Wyman-Gordon Co. and Rome Industries, Inc. v. Commissioner, T.C. Memo. 1988-292

Discharge of indebtedness income, even when excluded from taxable income due to insolvency, does not automatically increase earnings and profits to reduce an excess loss account in consolidated tax returns if it leads to excessive tax benefits and undermines the purpose of consolidated return regulations.

Summary

Wyman-Gordon Co., the parent of an affiliated group, sought to reduce its excess loss account (ELA) related to its insolvent subsidiary, Woods & Copeland, by including Woods & Copeland's discharge of indebtedness income in its earnings and profits. This discharge income was excluded from Woods & Copeland's taxable income due to insolvency. The Tax Court held that discharge of indebtedness income excluded from taxable income due to insolvency does not automatically increase earnings and profits for the purpose of reducing an excess loss account in consolidated returns, particularly when it would create double tax benefits and contradict the policy of consolidated return regulations. The court emphasized the primary objective of consolidated return regulations to prevent tax avoidance and ensure a clear reflection of income tax liability.

Facts

Wyman-Gordon Co. (Wyman-Gordon) was the common parent of an affiliated group that included Rome Industries, Inc. (Rome) and Woods & Copeland Manufacturing, Inc. (Woods & Copeland). Wyman-Gordon made loans to Woods & Copeland, which became significantly indebted. Woods & Copeland incurred net operating losses in 1977 and 1978 that were used to offset the consolidated taxable income of the affiliated group. These losses resulted in Rome establishing an excess loss account (ELA) with respect to its stock in Woods & Copeland. In 1978, Woods & Copeland transferred all its assets to Wyman-Gordon in partial satisfaction of its debt, resulting in a discharge of $2,038,161 of indebtedness. Woods & Copeland, being insolvent, excluded this discharge of indebtedness income from its taxable income but included it in its earnings and profits to reduce Rome's ELA.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Wyman-Gordon's consolidated federal income tax liabilities for 1977, 1978, and 1979. After concessions on other issues, the Tax Court was left to decide the effect of discharge of indebtedness income on earnings and profits and the computation of the excess loss account. The Commissioner argued that Woods & Copeland should not include the discharge of indebtedness income in its earnings and profits, leading to a larger ELA for Rome. Wyman-Gordon argued that the discharge of indebtedness income should increase earnings and profits, reducing the ELA.

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Issue(s)

1. Whether discharge of indebtedness income, which is excluded from taxable income due to the insolvency of the subsidiary, should be included in the subsidiary's earnings and profits for purposes of adjusting the excess loss account under consolidated return regulations.

Holding

1. No, because including discharge of indebtedness income in earnings and profits in this context would allow the affiliated group to obtain excessive tax benefits by improperly reducing the excess loss account, which is contrary to the purpose and policy of consolidated return regulations.

Court's Reasoning

The Tax Court reasoned that the consolidated return regulations, authorized by Section 1502 of the Internal Revenue Code, are designed to clearly reflect the income tax liability of affiliated groups and to prevent tax avoidance. The court emphasized the policy against double deductions, citing *Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934). The court noted that allowing the discharge of indebtedness income to increase earnings and profits and reduce the ELA would provide a double tax benefit: the group had already used Woods & Copeland's losses to offset consolidated income and Wyman-Gordon had taken a bad debt deduction. The court distinguished *Woods Investment Co. v. Commissioner*, 85 T.C. 274 (1985), and *Meyer v. Commissioner*, 46 T.C. 65 (1966), noting that those cases dealt with dividend taxation and not excess loss accounts in consolidated returns. The court also discussed Section 312(l), enacted as part of the Bankruptcy Tax Act of 1980, which, along with amendments to Section 108, indicated a Congressional intent to prevent tax mischief related to discharge of indebtedness income and earnings and profits. The court stated, "Without a clear mandate in the Code or regulations requiring a contrary interpretation, we adopt herein an interpretation of the pertinent provisions of sections 1.1502-19 and 1.1502-32, Income Tax Regs., that accomplishes a similar result with regard to years prior to the effective date of the 1980 legislation."

Practical Implications

This case clarifies that discharge of indebtedness income, even when excluded from taxable income due to insolvency, is not automatically included in earnings and profits for the purpose of reducing an excess loss account in consolidated tax returns. The decision highlights the importance of interpreting consolidated return regulations in a manner that prevents double tax benefits and ensures the clear reflection of income. It underscores that the overarching policy of consolidated return rules is to prevent tax avoidance. Legal practitioners should consider this case when advising clients on consolidated returns, excess loss accounts, and the

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tax implications of discharge of indebtedness income within affiliated groups, particularly in insolvency situations. The case emphasizes that the specific context of consolidated returns and the potential for double deductions will heavily influence the tax treatment of discharge of indebtedness income concerning earnings and profits and excess loss accounts.

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