1,282	100.0	1,005	78.4	277	21.6	6,165
1944	1,298	100.0	1,009	77.7	289	22.3	5,780
1945	1,409	100.0	1,080	76.7	329	23.3	6,093
1946	1,148	100.0	763	66.5	385	33.5	5,037
1947	1,210	100.0	767	63.4	443	36.6	5,349
1948	1,418	100.0	878	61.9	540	38.1	6,373
1949	1,679	100.0	936	55.7	743	44.3	6,825
1950	1,618	100.0	998	61.7	613	38.3	6,692
1951	1,940	100.0	1,180	60.8	760	39.2	7,551

Source: *Statistics of Income for 1947, Part 2*; Table 19; Treasury Releases No. S-2721, June 19, 1951, and No. S-3012, April 3, 1952; *Statistics of Income for 1950, Part 2, Preliminary Report*; *Statistics of Income for 1951, Part 2*.

* Excluding excess profits tax returns.

n.a. Not available.

elimination of the 2-per cent tax for most public utilities will promote the use of consolidated returns. In many corporate sectors, there is ample room for an expansion in the number of groups eligible to avail themselves of this method. In recent years, for example, only about 25 per cent or 35 per cent of all public utility income has been reported on a consolidated basis.

terest.

The statistical data below cover 1951 and preceding years.

Consolidated returns in relation to total corporate returns. In 1929-1932, the four-year period prior to the imposition of an additional tax, an average of 8,407 consolidated returns were filed each year by affiliated groups which included within them an average of about

30,715 subsidiaries. By contrast, in the four-year period, 1948-1951, the number of consolidated returns filed annually averaged about 1,640, approximately one-fifth of the previous figure, and the number of subsidiaries averaged 6,860, also about one-fifth of the earlier total. (See Table 1.)

corporations, over 50 per cent of their net income, and over 53 per cent of the income tax were accounted for on consolidated returns. In the years 1948-1951, the corresponding ratios had dwindled to 8.0 per cent, 7.8 per cent, and 8.1 per cent respectively. (See Table 2.)

TABLE 2

GROSS AND NET INCOME AND INCOME TAX REPORTED FOR ALL CORPORATE RETURNS AND FOR CONSOLIDATED RETURNS, 1928-1931 AND 1948-1951
(Money figures in billions)

	1928	1929	1930	1931	Average 1928- 1931	1948	1949	1950	1951	Average 1948- 1951
Gross income:										
All corporate returns	\$153.3	\$161.2	\$136.6	\$108.1		\$411.0	\$393.5	\$429.6	\$479.2	
Consolidated returns	69.8	72.5	65.9	50.2		31.3	30.1	30.9	45.7	
Ratio of consolidated to all returns ..	45.5%	45.0%	48.3%	46.5%	46.3%	7.6%	7.7%	7.2%	9.5%	8.0%
Net income:										
All corporate returns	\$10.6	\$11.7	\$6.4	\$3.7		\$36.3	\$30.6	\$44.1	\$45.3	
Consolidated returns	5.1	6.0	3.4	1.8		2.6	2.2	3.3	4.2	
Ratio of consolidated to all returns ..	47.7%	51.1%	52.5%	50.1%	50.4%	7.2%	7.3%	7.5%	9.3%	7.8%
Income tax:										
All corporate returns	\$1.2	\$1.2	\$.7	\$.4		\$11.9	\$9.8	\$15.9	\$19.6	
Consolidated returns6	.6	.4	.2		.9	.7	1.2	1.9	
Ratio of consolidated to all returns ..	49.9%	52.9%	56.0%	54.3%	53.3%	7.4%	7.5%	7.7%	9.7%	8.1%

Source: *Statistics of Income for 1949, Part 2*; Treasury Releases No. S-2721, June 19, 1951 and No. S-3012, April 3, 1952; *Statistics of Income for 1950, Part 2, Preliminary Report*; *Statistics of Income for 1951, Part 2*.

Note: Due to rounding of money figures, some percentages may appear inexact.

A more significant decline in the position of consolidated returns is measured by the proportion of total corporate gross and net income and income tax reported on consolidated returns. In the years 1928-1931, over 46 per cent of aggregate gross income of

Use of consolidated returns by various industry groups. A similar index may be used to measure the importance of consolidated returns in various industry groups. For this purpose, the proportion of any industry's income, gross and net, and of the tax paid may be com-

pared in two representative years. The years here selected for comparison are 1929 and 1951, reflecting changes over a 22-year period.

