INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-135559-06

Chief, Appeals Office

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer:

Holding:

Country A:

FSub1:

FSub2:

FSub3:

FSub4:

Year 1:

ISSUE

Whether, for purposes of the gross receipts test in § 165(g)(3)(B) of the Internal Revenue Code, the term "dividends" includes dividends received from a lower-tier subsidiary by the corporation whose stock became worthless, if the dividends are attributable to income derived from the conduct of an active trade or business by the lower-tier subsidiary.

CONCLUSION

For purposes of the gross receipts test in § 165(g)(3)(B), the term "dividends" includes all dividends, including dividends received from a lower-tier subsidiary attributable to income derived from the conduct of an active trade or business by the lower-tier subsidiary.

FACTS

Taxpayer is a domestic corporation that joins its parent in the filing of a consolidated return. Taxpayer wholly owned Holding, a Country A corporation through which Taxpayer conducted business in Country A prior to Year 1.

Holding was a holding company at the top of a group of Country A corporations (collectively referred to as the A Group). Holding wholly owned FSub1, an operating company engaged in active business, and FSub2, a holding company that wholly owned FSub3, an operating company, and FSub4. FSub4 was the owner of assets that were rented to FSub3 for use in FSub3's trade or business.

Thus FSub1 and FSub3 were operating companies whose gross receipts came from the conduct of an active business. FSub2 was a holding company whose gross receipts were dividends from FSub3, an operating company, and FSub4, whose receipts were primarily rents from FSub3.

More than 90% of Holding’s gross receipts were from dividends received from its subsidiaries.

In Year 1 Taxpayer discontinued operations in Country A due to unsatisfactory performance and operating losses. At this time the A Group began unwinding its affairs and disposing of its assets. Appeals and the taxpayer agree that in Year 1 the stock of Holding became worthless. We accept this representation. The issue is whether Taxpayer's loss on the worthlessness of Holding's stock was a capital loss or an ordinary loss, a question that turns on the character of Holding's gross receipts under

§ 165(g)(3)(B).

LAW AND ANALYSIS

Section 165(a) allows a deduction for any uncompensated loss sustained during the taxable year. Section 165(f) provides that losses from the sale or exchange of capital assets (that is, capital losses) are allowed only to the extent allowed in §§ 1211 and 1212. Under those provisions, a corporation's capital loss deduction in a given year is limited to its capital gains. Stock is a capital asset under § 1221 unless it falls within the listed exclusions in § 1221(a). Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988).

Generally, a loss from the worthlessness of an asset is ordinary due to the absence of a “sale or exchange," within the meaning of § 1222, whether or not the asset is a capital asset. See Rev. Rul. 93-80, 1993-2 C.B. 239.

In the case of a "security," however, defined in § 165(g)(2) as including stock in a corporation, § 165(g)(1) provides that the loss resulting from the worthlessness of a security that is a capital asset is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

As an exception, §165(g)(3) provides an ordinary loss to a domestic corporation whose stock in a domestic or foreign subsidiary meeting certain requirements becomes wholly worthless. Specifically, § 165(g)(3) provides that a security in a corporation that is affiliated with the taxpayer is not a capital asset for purposes of § 165(g)(1). A corporation is treated as "affiliated with the taxpayer" for this purpose if two requirements are met: an ownership test and a gross receipts test.

First, under § 165(g)(3)(A), the taxpayer must own directly stock in the corporation meeting the requirements of § 1504(a)(2) (at least 80% of the voting power and value of the corporation's stock).

Second, under § 165(g)(3)(B), more than 90 percent of the aggregate of the corporation's gross receipts for all tax years must be from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

Section 316(a) provides that for purposes of the income tax subtitle of the Code, the term "dividend" means any distribution of property made by a corporation to its shareholders out of accumulated or current earnings and profits. Certain items are treated as dividends by statute. See, e.g., § 565 (consent dividends).

Taxpayer is a domestic corporation that owns 100% of the stock of Holding, whose stock became wholly worthless in Year 1. Thus the ownership requirement of §165(g)(3)(A) is met.

However, more than 90% of Holding's aggregate gross receipts came from dividends paid to it by its subsidiaries. On its face, therefore, the gross receipts test in § 165(g)(3)(B) is not satisfied.

