Strafford

*Presenting a live 90-minute webinar with interactive Q&A*

# Consolidated Group Tax Allocations: Navigating Consolidated Return Rules

Leveraging Allocation Agreements in Acquisitions, Spin-Offs, Issuances of Stock; Implementing New Interagency Guidance for Banks

WEDNESDAY, NOVEMBER 12, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:


Stanley Barsky, Esq., **Cooley**, New York

Keith Fisher, Of Counsel, **Ballard Spahr**, Washington, D.C.

Wayne Strasbaugh, Partner, **Ballard Spahr**, Philadelphia


The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

**NOTE: If you are seeking CPE credit, you must listen via your computer — phone listening is no longer permitted.**

# Tips on Drafting Tax Sharing Agreements

By Stanley Barsky

Stanley Barsky

Stanley Barsky is an associate in the tax practice group of Cooley LLP, New York. He wishes to thank Lesse Castleberry for his helpful insights.

Drafting a tax sharing agreement is an arduous process. However, it can be manageable if the drafter identifies all interested parties, the items that the tax sharing agreement should address, and the parties' respective stakes in those items.

## A. Introduction

This article offers suggestions on drafting tax sharing agreements in two contexts. First, a continuing consolidated group may need a tax sharing agreement to address concerns of outside constituents. Second, if a member leaves a consolidated group, a tax sharing agreement can spell out the group's rights and obligations vis-à-vis the departed member.

Professionals who are asked to draft tax sharing agreements usually approach the project with trepidation. They know that failure to address all potential scenarios can trigger a dispute and that the drafter may be blamed for failing to anticipate and prevent it. At the same time, there is very little public information that would give a drafter insight into what issues commonly give rise to disputes. That is because tax sharing agreements usually have arbitration clauses, which means that contests remain private. Perhaps the best sources of information about what disputes may arise are publicly available tax sharing agreements.

Disputes regarding tax sharing agreements tend to involve material items that the agreement fails to expressly address. These disputes often can be anticipated and prevented at the drafting stage if the drafter has a solid grasp of the facts. First, the drafter should identify all interested parties. (See Part B.) The obvious candidates are the parties to the tax sharing agreement; however, there can be others. Second, the drafter should identify the items that the tax sharing agreement should address. (See Part C.) This requires a solid grasp of the parties' businesses and material items of income and expense, and also an appreciation of the stakes each interested party has in the material items. Finally, the drafter should consider the tips outlined in this article. (See Part D.)

## B. Identify the Interested Parties

It is important to identify all interested parties when drafting a tax sharing agreement, even those that are not signatories to the agreement. For example, regulatory mandates usually must be respected regardless of how active the regulator is in the drafting of a tax sharing agreement. Others, such as outside creditors, may not assert or be aware of their interests, but it is still a good idea to anticipate how those interests may affect the parties.

**1. Continuing consolidated group.** Regulators, creditors, outside shareholders, officers, and employees may be affected by how a company's share of the consolidated federal income tax liability is determined. The existence of an interested party may not be immediately apparent. For example, in the context of a family-run business, compensation of a particular common shareholder of the parent corporation may be determined by reference to the financial performance of a particular subsidiary, which in turn will be affected by the subsidiary's share of the consolidated tax liability.

**2. Member leaving a consolidated group.** When a member leaves its consolidated group, such as in a sale or split-off, the old group, the new owners, and possibly all of the parties discussed above may want to expressly allocate pre-separation (and possibly post-separation) tax items between the departed member and its former group.

## C. Identify the Relevant Items

It is important to consider all of the pertinent facts that may be relevant to a specific group or transaction. The drafter is better off with a checklist of potentially relevant items because without one, it is too easy to overlook an item that turns out to be material. The following list is a starting point.