In 1929, outstanding major industry groups—mining, manufacturing, and public utilities—reported one-half or more of their total income and tax on

consolidated returns between net income and deficit (no net income) classes from 1932-1951 shows that the number of affiliated groups subject to the additional tax has increased substantially. When the additional tax was first levied in 1932, only 17 per cent of the total number of consolidated

TABLE 3

PER CENT OF TOTAL CORPORATE GROSS AND NET INCOME AND INCOME TAX REPORTED ON CONSOLIDATED RETURNS FOR SELECTED INDUSTRY GROUPS, 1951 AND 1929

Industry Group	Ratio of Consolidated Returns to All Corporate Returns					
	1951			1929		
	Gross Income	Net Income	Income Tax	Gross Income	Net Income	Income Tax
Agriculture, forestry, fishery ..	16.6%	28.7%	25.0%	33.4%	111.3% †	41.7%
Mining and quarrying	11.8	5.3	5.5	57.1	74.2	58.9
Construction	2.4	3.1	3.5	14.6	31.8	24.8
Manufacturing	9.8	9.1	8.3	57.2	47.2	59.0
Food, beverages, tobacco ...	8.4	9.0	8.6	62.0	54.8	52.3
Rubber	0.8	0.4	0.4	81.6	26.5	65.4
Chemicals	2.0	1.1	1.1	78.6	80.8	78.9
Metal products*	24.1	23.5	24.3	67.3	67.7	64.1
Petroleum and coal	47.8	50.0	45.0	n.a.	n.a.	n.a.
Public utilities	26.3	25.4	24.8	83.0	82.6	80.2
Transportation	18.1	7.1	6.4	n.a.	n.a.	n.a.
Communications	60.2	68.4	67.3	n.a.	n.a.	n.a.
Electricity and gas	27.2	24.7	24.9	n.a.	n.a.	n.a.
Trade	4.6	3.0	3.3	22.0	41.1	35.3
Service	11.9	13.8	13.5	27.8	57.5	40.5
Finance	12.1	4.4	7.3	20.8	18.9	22.2

Source: *Statistics of Income, 1951, Part 1*, and *Statistics of Income, 1929*.

* Only primary metals included in 1951 category.

† Reflects large amounts of deficits in total corporate group.

n.a. Not available.

consolidated returns. This was nearly uniformly true in many important branches of manufacturing. By 1951, the consolidated return did not predominate in any major industry, except communications, although it continued to occupy an important position in agriculture, public utilities, metal products, and petroleum and coal products. (See Table 3.)

Relation between net income and deficit consolidated returns and total assets classes. Analysis of the appor-

portion of consolidated returns between net income and deficit (no net income) classes from 1932-1951 shows that the number of affiliated groups subject to the additional tax has increased substantially. When the additional tax was first levied in 1932, only 17 per cent of the total number of consolidated

return taxpayers were taxable and in 1933-1935, the number of taxable affiliated groups did not exceed one-third of the total in any one year. By comparison, the World War II and post-war records have been consistently better. Over the period 1942-1951, roughly two-thirds to three-fourths of all affiliated groups incurred the tax. (See Table 1.)

Affiliated groups divided into net income and deficit classes also may be arranged by total assets classes. (See

Table 4.) Such a classification for the year 1949 clearly indicates that the proportion of consolidated returns in any total assets class showing net income varied directly with the size of that total assets class. Similarly, the proportion of consolidated returns in any total assets class showing a deficit varied inversely with the size of the total assets

dominant position of large corporate enterprise in the use of consolidated returns is demonstrated by the data in Tables 5 and 6. Table 5 compares 1929 and 1949 with reference to the number of returns and amount of net income or deficit distributed among ten net income and deficit classes. The data in this table indicate that a similar income

TABLE 4

ALL CONSOLIDATED RETURNS, CONSOLIDATED RETURNS WITH NET INCOME AND WITH NO NET INCOME DISTRIBUTED BY TOTAL ASSETS CLASSES, 1949