Taxpayer proposes, however, that in interpreting § 165(g)(3)(B), the Service should apply the rule found in § 1362(d)(3)(E). Section 1362 provides that an S corporation election is terminated whenever, among other things, a corporation has gross receipts more than 25% of which are passive investment income. Section 1362(d)(3)(E) provides that for purposes of the definition of passive investment income in § 1362(d)(3)(C), which is similar to the definition in § 165(g)(3)(B), an S corporation's passive investment income does not include dividends from subsidiary C corporations that meet the ownership requirements of § 1504(a)(2), to the extent the dividends are attributable to earnings and profits "derived from the active conduct of a trade or business."

The dividends received by Holding are "dividends" as defined in § 316(a), and there is no counterpart to § 1362(d)(3)(E) in § 165(g)(3)(B) that would draw a statutory distinction among types of dividends for § 165(g)(3)(B) purposes.

Taxpayer argues, however, that a distinction between dividends from active and passive sources is supported by the "analytical approach" followed by the Service in Rev. Rul. 88-65, 1988-2 C.B. 32.

Rev. Rul. 88-65 holds that if significant services are performed by a corporation in connection with the leasing of automobiles and trucks, the amounts received under the leases are not "rents," within the meaning of § 165(g)(3)(B).

In its analysis, Rev. Rul. 88-65 first cites the legislative history of § 165(g)(3), indicating that Congress intended to allow an ordinary loss deduction for worthless securities only when the subsidiary is an operating company, as opposed to an investment or holding company. See S. Rep. No. 91-1530, 91st Cong., 2d Sess. 2 (1970), 1971-1 C.B. 617, 618; S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543.

Next, pointing out that the term "rents" is not defined or discussed in the Code, Rev. Rul. 88-65 observes that § 165(g)(3)(B) groups rents with other types of investment income. To further elucidate this interpretation, Rev. Rul. 88-65 notes that the language in section 165(g)(3)(B) is similar to that found in two analogous contexts: § 1244(c)(1)(C) and § 1362(d)(3)(C).

Section 1244 allows an ordinary loss deduction for the sale or exchange of stock in certain corporations if, among other requirements, the corporation derived more than 50% of its gross receipts over five years from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. The § 1244 regulations define “rents” to exclude “payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant.” Section 1.1244(c)-1(e)(1)(iii).

Section 1362(d)(3) is described above. As Rev. Rul. 88-65 points out, two revenue rulings under the predecessor to § 1362(d)(3), former § 1372(e)(5), had concluded that short-term rents for motor vehicles are not "rents" within the meaning of that section if significant services are provided. See Rev. Rul. 65-40, 1965-1 C.B. 429; Rev. Rul. 76-469, 1976-2 C.B. 252.

Rev. Rul. 88-65 concludes from this analysis that to further the congressional purpose behind § 165(g)(3)(B) “it is appropriate to distinguish between active and passive rental income in the same manner as provided for in the regulations under § 1244 and former § 1372.”

Although we agree with the analysis of Rev. Rul. 88-65, and agree that the general purpose behind § 165(g)(3)(B) is to distinguish between active and passive income, application of the analysis in Rev. Rul. 88-65 leads to a different conclusion on the present issue.

First, as noted in Rev. Rul. 88-65, the term "rents" is not statutorily defined, and has been interpreted in analogous contexts to exclude payments where significant services are rendered. By contrast, the term "dividends" is defined in the Code, and we are not aware of a situation in which—in the absence of specific statutory authority—the term has been interpreted more narrowly so as to differentiate between active and passive dividends.

Second, an examination of the same analogous statutory contexts considered in Rev. Rul. 88-65 highlights the significance of express statutory authority.

As noted above, in defining "passive investment income" the regulations under § 1362 do in fact draw a distinction between dividends, depending on whether they derive from a corporation engaged in the active conduct of a trade or business. See § 1.1362-8. However, these regulations implement a specific statutory provision, § 1362(d)(3)(E), that requires the distinction, expressly extending S corporation status to certain companies that would otherwise be disqualified.

By contrast, the regulations under § 1244—which, like § 165(g)(3)(B), has no statutory counterpart to § 1362(d)(3)(E)—contain no provision characterizing dividends as active

income for purposes of that section. Rather, § 1.1244(c)-1(e)(1)(iv) defines dividends as follows:

> The term dividends as used in subdivision (i) of this subparagraph includes dividends as defined in section 316, amounts required to be included in gross income under section 551 (relating to foreign personal holding company income taxed to United States shareholders), and consent dividends determined as provided in section 565.

