X and Y corporations are wholly-owned subsidiaries of P corporation, and M and R corporations are wholly-owned subsidiaries of X corporation, all of which qualify as members of an affiliated group as that term is defined in section 1504. Prior to 1971 each member of the affiliated group entered into an agreement that provided for the filing of a consolidated Federal income tax return, the allocation of consolidated tax liability in accordance with section 1552(a)(2), the computation of a hypothetical tax for each member of the affiliated group on a separate return basis, and a transfer of funds from members whose hypothetical tax was reduced to members whose losses or credits generated such tax reductions. Under the agreement all funds are to be paid directly to P, which in turn, will disburse the funds in accordance with the agreement.

Neither P nor X had income or loss for consolidated return purposes for 1971. The actual consolidated tax liability for 1971 was 300x dollars. R had a loss resulting in a tax saving to the group of 300x dollars. M's separate entity tax was 400 (for which it made a payment to P) and its combined entity tax was 200. Y's separate entity tax was 200 (for which it made a payment to P) and its combined entity tax was 100.

With respect to the 200x dollars paid by Y to P, 100x dollars is in payment of Y's allocable share of the consolidated tax liability and the other 100x dollars is a distribution of a dividend to P. Of the 300x dollars paid by P to R, 100x dollars will be considered a contribution by P to the capital of X and a further contribution by X to the capital of R. With respect to the 400x dollars paid directly by M to P, 200x dollars is in payment of M's allocable share of the consolidated tax liability and 200x dollars will be considered as a dividend distribution to X. X will be treated as having made a capital contribution of 200x dollars to R. Under Reg. 1.1502-14 the amounts treated as dividends are considered intercompany items that are eliminated in computing the taxable income of the group. Thus, P is treated as having received dividends totalling 100x dollars and making a contribution to capital of 100x dollars to X. X is treated as having received a dividend of 200x dollars and having contributed 300x dollars to the capital of R.