Total Assets Classes (In thousands of dollars)	All Consolidated Returns		Consolidated Returns With Net Income			Consolidated Returns With No Net Income		
	Number of Returns	Number of subsidiaries	Number of Returns	Per Cent of Total in Assets Classes	Number of subsidiaries	Number of Returns	Per Cent of Total in Assets Classes	Number of subsidiaries
Total	1,630	6,587	914	56.1%	4,647	716	43.9%	1,940
Under \$ 50	75	84	25	33.3	28	50	66.7	56
50 under 100	104	120	42	40.4	52	62	59.6	68
100 under 250	260	343	128	49.2	162	132	50.8	181
250 under 500	203	349	106	52.2	183	97	47.8	166
500 under 1,000	234	421	119	50.8	215	115	49.2	206
1,000 under 5,000	392	1,169	229	58.4	666	163	41.6	503
5,000 under 10,000	106	596	66	62.3	293	40	37.7	303
10,000 under 50,000	134	1,182	96	71.6	908	38	28.4	274
50,000 under 100,000	42	426	29	69.0	276	13	31.0	150
100,000 and over	80	1,897	74	92.5	1,964	6	7.5	33

Source: *Statistics of Income for 1949, Part 2, Preliminary.*

class. In other words, the larger the total assets class, the larger was the percentage of returns with net income and the smaller the percentage of deficit returns. Thus, affiliated groups in the smallest assets-size bracket, those with less than \$50,000, had only one-third of their number in the net income category and two-thirds in the deficit class. Those in the highest assets-size bracket—\$100 million and over—had 92.5 per cent of their total in the net income category and 7.5 per cent in the deficit group.

Relation between net income and deficit consolidated returns and net income and deficit classes. The pre-

pattern has prevailed for the two years compared in the 20-year period. However, the 1949 distribution is far more skewed than the 1929 distribution owing to the marked increase in the top bracket class in the number of returns included and, particularly, the proportionate amount of net income or deficit. In interpreting these data, allowance must be made, of course, for the change in the characteristic size of business units, money inflation, and the representativeness of the years compared.

Relation between ownership of selected balance sheet items and total assets classes. The predominant position of the large corporate group can also be

shown by the concentration in the ownership of certain selected balance sheet items indicative of financial strength. (See Table 6.) The salient fact emerging from the data in Table 6 is that the top assets-size group consisting of 4.5 per cent of all groups filing consolidated returns holds about 86 per cent of the total assets of such taxpayers

holding company structures, often compelling numerous operating subsidiaries to coalesce into more efficient, integrated units.

Compared to the more basic forces of technological change and operating efficiency, the tax factor appears as a sufficient, but not necessary, reason for the declining importance of consolidated

TABLE 5
PERCENTAGE DISTRIBUTION OF CONSOLIDATED RETURNS WITH NET INCOME
AND WITH NO NET INCOME BY NET INCOME AND DEFICIT
CLASSES, 1949 AND 1929

Net Income and Deficit Classes (In thousands)	1949				1929				
	Returns With Net Income		Returns With No Net Income		Returns With Net Income		Returns With No Net Income		
	Number of Returns	Net Income	Number of Returns	Deficit	Number of Returns	Net Income	Number of Returns	Deficit	
Under \$ 5	5	14.6%	*	21.3%	0.2%	14.5%	0.0%	18.9%	0.2%
\$ 5 under 15	15	15.0	0.1%	18.2	0.7	12.1	0.1	16.8	0.7
15 under 25	25	10.9	0.1	9.8	0.8	7.7	0.1	8.3	0.7
25 under 50	50	10.5	0.2	13.3	1.9	9.4	0.3	13.8	2.3
50 under 100	100	9.0	0.3	12.1	3.3	11.0	0.7	13.8	4.5
100 under 250	250	11.1	0.8	12.3	7.8	13.7	2.0	14.1	10.1
250 under 500	500	7.6	1.2	5.3	7.5	9.0	2.9	6.7	10.8
500 under 1,000	1,000	5.0	1.5	4.0	11.0	8.3	5.3	3.7	11.8
1,000 under 5,000	5,000	9.2	8.8	3.0	24.5	9.8	18.8	3.6	32.2
5,000 and over		7.2	87.2	0.8	42.3	4.4	69.7	0.4	26.8
Total		100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Special Tabulation, Statistical Division, Bureau of Internal Revenue and *Statistics of Income for 1949, Part 2, Preliminary.*

* Amount negligible.

Note: Figures may not add to 100.0% because of rounding.

and that the ownership of significant asset items by the other nine assets-size groups listed in the tabulation is very small by comparison.

Reasons for the decline in consolidated returns

The decline in the importance of consolidated returns may be explained by economic factors responsible for shrinking the population of affiliated groups as well as by tax factors. Strong pressures over the past two decades—technological change, war, heavy taxation, and legislative reform—have acted upon

returns. But, since this survey is confined to tax factors—rates and income tax provisions—the broad economic forces need not be considered. Outstanding among recent changes in tax provisions have been:

- (1) The enactment of liberal net operating loss carry-overs available to all corporate taxpayers.
- (2) The new rate schedules and structure of the corporate tax, particularly with respect to graduation and surtax exemptions.
- (3) With higher surtax schedules, the smaller amount of intercompany

dividends which, in a consolidated return, would offset the tax otherwise applicable to such dividend income at prevailing rates.

As these changes have the most direct bearing on the tax considerations responsible for the decline in the use of consolidated returns, they will be analyzed further.

The net operating loss carry-over. In 1933, a major reason for the statutory restriction on consolidated returns was the premium afforded affiliated groups in the offsetting of subsidiary losses against consolidated net income. In 1939, after a six-year denial, a net operating loss carry-over was reestablished in the form of a two-year loss carry-forward. To some extent, this provision neutralized the advantage of consolidated returns to affiliated groups with net operating losses. Subsequent revenue laws went even further in liberalizing the treatment of business losses. In 1942, when the general option to file consolidated returns was revived, a two-year carry-back was added providing a five-year averaging period for business income. Under the Revenue Act of 1950, the averaging period was extended to 7 years and under the Revenue Act of 1954 to 8 years.¹³ Although these provisions would probably make it possible for most losses to be absorbed eventually, the consolidated return continues to offer to affiliated groups a larger current income base against which losses can be offset in the taxable year. In an abstruse sense, this advantage can be interpreted as savings accruing from dispensing with the necessity for discounting a loss

by bringing it forward as a carry-over against future income.

The loss offset allowance in a consolidated return is, nevertheless, not without its drawbacks. It is hedged about by complex limitations which may appreciably reduce its value.

Although the liberalization of the loss offset provision has undoubtedly caused many affiliated groups to abandon the consolidated return, the benefit of current deductibility still seems to attract groups in many risky industries. For instance, extensive use of consolidated returns is made by the petroleum industry in which exploration and development activities may lead to losses by an affiliated corporation. A similar condition holds for such industries as chemicals and metals in which subsidiaries are often used to operate experimental or development pilot projects.

Structural changes in the corporate income tax. A fundamental structural difference between the prewar corporate income tax and the one in effect since 1942 derives from the steeper graduation in corporate tax rates. From the beginning of World War II, effective rates have, generally speaking, more than doubled for small corporations, but for large corporations they have more than tripled. Widening the effective rate gap has affected the relationship of consolidated to separate returns by interposing a calculable tax cost differential on small corporations which elect to merge into larger income units.

The diverse effect of these structural changes can be illustrated by comparing earlier tax scales with those in effect since 1942. In 1928 and 1929, when consolidated returns had reached a peak in popularity, most corporate taxpayers were subject to a relatively low, flat-

¹³ The Revenue Act of 1950 provided a 5-year carry-forward plus a one-year carryback. Under the Revenue Act of 1954 the carryback will be extended by an additional year.

rate tax on income. The rate was uniformly 12 per cent in 1928, and in 1929 it was 11 per cent, a specific exemption of \$3,000 being allowed on corporate incomes below \$25,000. In 1932 and 1933, just prior to the revocation of the general option to file consolidated returns, the rate was again made uniform

per cent on income up to \$25,000. With allowance for further progression on incomes in the "notch" area, as income rose from \$25,000 to \$50,000, rates jumped 13 percentage points to a maximum of 40 per cent. Throughout 1946-1949, progression on corporate incomes up to \$50,000 was continued, the

TABLE 6

SELECTED ASSET AND LIABILITY ITEMS, NUMBER OF CONSOLIDATED RETURNS WITH BALANCE SHEETS AND NUMBER OF SUBSIDIARIES, GROSS AND NET INCOME AND INCOME TAX PAID DISTRIBUTED BY TOTAL ASSETS CLASSES, 1951

(Total Assets Classes in thousands)