**1. Substantive items.**

**a. Continuing consolidated group.**

**i. Consolidated tax liability of a continuing group.** In the context of a continuing consolidated group, it is important to allocate the consolidated tax liability among the members if the parties expect one member's losses or credits to offset another member's taxable income. The Internal Revenue Code and Treasury regulations provide various rules for allocating the consolidated tax liability among the group members, but only for the purposes of determining the members' respective

earnings and profits and investment basis adjustments.[1] Tax sharing agreements usually adopt one of these methods for the more important purpose of allocating responsibility for the consolidated tax liability among the members. When choosing a method, keep in mind that the methods described in reg. section 1.1502-32(b)(3)(iv)(D) and -33(d), unlike the methods specified in section 1552, permit the parties to take into account absorption by one member of another member's tax attributes.

**ii. Tax refunds.** In general, the IRS pays tax refunds to the parent corporation.[2] If the refund ultimately belongs to a subsidiary, it may be important to specify the capacity in which the parent corporation receives the refund, that is, whether the parent is an agent or a debtor of the subsidiary. The clearest example of why this may matter is when parent and subsidiary, each having outside creditors, both file for bankruptcy. If the parent receives the refund as an agent of the subsidiary, the parent's creditors should be structurally subordinated to the subsidiary's creditors regarding the refund. Otherwise, the subsidiary's bankruptcy estate may have to share the refund with the parent's other creditors.

**b. Member leaving a consolidated group.**

**i. Pre- and post-separation taxable income.** If a member leaves its consolidated group other than at the end of the year, its tax year ends at the end of the day on which it leaves the group.[3] The parties must allocate the items arising in the consolidated group's tax year spanning the separation between the member's tax periods that sandwich the separation. The old consolidated group is responsible for reporting the departed member's pre-separation income and the departed member is responsible for its post-separation income. The parties can allocate the departed member's items using a closing of the books or pro rata.[4]

**ii. Pre- and post-separation losses and credits.** The departing member will take its share of the consolidated net operating losses and credits with it when it leaves.[5] The consolidated group may insist on compensation for the lost losses and credits; however, in that case, the agreement should consider any limits imposed on the use of losses and credits by the departed member.[6] If a departing member joins a new consolidated group and the member's losses are likely to be of limited use (because of section 382 or otherwise), the purchasing group may choose to waive the member's previous losses.[7] This election is made to avoid the stock basis reduction that would occur when the losses expire unused.

A departed member may incur losses or credits after the separation that can be carried back to the pre-separation tax periods of its old group. If the post-separation losses or credits are carried back to a pre-separation tax period, the resulting refund will be paid to the common parent of the old group. The departed member will expect to be compensated for it. To simplify matters, the departed member may choose not to carry back its post-separation NOLs.[8] However, that is a time value of money disadvantage, as well as a bet that the departed member will be able to use the losses in the future.

**iii. Material expenditures.** It is important to identify the party that should receive a tax benefit (or the economic equivalent of the benefit) associated with any material expenditure. For example, the IRS may defer to a post-separation year a deduction for a particular expenditure that was claimed by the old group in a pre-separation year. The old group would lose the deduction. Or, in the case of an indemnity for a contingent liability, the indemnifying party may not receive any benefit under tax law if the indemnity payment is treated as a pre-separation capital contribution or distribution.[9]

**iv. Failure of tax-free treatment.** If a member leaves a consolidated group in a transaction that the parties expect to qualify for tax-free treatment, such as under section 355, it is important to expressly address which party should bear the burden if the departure gives rise to a tax liability. The parent usually raises this issue because the parent rather than the spun-off subsidiary bears the corporate-level burden of a taxable spinoff. Tax sharing agreements usually provide that if the tax arises out of one party's breach of its representations or covenants, that party is responsible for the tax.[10]

**2. Procedural items.**

**a. Items to consider regardless of whether a member is leaving the group.**

**i. Term.** In the case of a continuing group, the tax sharing agreement should have an open term. In

[1] *See* section 1552(a); reg. section 1.1502-33(d), -32(b)(3)(iv)(D).

