INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 165.06-00, 165.06-02
CASE-MIS No.: TAM-128895-08

Appeals Area Director

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

Corporation A =

FSub=

x =

Country A =

y =

Year 1 =

z =

ISSUE:

Whether the “gross receipts test” of § 165(g)(3)(B) of the Internal Revenue Code precludes Taxpayer from deducting an ordinary loss for the worthless stock of a wholly-owned operating company that never received any gross receipts.

CONCLUSION:

The gross receipts test of § 165(g)(3)(B) does not preclude Taxpayer from deducting an ordinary loss for the worthless stock of a wholly-owned operating company that never received any gross receipts.

FACTS:

Taxpayer, a domestic corporation and member of the Corporation A consolidated group, owned 100 percent of FSub. FSub is a controlled foreign corporation organized to for and x in Country A. FSub obtained x and for y from Country A. The required FSub to the and to used on the if FSub to x in . FSub y but to x in . FSub all of its for y in Year 1.

As of December 31, Year 1, FSub’s balance sheet showed liabilities exceeding its total assets. FSub’s financial statements showed no gross receipts during its existence. Taxpayer states that if FSub’s activities had been successful, it would have generated substantial gross receipts from operations. The Taxpayer, the LMSB Operating Division (LMSB), and the Appeals Division (Appeals) all agree that FSub functioned as an operating company, as opposed to an investment or holding company.

Taxpayer’s investment in FSub became worthless in Year 1, the year in which it its final , thus entitling Taxpayer to a worthless stock deduction in that taxable year. The loss is equal to Taxpayer’s basis in the FSub common stock, which was $z. Taxpayer claimed an ordinary deduction for its basis in the worthless stock of FSub under §165(g)(3) of the Code.

LAW AND ANALYSIS:

Section 165(a) of the Code allows as a deduction any loss sustained during the year and not compensated for by insurance or otherwise.

Section 165(g)(1) of the Code provides the general rule that if any security which is a capital asset becomes worthless during the tax year, the resulting loss is treated as a loss from the sale or exchange of a capital asset. Section 165(g)(2) defines a security to include a share of stock in a corporation.

Section 165(g)(3) of the Code provides an exception to the general capital loss rule and allows a taxpayer that is a domestic corporation to claim an ordinary loss for worthless securities of an "affiliated" corporation. *See also* § 1.165-5(d) of the Income Tax Regulations. Under § 165(g)(3), a corporation is treated as "affiliated with the taxpayer" only if--

(A) the taxpayer owns directly stock in the corporation meeting the requirements of § 1504(a)(2) (i.e., at least 80 percent of the voting power and value of the corporation's stock) ["ownership test"], and

(B) more than 90 percent of the aggregate of the corporation's gross receipts for all taxable years has been 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 ["gross receipts test"]. *See also* § 1.165-5(d)(2)(iii), which provides that the gross receipts test applies for all the taxable years during which the subsidiary has been in existence.

In this case, the ownership test of §165(g)(3)(A) is satisfied because FSub is wholly owned by Taxpayer. The question is how to apply § 165(g)(3)(B) to FSub, an operating company that received no gross receipts during its existence.

LMSB argues that the specific, numerical gross receipts test of § 165(g)(3)(B) necessarily requires some amount of gross receipts and precludes § 165(g)(3)(B) classification when a company has no gross receipts. LMSB contends that the numerical gross receipts test is exclusive and that the Taxpayer may not resort to an alternative, subjective test for determining whether FSub is an operating company, or an investment or holding company.

Taxpayer and Appeals argue that where a subsidiary becomes worthless without ever receiving any gross receipts, the gross receipts test is inapplicable. In that case, the appropriate approach is to look to the purpose of the statute, i.e., permit ordinary loss treatment for subsidiaries that are truly operating companies, rather than investment or holding companies. Under this approach, FSub would qualify as an operating company under §165(g)(3)(B) classification, because it really operated and did not have any disqualifying passive investment income.

We agree with the Taxpayer and Appeals. Section 165(g)(3)(B) should not be read narrowly to impose an exclusive minimum gross receipts requirement as a condition for claiming an ordinary loss for worthless stock. Certainly, when a company has gross receipts the statute's numerical gross receipts formula should control. However, when a company has no gross receipts, the categorical denial of § 165(g)(3)(B) classification of operating company status can produce anomalous results clearly contrary to the statutory purpose. For example, LMSB's approach (categorical denial in the absence of gross receipts) would deny ordinary loss treatment for a company (like FSub) with no disqualifying passive investment income but would allow ordinary loss treatment for a very large company with millions of dollars of passive investment income as long as the amount of passive income was less than 10 percent of the company's gross receipts. We think that the legislative history supports a broader reading of the operating company exception to capital loss treatment.

The gross receipts test was apparently designed to determine whether a subsidiary is an operating company (for which an ordinary loss is allowed) or a holding or investment company (for which an ordinary loss is not allowed). The Revenue Act of 1942, Pub. L. No. 754, section 123(a)(1), 56 Stat. 798, 820 (1942), added § 23(g)(4) (the predecessor to §165(g)(3)), to provide for an ordinary loss for worthless stock instead of capital loss treatment of certain affiliated corporations. The legislative history indicates the purpose of § 23(g)(4) was to allow a parent corporation to claim an ordinary loss deduction for the stock of its subsidiary if it becomes worthless, regardless of whether the parent and subsidiary file a consolidated return or not. S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543. Section 23(g)(4) included an ownership test and a gross income (changed in 1954 to gross receipts) test.

Shortly after its enactment, § 23(g)(4) was amended by Congress to provide that certain rents and interest earned by an operating company were to be treated as operating income, rather than passive income, in applying the gross income test. *See* Pub. L. No. 235, section 112(a), 58 Stat. 21, 35 (1944); 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; 90 Cong. Rec. S121-122 (daily ed. Jan. 12, 1944) (statement of Sen. Davis). In introducing the amendment, Senator Davis noted that Congress' intent in enacting the gross income test was to permit the loss as an ordinary loss only when the subsidiary was an operating company as opposed to an investment or holding company. The intent of the change, as explained by Senator Davis, was to exclude certain rents and interest derived by a company that was solely an operating company from the scope of passive income in accordance with the intent of Congress. The rent and interest from the sources described were viewed as "incidental to the operating activities of the company" and as arising from a "direct result of its activities as an operating company." 90 Cong. Rec. S at 122.

We conclude that the legislative history supports Taxpayer's argument that Congress intended to permit ordinary loss treatment where the subsidiary is an operating company rather than an investment or holding company. We think that the numerical gross receipts test of § 165(g)(3)(B) was meant to implement that statutory intent, and applies when a company has gross receipts. However, the test should not be applied to deny operating company classification to a truly operating company (with no disqualifying passive income) that just happens to have no gross receipts. Because FSub functioned as an operating subsidiary of Taxpayer, and not as an investment or holding company, Taxpayer may take an ordinary loss deduction for the worthless stock of FSub.

CAVEAT(S):

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