	Total Assets Classes										
	Total	Under \$50	\$50 under \$100	\$100 under \$250	\$250 under \$500	\$500 under \$1,000	\$1,000 under \$5,000	\$5,000 under \$10,000	\$10,000 under \$50,000	\$50,000 under \$100,000	\$100,000 or more
Number of returns ...	100.0%	4.1%	5.7%	14.2%	13.0%	12.1%	27.1%	8.4%	8.6%	2.3%	4.5%
Number of subsidiaries	100.0	1.3	1.9	4.6	5.1	6.2	18.4	12.2	17.4	5.6	27.3
Assets:											
Investments, government obligations ...	100.0	*	*	*	*	*	0.5	0.5	3.3	2.7	93.0
Other investments ...	100.0	*	*	*	0.1	0.2	1.9	1.9	6.1	5.4	84.4
Gross capital assets ...	100.0	*	*	*	0.1	0.2	1.4	1.4	4.6	4.4	87.9
Total assets	100.0	*	*	0.1	0.1	0.3	1.8	1.7	5.8	4.7	85.5
Liabilities:											
Capital stock, common	100.0	*	*	0.1	0.2	0.2	1.1	1.1	3.5	3.4	90.4
Surplus and undivided profits	100.0	*	*	0.1	0.2	0.3	1.9	2.1	7.9	5.7	81.8

Source: *Statistics of Income for 1951, Part 2.*

* Amounts negligible.

at 13¾ per cent. With uniform rates, it was not particularly material whether joint filing increased the amount of taxable income. This could no longer be disregarded in 1942, however, when the general option was restored for income tax purposes. Not only had tax rates increased greatly but the corporate income tax had become quite progressive up to the \$50,000 income level. Small business, defined as companies with net incomes up to \$25,000, was taxed at effective rates stepped up from 25 per cent on the first \$5,000 to 27

tax on small business varying from 21 per cent on the first \$5,000 to 23 per cent on net income up to \$25,000. Between the \$25,000 level and \$50,000, effective rates jumped 15 points to a maximum of 38 per cent.

Later, the tax structure was further remodeled. With the Revenue Acts of 1950 and 1952, progression was extended on up the income scale, the maximum effective rate being attained only at the level of, say, \$10 million. But the more revolutionary innovation was the sharp break in effective rates at

the \$25,000 income limit owing to the jump in marginal rates at that point. At this dividing line, under the 1952 rate schedule, the marginal rate moved up 22 percentage points. This effect was achieved by replacing intermediary rate progression with a simple, dual-rate structure consisting of a normal tax, applicable to all corporations, and a surtax applicable only to corporate net incomes exceeding a surtax exemption of \$25,000. In 1952, the normal tax rate was 30 per cent and the surtax rate, 22 per cent, resulting in a marginal rate of 52 per cent on the portion of income in excess of \$25,000. On and after April 1, 1956, the normal tax rate is scheduled to fall to 25 per cent and the marginal rate to 47 per cent on incomes in excess of \$25,000.

Since 1942 the burden on a taxpayer forfeiting its status as a small business had grown substantially heavier. Under the 1942-1949 tax schedules, savings could be achieved by splitting up aggregate net income into fragments of less than \$50,000, even though the 53 per cent marginal rate in the "notch" area made it preferable to fragmentize income into portions of \$25,000 or less.

At the 1950 and subsequent tax rates, there are no tax savings unless corporations or affiliated groups can be split up into units of \$25,000 or less for the purpose of multiplying surtax exemptions, the full value of each of which is now worth \$5,500.¹⁴

Rate progression prior to 1950 and the surtax exemption thenceforth has added a measurable money expense to affiliated groups filing consolidated returns. This point may be illustrated by means of simple examples.¹⁵ Under

¹⁴ The minimum excess profits tax credit of \$21,000 for excess profits tax years would have, at the 30-per cent rate, a full value of \$7,500.

the 1942 rates, a group composed of a parent and two subsidiaries splitting a \$75,000 income equally three ways in separate returns would incur a tax liability of \$20,250. By filing a consolidated return and paying taxes at the maximum rate plus the 2-per cent surtax addition, the tax liability would increase by \$11,250, nearly 56 per cent more than would be due on a separate return basis. Under the 1952 rates, the tax benefit forfeited for this group would amount to \$11,000.

Since the cost of foregoing the multiple surtax exemptions is a constant figure, determined only by the number of small subsidiaries in the affiliated group, its relative burden diminishes as the size of the group's income increases. It will amount to 11 per cent of a consolidated surtax net income of \$100,000 for a group with two small subsidiaries. If the group's consolidated surtax net income were \$1 million, the burden would be 1.1 per cent. From these calculations, it may be concluded that the rate deterrent to the election of consolidated returns is felt principally by affiliated groups of corporations with small incomes. It is, however, outweighed by other considerations in the case of affiliated groups made up of large corporations whose individual incomes may be well in excess of \$25,000.

It should be emphasized that the cost of foregoing multiple exemptions is but one among a multitude of factors which are brought into play upon the election of a consolidated return.