[2] *See* reg. section 1.1502-77.

[3] *See* reg. section 1.1502-76(b)(1)(ii)(A)(1).

[4] *See* reg. section 1.1502-76(b)(2).

[5] *See* reg. section 1.1502-21, -79.

[6] *See* section 382; reg. section 1.1502-36(d).

[7] *See* reg. section 1.1502-32(b)(4).

[8] *See* section 172(b)(3).

[9] If the payment is treated as a pre-separation capital contribution, the parent corporation should have a higher tax basis in the stock of a subsidiary. However, the additional basis may be useful to the old group only if the departed member left the old group in a taxable transaction.

[10] As a practical matter, the departed member may not have the wherewithal to fully satisfy its indemnity obligation.

the case of a member leaving the group, tax indemnities typically run until the statute of limitations on the underlying tax expires.

**ii. Timing of payments.** Payments under a tax sharing agreement should be due when the payments, including estimated tax payments, are due to (or received from) a taxing authority.

**iii. Interest.** Interest is normally charged on late payments. Interest could be based on the applicable federal rate or the payee's cost of borrowing funds. (The former may turn out to be a bargain rate to the obligor.) Failure to charge arm's-length interest may provide an incentive to contest an otherwise noncontroversial obligation under the agreement (except to the extent that the obligation reflects an interest component that the payee owes to a taxing authority).

**b. Member leaving a consolidated group.**

**i. Preparation of tax returns.** Each party should prepare its own tax returns. Also, it may be important for one party to have the right to review (and possibly consent) to another party's tax return, for example, if the first party is managing a tax issue that could be implicated on the second party's tax return. For confidentiality reasons, sometimes the taxpayer will permit only the other party's accountants to review its returns and will not permit the accountants to share detailed return information with the other party.

**ii. Tax audits and contests.** Each party usually controls its own tax audits and contests. In the event of an indemnity obligation, the indemnifying party should make sure that the indemnified party does not give up or trade issues for which it is indemnified. Accordingly, the indemnifying party should insist on the right to control the contest, and if that is not possible, to review and consent to settlement of any item that will give rise to the indemnity obligation. The indemnified party could condition the indemnifying party's right to participate in the contest on the indemnifying party's acknowledgment of its indemnity obligation.

**iii. Cooperation.** It is usually in the interest of the parties to cooperate, and they should expressly commit in the agreement to do so. (A dispute about a particular provision of a sale or separation agreement, or the tax sharing agreement, can sour the relationship between the parties.)

**iv. Tax rate.** Frequently, the purpose of a tax sharing agreement is to reach a different outcome than the one that would result under the tax laws. However, a tax sharing agreement generally cannot shift an item of income or expense between the respective tax returns of the parties.[11] The indemnified party's actual tax cost may be used to determine the amount of the indemnity but this approach can lead to messy tax accounting and disclosure issues. To avoid these problems, indemnity payments can be based on an assumed tax rate such as the highest marginal federal, state, and local tax rate imposed on a C corporation, all of the income of which is allocated to a particular jurisdiction, or the effective rate if the company has a rate that is determined by outside accountants for independent business reasons. The parties should recognize that by choosing a single tax rate, they will either overstate or understate the indemnified party's actual tax cost.

### D. Drafting Tips

Consider the following tips when drafting the tax sharing agreement.

**1. Try to gather the facts before you start drafting.** Track down the relevant facts. There are two main categories. First, there are facts about the businesses of the parties to the tax sharing agreement. What are the sources of income in the economic sense? What are the expenditures? What are the assets and liabilities, including any contingent liabilities? What are the tax attributes? What is the tax audit history? Second, in the case of a separation, there are the terms of the separation or sale agreements.

