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Person To Contact:
, ID No.

Telephone Number:

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In re: A ruling request regarding § 165(g)(3)(B) of the Internal Revenue Code.

Legend

X =

Y =

Z =

FP =

FC1 =

FC2 =

FP2 =

Year 1 =

Year 4 =

State A =

a% =

b% =

c% =

d% =

e% =

$a =

$b =

Dear :

This is in response to your representative's June 27, 2012, letter and December 17, 2012, supplemental submission requesting a ruling on the application of § 165(g)(3)(B) to an insolvent subsidiary that will elect to be treated as a disregarded entity for federal tax purposes.

FACTS

X is a publicly traded corporation organized under the laws of State A. X operates in the United States and in numerous foreign countries, principally through foreign subsidiaries.

X is the parent of a consolidated group of corporations. Among other subsidiaries, X owns a% of both Y and Z. Y and Z are both State A corporations and join X in filing a consolidated return. X and its subsidiaries derive most of their combined receipts from the sale of products.

Y owns b% of FP, a foreign entity classified as a partnership for U.S. federal tax purposes. X owns the remainder of FP. Y also owns c% of FC1, a foreign entity classified as a corporation for U.S. federal tax purposes. FP owns the remainder of FC1.

Z owns a% of FC2, a foreign entity classified as a corporation for U.S. federal tax purposes. FC2 owns d% of FP2, a foreign entity classified as a partnership for U.S. federal tax purposes. FC1 owns the remainder of FP2.

FC2 acquired its d% interest in FP2 in Year 1 by issuing a note payable with a principal amount of approximately $a as consideration in the exchange. Additionally, FC2 currently holds FP2 debt with a principal amount of $b. A third party valuation report determined FC2 to be insolvent as of Year 4. FC2 derives much of its revenue from its investment in FP2, but FP2 has substantial active business operations conducted through disregarded entities. FC2 can only satisfy the gross receipts test in § 165(g)(3)(B) if its distributive share of FP2's gross receipts are counted. No gross receipts arising from the operating companies following their elections to be taxed as corporations will be counted.

X intends to restructure certain foreign operations in order to (1) consolidate operations under its foreign holding company structure; (2) achieve entity simplification and cost reduction; and (3) achieve local tax efficiency in the foreign jurisdiction.

As part of a single integrated plan, the following steps will be taken as part of the restructuring:

1. X has transferred its interest in FP to Z.

2. X and Y will merge, with X surviving.

3. The disregarded operating companies owned by FC2 will make check-the-box elections to change their classification from disregarded entities to corporations for U.S. federal income tax purposes.

4. FC2 will make a check-the-box election to change its classification from a corporation to a disregarded entity for U.S. federal income tax purposes (FC2 Election).

5. Z will transfer all of FC2 to FP for no consideration.

X represents the following:

1. At all times, all instruments referred to as debt herein have been treated as debt for U.S. federal tax purposes. Also, at all times, all instruments referred to as equity herein have been treated as equity for U.S. federal tax purposes.

2. At all times relevant to the FC2 Election, FC2 will be an eligible entity as defined in § 301.7701-3(a) of the Procedure and Administration Regulations.

3. FC2 will not have made a check-the-box election to change its entity classification within the 60-month period preceding the FC2 Election.

4. A timely and valid check-the-box election will be made and the result will be to treat FC2 as a disregarded entity for U.S. federal tax purposes.

5. At all times relevant to the proposed restructuring, FC2 will have one class of issued and outstanding stock, all of which will be owned by Z on the effective date of the FC2 Election.

6. In each year prior to the effective date of the FC2 Election, FC2 did not cease business, file for bankruptcy, or have any other identifiable event.

7. In each year prior to the effective date of the FC2 Election, FC2's current liabilities (not taking into account any contingent liabilities) will exceed the fair market value of FC2's assets (including tangible and intangible assets such as goodwill and going concern value).

8. None of the FC2 stock was acquired for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under § 165(g)(3).

9. At all times relevant to the proposed restructuring, FP2 will be properly classified as a partnership for U.S. federal tax purposes.

10. Taking into account FC2's distributive share of FP2's gross receipts, more than % of the aggregate gross receipts of FC2 for all taxable years will be from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stocks and securities, within the meaning of § 165(g)(3)(B). For purposes of this representation, FC2 will take into account the gross receipts arising from its check-the-box election.

RULINGS REQUESTED

1. FC2 should include its distributive share of FP2's gross receipts for purposes of computing the gross receipts test under § 165(g)(3)(B).

2. Z is entitled to an ordinary worthless stock deduction under § 165(g)(3) for FC2's stock.

3. Neither the operating companies' elections to be treated as corporations nor Z's transfer of FC2 to FP will affect Z's ability to claim a worthless stock deduction with respect to the stock of FC2 under § 165(g)(3).

LAW & ANALYSIS

X represents that FC2 is an eligible entity that may check-the-box to change its entity classification under § 301.7701-3(c)(1)(i), and proposes to do so and change its classification from corporation to disregarded entity. This will result in FC2 being deemed to distribute all of its assets and liabilities to Z in liquidation. Section 301.7701-3(g)(1)(iii).