This regulation is consistent with the legislative history to § 1244, which explains its 50% gross receipts test as a restriction designed to limit ordinary loss treatment under § 1244 to "companies which are largely operating companies." H. Rpt. No. 2198, 85th Cong., 1st Sess. (1958), 1959-2 C.B. 709, 711.

Thus, unlike Rev. Rul. 88-65, where these two analogies provided a consistent interpretation, on the present issue they differ. Given these alternatives, the § 1244 context, not the § 1362 context, is the more appropriate analogy to look to in construing § 165(g)(3)(B).

Finally, in its analysis Rev. Rul. 88-65 emphasizes the distinction, drawn in the legislative history and several cases, between stock in operating companies and stock in holding companies.[1] Consistent with this approach, Rev. Rul. 88-65 looks at the activities *of the corporation whose stock became worthless*, and finds that where a significant amount of "rental" income is compensation for services *performed by that corporation*, it should be treated as active income. In the present case, by contrast, it is conceded that Holding was a holding company that itself engaged in no significant business activity. Thus—even assuming, for argument's sake, that we had the authority to read the statutory exception in § 1362(d)(3)(E) into § 165(g)(3)(B)—determining whether receipts are active by looking at the activities of *other corporations* would be taking a significant step beyond the analysis in Rev. Rul. 88-65. In fact, extending the exception in § 165(g)(3) to cover stock in holding companies as well as operating companies would directly contradict the stated rationale of Rev. Rul. 88-65.[2]

The taxpayer has identified several other provisions that treat dividends received from operating subsidiaries in certain situations as active income, including § 954(c)(3)(A)(i), relating to the definition of foreign personal holding company income as a component of

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[1] See Adam, Meldrum & Anderson Co., Inc., v. Commissioner, 215 F.2d 163, 167 (2d Cir. 1954), cert. denied, 348 U.S. 913 (1955); Byerlite Corporation v. Williams, 170 F. Supp. 48, 61 (N.D. Ohio), rev'd on another issue, 286 F.2d 285 (6th Cir. 1960).

[2] The taxpayer argues that § 165(g)(3)(B) is an older provision in need of "updating." If so, that is for Congress to do. We note that § 165(g)(3)(A) was amended as recently as 2000 (to cross-reference § 1504(a)(2) directly), but no change was made to 165(g)(3)(B). P.L. 106-554—APPENDIX G, 114 Stat. 2763A–587 (2000).

subpart F income; former § 552(c)(2), relating to the definition of foreign personal holding company income for purposes of the tax on undistributed foreign personal holding company income; and § 1297(b), which defines passive income for purposes of determining whether a foreign corporation is a passive foreign investment company. These are not administrative interpretations of an ambiguous statutory term, however. Like § 1362(d)(3), these provisions operate by identifying a class of dividends to be treated in a certain manner. In our view, these provisions reinforce the conclusion that in the absence of such statutory authority we should apply the normal definition of "dividends," as set out in § 316 and the § 1244 regulations.[3]

We conclude that the term dividends as used under § 165(g)(3)(B) means all dividends received by the worthless subsidiary, whether or not the dividends are attributable to income derived from the conduct of an active trade or business by a lower-tier corporation.

Having reached this conclusion, we do not need to address the sub-issues raised regarding how to characterize the dividends received by FSub2, and the rents received by FSub4, for purposes of § 165(g)(3)(B).

CAVEATS

We express no opinion with regard to whether the stock of Holding became worthless in Year 1.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

[3] Similarly, a recent advice memorandum concluded that for purposes of computing the gross receipts test of § 165(g)(3)(B) in the context of a consolidated return, under the consolidated return regulations a parent determines the character of dividends received by a worthless subsidiary by reference to the active or passive activities of lower-tier subsidiaries, in a manner similar to the result sought by Taxpayer here. Again, however, this result is reached by operation of statutory authority not found in § 165(g)(3): the broad grant of authority to issue legislative regulations under § 1502. See, e.g., § 1.1502-13(a)(2) (separate and single entity treatment of intercompany transactions). The present situation, which concerns the normal operation of § 165(g)(3) in a nonconsolidated setting, is distinguishable.