**2. Understand the tax law.** The tax law determines the obligation to pay taxes independently of what a tax sharing agreement may provide.[12] To a large extent, the purpose of a tax sharing agreement is to either confirm or change the economic effect of tax law on the parties. Accordingly, it is necessary to know how the material items would be treated in the absence of a tax sharing agreement.[13]

It is also important to consider the tax treatment of payments made under a tax sharing agreement. In the context of a continuing group, the tax law generally respects an allocation of tax liability among group members in accordance with the principles outlined in section 1552 and the percentage method under reg. section 1.1502-33(d)(3).[14] If a member does not pay its obligation, the amount not

---

[11]Some provisions effectively provide for ''shifting'' of items. *See* reg. section 1.1502-36(d), -76(b).

[12]Moreover, each member of a consolidated group is severally liable for the full amount of the group's tax liability. *See* reg. section 1.1502-6.

[13]For the authoritative discussion of the consolidated return regulations and related provisions, see Andrew J. Dubroff, Jerred G. Blanchard Jr., Marc A. Countryman, and Steven B. Teplinsky, *Federal Income Taxation of Corporations Filing Consolidated Returns* (Matthew Bender, rev. ed.).

[14]*See* reg. sections 1.1502-32(b)(3)(iv)(D) and 1.1552-1(b)(2).

paid is treated as a distribution, a capital contribution, or both, depending on the relationship between the obligor and the obligee.

In the context of a member leaving the group, payments between the departed member and its former group relating to an item that arose in a pre-separation tax period should be characterized as if they occurred immediately before the member left the group and should be treated as a capital contribution, a distribution, or both, depending on the relationship between the payee and payer immediately before the distribution.[15] If a payment under a tax sharing agreement between a departed member and its old group does not relate to an item that arose in a pre-separation tax period, it may be difficult for the payee to avoid taxable income in connection with the payment.

**3. Arm's-length terms.** It can be tempting for a parent corporation to dictate the terms of a tax sharing agreement. However, it is important to abjure heavy-handedness, lest the subsidiary try to wriggle free of its obligations.[16]

**4. Precedents.** As with all complicated agreements, it is never a good idea to draft a tax sharing agreement from scratch. That is fraught with perils and is unnecessarily time-consuming. When drafting a tax sharing agreement, it is advisable to search for models that are more or less on point. The model can serve as a checklist of topics to be covered and provide some boilerplate that can be adopted virtually intact.

**5. Arbitration.** Disputes arising out of tax sharing agreements are contract disputes, the resolution of which sometimes depends on subtle tax rules. There are a lot more disputes arising out of tax sharing agreements than one would conclude after examining tax news, reported decisions, and filed briefs. Some are settled. Some are arbitrated. (Many tax sharing agreements have arbitration clauses.) A detailed analysis of the pros and cons of arbitration are beyond the scope of this article. Nevertheless, it is generally understood that arbitration (1) helps keep conflicts confidential, (2) is quicker and less costly than litigation, and (3) helps to ensure that conflicts are resolved by experts.[17]

[15]*See Arrowsmith v. Commissioner*, 344 U.S. 900 (1952). A recent ruling suggests that the IRS may treat a selling group as having income if the selling group and the buying group agree after the sale to cause the departed subsidiary to carry back post-sale losses to pre-sale years, and divide the resulting tax refund. *See* ECC 201310039.

[16]For an example of a subsidiary claiming that its parent breached its fiduciary duty to the subsidiary in the context of a tax sharing agreement, see *Marvel Ent. Grp. Inc. v. Mafco Holdings Inc.*, 273 B.R. 58 (D.C. Del. 2002). For an excellent discussion of *Marvel* and the issues it raised, see Dale L. Ponikvar and Russell J. Kestenbaum, "Aspects of the Consolidated Group in Bankruptcy: Tax Sharing and Tax Sharing Agreements," 58 *Tax Law.* 803 (2005).

[17]*See* Martin Domke et al., *Domke on Commercial Arbitration*, section 1:4 (2013).