Section 332(a) provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

Section 1.332-2(b) provides that § 332 (non-recognition) applies only if the recipient corporation receives at least partial payment for its stock in the liquidating corporation, and references § 165(g) for the consequences of worthless securities if § 332 does not apply.

Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise, including capital losses. Section 165(f). A loss deduction is permitted under § 165 only for the taxable year in which the loss is sustained, as evidenced by closed and completed transactions and as fixed by identifiable events. Section § 1.165-1(b). A capital loss results from the sale or exchange of a capital asset. Section 1222. Stock in a corporation is generally a capital asset. Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988). For most capital assets, a loss due to worthlessness or abandonment is ordinary for lack of a sale or exchange. See, Echols v. Commissioner, 950 F.2d 209 (5th Cir. 1991).

However, for securities, § 165(g)(1), provides the missing sale or exchange, deemed to occur on the last day of the taxable year, and the resulting loss is generally capital. Section 165(g)(2)(A) provides that the term security includes a share of stock in a corporation. Under § 165(g)(3), any security in a corporation “affiliated” with a taxpayer that is a domestic corporation is not treated as a capital asset, and the loss is ordinary. For purposes of § 165(g)(3), a corporation is treated as "affiliated" with the taxpayer (a domestic corporation) only if the taxpayer directly owns stock of the corporation that meets the requirements of § 1504(a)(2), and more than 90 percent of the aggregate of the corporation's gross receipts ("gross receipts") for all taxable years has been from sources other than royalties, certain rents, dividends, certain interest, annuities, and gains from sales of stocks and securities.

Rev. Rul. 70-489, 1970-2 C.B. 53, *amplifying* Rev. Rul. 59-296, 1959-2 C.B. 87, holds that where a wholly owned subsidiary had bona fide indebtedness to its parent corporation that exceeded the fair market value of its assets and the subsidiary transferred all of its assets to its parent in partial satisfaction of its indebtedness, the parent could claim both a bad debt deduction and a worthless security deduction, even though the parent continued the business formerly conducted by the subsidiary.

Rev. Rul. 2003-125, 2003-2 C.B. 1243, holds that when an entity classification election is made to change an entity from a corporation to a disregarded entity, the former shareholder of such corporation is allowed a worthless security deduction under § 165(g)(3) if the fair market value of the assets of the corporation does not exceed the total amount of the corporation's liabilities, such that on the deemed liquidation of the corporation, the former corporate shareholder receives no payment on its stock in the liquidated corporation.

Section 702(a) provides that in determining his income tax, each partner shall take into account separately his distributive share of the partnership’s items enumerated therein.

Section 1.702-1(a) provides, in part, that each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction or credit described in subparagraphs (1) through (9) of that paragraph. Section 1.701-1(a)(8)(ii) states, in part, that each partner must also take into account separately his distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Rev. Rul. 71-455, 1972-1 C.B. 318, held that an S corporation's distributive share of gross receipts from a partnership should be included for purposes of applying the passive investment income test under § 1372(e)(5). The ruling relied on § 1.702-1(a)(8) in finding that the partner's distributive share of gross receipts should flow through to the partner under § 702.

FC2, an eligible entity currently classified as a corporation, will elect to be treated as a disregarded entity as part of the proposed restructuring. As a result, FC2 will be deemed to distribute all of its assets and liabilities to Z, its sole shareholder. X represents that, as of the effective date of the election, FC2's liabilities will exceed the fair market value of FC2's assets, taking into account goodwill and going concern value. Consequently, Z will not receive payment in exchange for its FC2 stock and § 165(g) will apply to the transaction. Since Z is the sole shareholder of FC2 the ownership test in § 165(g)(3)(A) is satisfied. However, FC2's principal asset is its interest in FP2, and FC2 can only meet the gross receipts test under § 165(g)(3)(B) if it can look through its FP2 partnership interest and include its distributive share of FP2's gross receipts for purposes of testing the 90% gross receipt threshold.

A partnership should be treated as an aggregate for purposes of the 90% gross receipts test as the income tax liability at the partner level would differ if the partner did not take its distributive share of partnership income into account. Therefore, in calculating FC2's gross receipts, the character of each item in the hands of FP2 passes through to FC2 as if earned directly.

RULINGS

Based solely on the information submitted and the representations set forth above, we rule as follows:

1. FC2 should include its distributive share of FP2's gross receipts for purposes of computing the gross receipts test under § 165(g)(3)(B).

2. Z is entitled to an ordinary worthless stock deduction under § 165(g)(3).

3. Neither the operating companies' elections to be treated as corporations nor Z's transfer of FC2 to FP will affect Z's ability to claim a worthless stock deduction with respect to the stock of FC2 under § 165(g)(3).

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. This letter does not address the tax consequences of steps 1, 2, 3 and 5 of the restructuring, other than how steps 3 and 5 relate to the consequences of step 4, the FC2 Election, as requested in ruling 3. We have assumed, based on the taxpayer's representation that no identifiable event had occurred before the check-the-box election, that the stock of FC2 was not worthless in an earlier year. We have also assumed that X's representation that FC2's liabilities will exceed the fair market value of FC2's assets taking into account goodwill and going concern value, fully values FP2 by taking into account the operating companies' goodwill and going concern value.

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.

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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

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

cc: