**Internal Revenue Service**

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Department of the Treasury
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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B03
PLR-119676-10

Date:
November 19, 2010

In Re:

Legend:

Parent = .

Sub =

A =

B =

Year 1 =

Year 2 =

Date 1 =

C = .

Date 2 =

D =

a =

b =

c =

Year 3 =

Date 3 =

d =

e =

Date 4 =

Dear :

This responds to a letter dated May 7, 2010, and supplemental letters dated July 30, 2010 and October 29, 2010, submitted on behalf of Parent, requesting a ruling that Parent's worthless securities deduction with respect to its Sub stock will be an ordinary loss under § 165(g)(3) of the Internal Revenue Code.

FACTS

Parent and its domestic corporate subsidiaries, including Sub, are members of an affiliated group of corporations of which Parent is the common parent (collectively, the A Group). The A Group files, and has historically filed, a U.S. consolidated federal income tax return on a calendar-year basis, using an accrual method of accounting.

Parent is a savings and loan holding company. Sub operated as a federally chartered savings bank and previously was B, which was acquired by the A Group in Year 1. Sub is also the successor to numerous other banks acquired by the A Group. Since Year 2, Parent has directly owned all of the outstanding stock of Sub.

On Date 1, Parent and C, one of its non-banking subsidiaries (collectively, the A Debtors), commenced voluntary cases under chapter 11 of title 11 of the United States Code in the United States Bankruptcy Court. Parent's bankruptcy filing was precipitated by the seizure of Sub by the Office of Thrift Supervision and its placement into the receivership of the FDIC on Date 2, and the FDIC's immediate sale (Receivership Sale), on the same date, of substantially all the assets of Sub to D. The FDIC, as receiver, continues to act on behalf of the legal entity of Sub and holds the remaining assets (including sale proceeds) of Sub.

Prior to Date 2, Sub was Parent's principal operating subsidiary. Sub and its subsidiaries provided a broad range of banking services, primarily to consumers. These services included accepting deposits from the general public and making residential mortgage loans, consumer loans, limited types of commercial real estate loans (primarily loans secured by multi-family properties) and other services typically associated with providing banking services to the general public. A significant portion of Sub's mortgage loans were transferred to captive REITs formed by Sub and a predecessor bank. These REITs regularly purchased mortgage loans from Sub and a predecessor bank, which continued to service these loans while held by the REITs. Most of the captive REITs were ultimately liquidated into Sub in liquidations qualifying under § 332 of the Code.

In the Receivership Sale, D purchased in a taxable transaction substantially all of the assets and assumed all the deposits and certain other liabilities of Sub for approximately $a in cash. Parent estimates that unassumed debt liabilities totaled approximately $b. The A Group reported a net loss of approximately $c on its Year 3 consolidated federal income tax return with respect to the Receivership Sale. Since the Receivership Sale, Sub's assets have principally consisted of the cash proceeds from the Receivership Sale, all or a portion of which have been invested in marketable securities, and certain intercompany claims and other causes of action.

On Date 3, the A Debtors filed a proposed plan of reorganization under chapter 11 of the Bankruptcy Code (Plan). The Plan is premised on the Bankruptcy Court's approval of a proposed settlement agreement that embodies a compromise and settlement of numerous disputes among the A Debtors, D and the FDIC. The existing outstanding stock of Parent will be canceled on the effective date of the Plan and it is currently contemplated that new common shares of reorganized Parent will be issued to certain claimholders. The Plan also provides for the establishment of a liquidating trust for the benefit of certain claimholders. At the present time, ignoring any possible recovery on the receiver's claims, the outstanding debt of Sub exceeds its assets (principally the $a of cash received from D) by approximately $d. Sub is and is expected to remain insolvent.

Parent has an adjusted tax basis in its Sub stock of at least approximately $e, as of Date 4. Sub continues to be a member of the A Group, and pursuant to § 1.1502-80(c) of the Income Tax Regulations, Parent has not claimed a worthless stock deduction with respect to the Sub stock. Parent expects to recognize its loss with respect to its Sub stock no later than the cancellation of the Sub stock upon the winding-up of the Sub receivership. However, Parent may seek to abandon its stock interest in Sub in advance of the completion of the receivership, in which event Parent will recognize the loss at the time of abandonment.

REPRESENTATIONS

Parent has made the following representations in connection with this ruling request:

1) Parent has not made an election pursuant to § 1.597-4(g) to disaffiliate Sub.

2) Sub will continue to be an affiliate of Parent within the meaning of § 1504(a)(2) until the earlier of the complete liquidation of Sub (as determined for federal income tax purposes) or Parent's abandonment of its Sub stock.

3) Parent's stock in Sub will be worthless within the meaning of § 165(g)(1) at the time specified in § 1.1502-80(c) of the regulations;

4) More than 90 percent of Sub's aggregate gross receipts for all taxable years has been from (i) interest income on, and gains from the sale of, real estate loans (including mortgage-backed securities) and consumer loans and (ii) service charges, fees, commissions and other non-interest income from operations. This takes into account the gross receipts of all § 381 predecessor entities, and excludes any prior intercompany distributions from such entities to prevent double counting.

5) All the income of clause (i) of the preceding representation included towards satisfying the 90 percent test was received by Sub or a predecessor bank, and all gains included in clause (i) qualified for ordinary income treatment. See § 582(c) 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 Parent 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 Parent" only if--

(A) the Parent 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.