Intercompany dividend income. The amount of intercompany dividend income transferred within the affiliation is another important consideration in the

¹⁵ The effect of intercompany dividends is not considered.

decision to elect a consolidated return. Owing to the higher level of wartime and postwar rates, effective tax rates on dividend income have naturally risen in proportion to the increase in total corporate rates. However, the cost of filing a consolidated return, measured by the amount of dividend income otherwise taxable, has been cheapened concomitantly. Under the higher rates, proportionately less dividend income is needed to counterbalance the 2-per cent surtax addition. This condition has probably enhanced the utility of consolidated returns even where dividend income has tended to fall off.

In contrast to the nontaxability of intercompany dividend income before 1933, the last year of the general option to file consolidated returns, the tax on this type of income in 1942 had risen to a maximum effective rate of 6 per cent. The 2-per cent surtax charge would just equal the tax on dividend income if intercompany dividends amounted to one-third of consolidated surtax net income.¹⁰ Under the 1952 rates, with a maximum tax on dividends of 7.8 per cent, the counterbalancing dividend income had declined to about 26 per cent

¹⁰ This ratio has been computed by applying the formula:

$$\frac{x}{y} = \frac{.02}{ER}$$

where x represents the amount of intercompany dividends, y is the amount of consolidated surtax net income and ER the effective rate of tax on intercorporate dividends. With a maximum effective rate of 7.8 per cent from 1950 on through March 31, 1955, and a constant marginal rate of 52 per cent on income in excess of \$25,000, the intercorporate dividend income, which exactly offsets the 2-per cent surtax addition, works out to 25.64 per cent, expressed as a percentage of consolidated surtax net income. However, these figures would probably be limited in application to a pure context where no distortions resulting from other considerations would exist. As such they can best be regarded as illustrative only.

of consolidated surtax net income for all income over \$25,000.¹⁷ Under the rates to take effect on April 1, 1956, the corresponding figures will be 7.05 per cent and 28.4 per cent. Consolidated returns, therefore, have remained attractive to industries in which affiliated corporations regularly transfer substantial amounts of earnings internally as in public utilities, trade and service chains and integrated manufacturing groups.

Justification for the tax on consolidated returns

Although the tax on consolidated returns was originally justified as much by welfare (i.e. anti-holding company) reasons as by administrative or technical ones, only the technical reason appears to have survived to the present. In recent legislative hearings on tax revision, debate on the 2-per cent tax turned exclusively on the technical aspect. Welfare considerations were mostly ignored and, if they persisted at all, were transmuted into the technical argument stressing tax savings.

At present, the question of the tax treatment of consolidated returns remains fast in its peculiar dilemma. On technical grounds, the removal of the tax has been supported by the contention that consolidated returns afford no special tax benefits and the affiliated group constitutes a taxable entity no different from an independent business. But the weakness in this contention seems to stem from the instability of affiliation as a legal relationship.¹⁸

¹⁷ See footnote 15.

¹⁸ In rebuttal, it may be pointed out that the statistics show the number of affiliated groups filing consolidated returns to have been fairly constant since 1943 (See Table 1.). It cannot be determined, however, whether the constant totals cover the same or different taxpayers.

Thus, the elective feature of the law implies that affiliation is a contingent and easily broken tie. The innumerable adjustments prescribed by the regulations exist principally for the purpose of preventing tax benefits accruing to corporations moving in and out of consolidation. Even though the election to file consolidated returns is irrevocably binding for subsequent years,¹⁰ a new election has been allowed, because of changes in law alone, in about 18 out of the past 25 years and in at least 8 out of the 10 years 1944-1954.

Many tax technicians favor a mandatory-type commitment in order to stabilize the affiliated group in its election over a longer period of time. This, it is believed, would reduce materially the windfall benefits involved in the

propitious timing of an election—when a sizable surplus accumulation had to be shifted as dividends among members of an affiliated group, or when one or more members developed losses useful in offsetting the profits of others. A mandatory type of return, however, would create a hardship and prove to be a nuisance in an era of intense corporate activity. Moreover, the present 80 per cent stock ownership standard would appear to make such a commitment even more unsuitable.

¹⁰ An election to file consolidated returns is binding for later years except where (1) a new member joins the group and such corporation was not created or organized by another member (2) the law or regulations have been amended making "less advantageous to affiliated groups as a class" the continued filing of consolidated returns and (3) the Commissioner, upon application by the common parent, grants permission to change to separate returns.