Section 1.165-5(i) of the regulations provides that a security that becomes wholly worthless includes a security that is abandoned and otherwise satisfies the requirements for a deductible loss under § 165. If the abandoned security is a capital asset and is not described in § 165(g)(3), the resulting loss is treated as a loss from the sale or exchange of a capital asset. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. All the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.

Section 582(c) of the Code provides, in general, that in the case of a financial institution (including a bank) the sale or exchange of a bond, debenture, note or certificate or other evidence of indebtedness shall not be considered a sale or exchange of a capital asset.

Parent represents that the Sub stock will be worthless within the meaning of § 165(g)(1) of the Code at the time specified in § 1.1502-80(c) of the regulations. Thus, the issue for our consideration is whether Parent meets the affiliation requirements of § 165(g)(3) so that it is entitled to claim an ordinary loss for the worthless securities of Sub. A corporation is treated as "affiliated with the taxpayer" under § 165(g)(3) if two requirements are met—the ownership test and the gross receipts test.

Under the facts of this case, the ownership test of §165(g)(3)(A) is satisfied because Parent has directly owned all of the stock of Sub since Year 2, and Parent represents that Parent has not made an election under § 1.597-4(g) to disaffiliate Sub, and that Sub will continue to be an affiliate of Parent within the meaning of §1504(a)(2) until the earlier of the complete liquidation of Sub (as determined for federal income tax purposes), or Parent's abandonment of its Sub stock.

For purposes of the gross receipts test of § 165(g)(3)(B), Parent represents that more than 90 percent of Sub's aggregate gross receipts for all taxable years has been from (i) interest income on, and gains from the sale of, real estate loans (including mortgage-backed securities) and consumer loans and (ii) service charges, fees, commissions and other non-interest income from operations, after taking into account the gross receipts of all § 381 predecessor entities and excluding any prior intercompany distributions from such predecessor entities to prevent double counting. Parent also represents that all of the income in clause (i) included towards satisfying the gross receipts test was received by Sub or a predecessor bank, and that all gains included qualified for ordinary income treatment by operation of § 582(c).

A literal reading of the gross receipts test requires that more than 90 percent of the aggregate of Sub's gross receipts be from sources other than disqualifying, specifically enumerated, sources of income, such as interest and gains from the sale of stock or securities. More than 90 percent of Sub's aggregate gross receipts for all taxable years has not been from service charges, fees, commissions and other non-interest income from operations. Thus, in this case, whether Parent meets the requirements of the gross receipts test depends on whether the interest income earned on, and gains from the sale of, real estate loans (including mortgage backed securities) and consumer loans received by a company operating as a bank are treated as active, operating gross receipts, rather than passive gross receipts, in applying the gross receipts test.[1]

The gross receipts test was designed to determine whether a subsidiary is an operating company (for which an ordinary loss may be 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 (rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business and interest received on the deferred purchase price of operating assets sold) 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-

[1] Section 582(b) provides that for purposes of § 165(g)(1) in the case of a parent <u>bank</u> owning directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset.

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.

Thus, the legislative history of § 165(g)(3) supports the argument that Congress intended to permit ordinary loss treatment where the subsidiary is an operating company rather than an investment or holding company, and that the terms rent and interest refer to income derived from a passive source. In Rev. Rul. 88-65, 1988-2 C.B. 32, the Service relied upon this legislative history, in part, in distinguishing between receipts from passive investment activities and receipts derived in the ordinary course of conducting an operating business. Under this ruling, amounts received under short-term automobile and truck leases do not constitute rents for purposes of § 165(g)(3)(B) because the leasing subsidiary performed significant services in connection with the leases.

Sub was clearly an operating company (until the seizure and sale of its business), and not an investment or holding company, and performed significant services in its banking activities that resulted in generating gross receipts in the form of interest income and gains from the sale or exchange of loans and mortgage backed securities. The legislative history of § 582(c) indicates Congress intended to treat gains from transactions in evidences of indebtedness of banks as ordinary income because these items of indebtedness are not true capital items, but are more like transactions in inventory or stock items. *See* H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 130 (1969), 1969-3 C.B. 200, 281; S. Rep. No. 91-552, 91st Cong., 1st Sess. 167 (1969), 1969-3 C.B. 423, 529. Congress recognized that making loans is the business of an active, operating bank. Thus, the phrase "gains from the sale or exchange of stock or securities" under § 165(g)(3)(B) should not include gains from the sale of items that qualify for ordinary income treatment under § 582(c). The active or passive analysis of Rev. Rul. 88-65 applies to interest income on, and gains from the sale of, real estate loans (including mortgage backed securities) and consumer loans, of Sub.

CONCLUSION

Accordingly, provided that all the requirements for claiming a worthless securities deduction under § 165(a) and § 165(g) (taking into account § 1.502-80(c)) are otherwise satisfied, Parent may claim an ordinary loss under §§ 165(a) and 165(g)(3) for its basis in Sub's stock.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. No opinion is expressed concerning whether any of the other requirements of § 165 not specifically addressed in this ruling are met. In addition, the ruling in this letter is conditioned on the standard representations contained in Revenue Procedure 2010-1.

The rulings contained in this letter are based on facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative(s). A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

Christopher F. Kane
Branch Chief, Branch 3
Income Tax & Accounting

cc: