Article from:

Taxing Times

February 2010 – Volume 6, Issue 1

GUIDANCE NEEDED TO CLARIFY ALLOWANCE OF ORDINARY LOSSES UNDER SECTION 165(g)(3) FOR WORTHLESS SECURITIES OF INSURANCE SUBSIDIARIES

By Maureen Nelson

The financial crisis of the recent past has prompted the director of the financial services industry portion of the Large and Mid-Size Business ("LMSB") Division of the Internal Revenue Service ("Service") to announce an increased focus during audit on the reporting by members of the financial services industry of losses attributable to bad debts or to worthless securities issued by subsidiaries.[1] The specific issues that might arise in an audit of claimed losses for worthless securities were not identified, but it is probably safe to assume that they would relate to whether the securities became worthless during the taxable year for which the losses were claimed[2] and, if so, whether the losses may be reported as ordinary losses under section 165(g)(3).[3]

Under section 165(g), losses from a subsidiary's worthless securities must be reported as capital losses, unless less than 10 percent of the subsidiary's total gross receipts have been from sources usually considered passive in nature, *i.e.*, royalties, rents, dividends, interest, annuities and capital gains (collectively, "passive source gross receipts").[4] In Rev. Rul. 88-65, however, the Treasury Department ("Treasury") and the Service concluded that rental receipts of a subsidiary earned in connection with the operation of its active vehicle leasing business would not be counted as passive source gross receipts when determining whether the subsidiary had passive source gross receipts in excess of the maximum allowed under section 165(g)(3) for ordinary loss treatment.[5] For several years thereafter, the Service agreed that under the published guidance the statute permitted parents of worthless financial service companies, such as thrifts and insurance companies, to exclude their subsidiaries' passive source gross receipts earned in connection with the conduct of their banking or insurance businesses from being treated as passive source gross receipts in the determination of whether the subsidiaries had excessive passive source gross receipts.[6]

More recently, however, the Service has denied that the published guidance allows for excluding an insurer's passive source gross receipts earned in connection with its conduct of an insurance business from the determination of whether its passive source gross receipts have exceeded the maximum allowed for ordinary losses.[7] Audit challenges to the character of the losses reported under section 165(g)(3) by members of the financial service industry are therefore likely to engender significant controversy because, as explained below, both taxpayers and revenue agents will be able to point to prior Service rulings, albeit unpublished, in support of the argument that Rev. Rul. 88-65's interpretation of section 165(g)(3) does or does not support the allowance of ordinary losses. In light of these contradictory interpretations of Rev. Rul. 88-65 by the Service and the current audit attention of the LMSB Division on losses claimed under section 165(g) by parents of insolvent financial services company, it would be helpful if Treasury were to issue guidance that reiterates the interpretation of section 165(g)(3) set forth in Rev. Rul. 88-65 and clarifies that it applies to passive source gross receipts of insurance companies (and other similarly situated taxpayers) earned in connection with their active trades or business.

THE STATUTE

Section 165(g)(3) departs from the usual rule of section 165(g), which mandates capital loss treatment for a worthless security,[8] by allowing a corporate taxpayer holding securities issued by an "affiliated corporation" that have become worthless during the year to report the losses as ordinary. A corporation whose securities have become worthless (the "issuer") is "affiliated" with a corporate taxpayer only if both an "ownership" test and a "passive source gross receipts" test are satisfied. The ownership test, found in section 165(g)(3)(A), requires the taxpayer alone, or along with members of its consolidated group, to own at least 80 percent of the vote and value of the stock of the issuer; the gross receipts test, found in section 165(g)(3)(B), requires that "more than 90 percent of the aggregate of the corporation's gross receipts for all tax years has been from sources other than royalties, rents …, dividends, interest …, annuities, and gains from sales or exchanges of stocks and securities."[9] The measure of gross receipts taken to satisfy the gross receipts test is the subsidiary's aggregate total gross receipts for its entire period of existence and not its gross receipts for any particular tax year.[10]

If section 165(g)(3)(B) were to be interpreted literally, no corporation engaged in the insurance or banking or property rental business or software licensing business, for example, would ever qualify as an "affiliated corporation" inasmuch as the very nature of such a business requires the subsidiary to have passive source gross receipts well in excess of the maximum allowed under the language of section 165(g)(3)(B).[11] Yet in Rev. Rul. 88-65, Treasury and the Service ruled that a corporation with gross receipts consisting exclusively of passive source gross receipts nonetheless qualified as an "affiliated corporation," with the result that its parent was allowed to report its losses from the issuer's worthless securities as ordinary losses.

THE REVENUE RULING, ITS UNDERLYING GENERAL COUNSEL MEMORANDUM, AND THE LEGISLATIVE HISTORY

Revenue Ruling 88-65 involves the parent of a corporation in the vehicle leasing business. In connection with conducting that business, the corporation maintained the vehicles and paid all applicable taxes and insurance costs. In 1988, the issuing corporation's shares became worthless. Despite the fact that the issuer had derived 100 percent of its gross receipts from rents, a type of passive source gross receipts identified in section 165(g)(3)(B), the ruling concludes that the issuer's parent was entitled to report as ordinary the losses it incurred when the issuer's securities became worthless.

Citing the legislative history underlying section 165(g)(3) (and its predecessor under the 1939 Code) to elucidate the purpose of the gross receipts test as a guide to interpreting section 165(g)(3)(B), Treasury and the Service observed that "Congress intended that an ordinary loss deduction for worthless securities be allowable only when the subsidiary is an operating company as opposed to an investment or holding company."[12] Treasury and the Service therefore found it proper to look to other Code sections where Congress sought to make the same distinction and did so by measuring the amount of a taxpayer's proceeds from royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities, such as section 1244(c)(1)(C) and former section 1372(e)(5)(C). Guidance issued under those other Code sections provides that the term "rents" when used in the statute does not include rents received by a taxpayer who provides significant services in connection with earning the rents because the provision of such services reveals that the taxpayer is actively conducting a trade or business. As explained in Rev. Rul 88-65, in order to further the congressional purpose in enacting section 165(g)(3), it is "appropriate to distinguish between active and passive rental income in the same manner" as in regulations issued under section 1244 and former section 1372, and therefore "rents" received by a taxpayer providing significant services would not be treated as "rents" in determining the issuer's satisfaction of the gross receipts test of section 165(g)(3)(B).

A more in-depth exploration of the relevant legislative history of section 165(g)(3) and the purpose of its particular definition of "affiliated corporation" is set forth in the general counsel memorandum ("GCM") underlying Rev. Rul. 88-65.[13] As explained in the GCM, prior to 1942, the Code required all loss due to the worthlessness of securities held as capital assets be treated as loss arising from the sale or exchange of a capital asset, *i.e.*, as capital loss. In the Revenue Act of 1942,[14] Congress created the exception to the capital loss rule now found in section 165(g)(3) that, when applicable, eliminates capital asset treatment for such securities and therefore allows for ordinary loss when and if such securities become worthless. The Senate Finance Committee explained the purpose of this exception:

> Under present law, losses by a parent corporation on the stock or securities of a subsidiary corporation becoming worthless are treated as capital losses in the same manner as in the case of other stock or securities held by the taxpayer. The committee bill would permit such losses to be taken in full as ordinary losses by the parent if it owns directly 95 percent of each class of the stock of the subsidiary. Such parent and subsidiary may file consolidated returns and to this extent the corporate entity is ignored. Thus the losses of one may be offset against the income of the other. It is deemed desirable and equitable, therefore, to allow the parent corporation to take in full the losses attributable to the complete worthlessness of the investment in the subsidiary.[15]

The committee bill would permit such losses to be taken in full as ordinary losses by the parent if it owns directly 95 percent of each class of the stock of the subsidiary.

The Service explains in the GCM that Congress permitted ordinary loss treatment when the taxpayer and the issuer were closely enough related to file consolidated returns, even if they did not in fact so file (the ownership test),[16] to ensure

CONTINUED ON PAGE 20

that if and when the securities of the subsidiary become worthless the loss would be regarded as a business loss of the parent corporation rather than as a loss on an investment.[17] "In the case of consolidated return treatment, the losses of one may be offset against the income of the other. In the case where the securities of the subsidiary company becomes [*sic*] worthless, following the same concept, the loss, in effect, is regarded as a loss of part of the business of the parent corporation rather than as a loss on an investment."[18] And in keeping with this notion of allowing ordinary loss for the operation of a business but not for an investment, Congress included the gross receipts test "to permit the loss as an ordinary loss only when the subsidiary was an operating company as opposed to an investment or holding company."[19] As the GCM notes, the statute's prohibition on excessive passive source income effects the "distinction between active and passive business operations" discussed in its legislative history.[20]

THE COURT CASE

Although neither the revenue ruling nor the general counsel memorandum mentions it, years earlier the Service had convinced two courts that the statute's prohibition on excessive passive source gross receipts should be interpreted literally. Under such an interpretation, the taxpayer, a retail store that owned a bank that provided banking services to the store's customers, was not entitled to report ordinary losses when the bank's securities became worthless because the bank had interest receipts that exceeded the maximum allowed under the predecessor to section 165(g)(3)(B). The taxpayer pointed to the active business operations of the bank subsidiary and cited the same legislative history relied upon by Treasury and the Service in Rev. Rul. 88-65 in support of its argument that it should be allowed ordinary loss treatment. In rejecting the taxpayer's request that it reject an "over-literal reading" of the statute and instead adopt an alternative reading consistent with the intent of Congress to permit ordinary losses when the issuing subsidiaries were active operating companies, the Court of Appeals for the Second Circuit warned:

> [T]he proposed alternative reading applying to "all operating companies" would open the door to insurance companies, finance companies, real estate operating companies, etc., without suggestion of any workable limitation. Congress has enunciated a clear and simple rule which …is not to be set aside.[21]

In each instance, the conclusion the parent was entitled to report ordinary loss was based on the determination that the passive source gross receipts of the subsidiary were earned as part of the operation of its active trade or business. …

THE UNPUBLISHED RULINGS

With the publication of Rev. Rul. 88-65, Treasury and the Service opened the door to ordinary loss claims with their rejection of the literal interpretation of the gross receipts test of section 165(g)(3)(B) approved by the courts in *Adam, Meldrum* and their adoption of an analytical approach to the interpretation of section 165(g)(3)(B), necessary to effect congressional intent to permit ordinary losses when the worthless securities were issued by an active operating subsidiary. But did Treasury intend to open the door to parents of some types of active businesses that necessarily earn significant amounts of passive source gross receipts in the conduct of their businesses, only to deny entry to parents of insurance companies?[22] Nothing in Rev. Rul. 88-65 or in the legislative history of section 165(g)(3) justifies such a narrow opening and, indeed, at first the Service acknowledged the applicability of the analytical approach of Rev. Rul. 88-65 to all active businesses generating significant amounts of passive source gross receipts in the conduct of their trades or businesses. Under the guidance of Rev. Rul. 88-65, the Service issued taxpayer-favorable rulings to the parents of insolvent insurance companies,[23] finance companies[24] and rental businesses,[25] all with excessive passive source gross receipts. In each instance, the conclusion the parent was entitled to report ordinary loss was based on the determination that the passive source gross receipts of the subsidiary were earned as part of the operation of its active trade or business and therefore should not be treated as passive source gross receipts for purposes of the gross receipts test of section 165(g)(3)(B).

For example, in PLR 9218038 (Jan. 29, 1992), the Service ruled that the nonbank parent of a thrift savings bank could report its losses on the thrift's worthless stock as ordinary losses, despite the subsidiary's failure to satisfy the literal language of section 165(g)(3)(B).[26] In response to the taxpayer's request that the Service determine that the "interest" income referred to in section 165(g)(3)(B) did not include interest "actively earned" by the subsidiary, the Service acknowledged the favorable precedent of *Adam, Meldrum* that would permit it to reject this interpretation. The Service noted, however, that such interest was similar to the types of passive source income included in the Code sections identified in Rev. Rul 88-65, *viz.*, sections 1244(c)(1) and 1372(e)(5)(C), and under those Code sections "a distinction is made between amounts received from the active conduct of a business and passive or investment income." In addition, noted the Service, section 543 includes in personal holding company income the same types of passive source gross receipts identified in section 165(g)(3)(B), but section 542 excludes from the definition of a personal holding company a lending or finance business, even though such businesses earn significant amounts of interest income. Finally, the Service also identified section 469, concerning the limitations on passive activity losses, as another place in the Code where interest income earned in the ordinary course of a trade or business should be distinguished from interest on investments. The Service concluded that, as it was for rents in Rev. Rul. 88-65, the distinction between active and passive income should be applied to interest earned as part of the active conduct of a trade or business for purposes of the gross receipts test of section 165(g)(3)(B).[27]

In field service advice issued two years later,[28] the Service noted that "[i]nsurance companies are required to accumulate and invest reserves to pay out on losses of the insured" and by doing so generate large amounts of passive source gross receipts. Nonetheless, the Service ruled that the parent of an insurance company, the shares of which had become worthless, could report the losses as ordinary. In extending the application of Rev. Rul. 88-65 to parents of insurance companies, the Service stated:

> Despite Adam, Meldrum & Anderson, we will no longer follow a literal interpretation test of section 165(g)(3). Instead, we will look to whether the income was "active" or "passive." In Rev. Rul. 88-65, the income was clearly from rents; however, the business was being actively managed. We believe that the distinction between active and passive income should be applied to other types of income. For example, a savings bank would be considered an actively managed business, notwithstanding the fact that its income was "interest" and a loss arising from the worthlessness of its securities would be an ordinary one to its parent. *See* PLR 9218038 (1/29/92). Accordingly, we would restrict the application of section 165(g)(3) to those situations in which the activities of the subsidiary are [not] (*sic*) passive in nature. In your case, an insurance business is an actively managed business and its income from interest and dividends are part of that business.

The Service next "opened the door" to the parent of another insolvent insurance company in a technical advice memorandum issued shortly after the field service advice.[29] In this ruling, the taxpayer acquired an insurance company in 1987 that shortly after acquisition experienced significant underwriting losses. During the period 1982-1990, 43 percent of the insurance company's gross receipts were passive source gross receipts. By 1990, the insurance company's reserve liabilities exceeded its assets and it was declared insolvent and placed in rehabilitation by the state insurance regulator. The taxpayer reported its loss from the worthless securities as ordinary loss and this treatment was challenged during audit. In the technical advice memorandum issued to the audit team, the Service agreed that the insurance subsidiary would not satisfy the gross receipts test of section 165(g)(3)(B) were the statute to be interpreted literally. While noting that the court in *Adam, Meldrum* had refused to consider the legislative history of section 165(g)(3) in denying ordinary loss treatment, the Service explained that "in contrast to this literal approach in defining the scope of section 165(g)(3) of the Code, Rev. Rul. 88-65 [citation omitted] employs a more analytical ap-

CONTINUED ON **PAGE 22**

proach … and relies for its rationale, in part, on the congressional purpose underlying section 165(g)(3)."

In TAM 9538005, the Service acknowledged that the subsidiary described in Rev. Rul. 88-65 was a vehicle rental company, not an insurance company. The Service noted that in their need to earn passive income, insurance companies are similar to banks, although they do not have the special rules that banks have under Treas. reg. §§ 1.165-5(h) and 1.582-1, which provide that if a bank subsidiary of a bank satisfies the ownership test, its securities will not be treated as capital assets in the hands of its bank parent. But this lack of a special rule for insurance companies did not deter the Service from concluding that the insurance subsidiary's passive source income should not be treated as passive source gross receipts in ascertaining the subsidiary's satisfaction of the gross receipts test. Just as in other situations—such as in the passive activity loss rules of section 469 and the personal holding company rules of section 542— where the receipt of excessive income from passive sources mandates or excludes specific tax treatment, the tax law treats the receipt of interest by insurance companies the same as the receipt of interest by banks because both earn interest as a necessary part of the active conduct of their businesses. Indeed, noted the Service, in the personal holding company legislation, "Congress sought to place insurance companies on the same field as banks, both of 'whose active businesses involve the investment of funds and the earning of interest and dividends.'"[30]

In concluding that the insolvent insurance company subsidiary should be treated as an "affiliated corporation" of the taxpayer, the Service in TAM 9538005 again referred to the legislative history underlying section 165(g)(3) and its predecessor as demonstrating congressional intent to permit ordinary loss when the subsidiary is an operating company and denying it when the subsidiary is an investment or holding company. The receipt of large amounts of income from passive sources, explained the Service, does not contradict the conclusion that an insurance company is an active business; rather, earning investment-type income is an integral part of its provision of insurance to customers.[31] Thus, excluding the interest and other passive source gross receipts of an insurance company from the meaning of royalties, rents, interest, etc, as those terms are used in section 165(g)(3)(B), is appropriate.

> The similar treatment of interest from banks and insurance companies in the context of passive and active income has been viewed as justified by practical reality. As with banks, investments are an integral part of an insurance company's business and are a principal source of its income. [Citation omitted.] Although life insurance companies are taxed differently than other types of insurance companies, life insurance companies maintain reserves that are expected to earn investment income. The investments that earn this income are an essential component of insurance companies' businesses. In addition, the activity necessary to earn interest in the situations of both banks and insurance companies is similar. Both involve similar types and amounts of effort to attract borrowers/insurers, to process their applications and premiums, to administer, account for, and report appropriate information, and actively to oversee and supervise invested funds.
>
> In this case, Insurance Company was an active insurance company, which actively sold credit life, accident and health insurance policies and earned significant premiums in connection therewith, which it invested as an integral part of its business and source of income. [Footnote omitted.] This is not the type of passive holding company that was intended to be excluded from the special ordinary loss treatment of section 165(g)(3) of the Code.[32]

Although this ruling is well-reasoned, entirely consistent with prior unpublished rulings, and amply supported by the analysis and rationale of Rev. Rul. 88-65, the Service signaled its desire to follow a different path two years later when it announced, in response to a letter ruling request, its withdrawal and reconsideration of TAM 9538005.[33] The Service revoked the 1995 TAM with the issuance of TAM 9817002,[34] in which it offered a more narrow interpretation of the scope of Rev. Rul. 88-65 than prior unpublished rulings, articulated a new explanation for the purpose of section 165(g)(3), and adopted a test different than that used in Rev. Rul. 88-65 for ascertaining when certain passive source gross receipts should not be included in the passive source gross receipts described in section 165(g)(3)(B).

At first, the "law and analysis" portion of TAM 9817002 reads much like those of the rulings described above, with a summary of the statute, a short discussion of its legislative history, and an explanation of the "analytical approach" of Rev. Rul. 88-65. In the 1998 TAM, however, the Service offers a new and slightly different congressional purpose for the ordinary loss rule found in section 165(g)(3) and suggests it was enacted to permit the parent to obtain the effect of filing a consolidated return with its subsidiary and thereby report directly the ordinary (or capital) losses the subsidiary would have recognized and contributed to consolidated taxable income had the subsidiary sold the assets producing the passive source gross receipts.

> The legislative history further indicates that its purpose was to provide the parent corporation with an ordinary loss in order to correspond more closely to the treatment allowed if the parent and subsidiary were able to ignore the separate corporate entities by filing consolidated returns. It also provides that, in such circumstances, the losses of one corporation may be offset against the income of the other, thus providing an indication that those losses should be treated as ordinary losses. Therefore, it is appropriate to treat the claimed loss arising from the worthlessness of the subsidiary stock in a manner consistent with the treatment the parent would have been afforded if the parent disposed of the underlying assets of the subsidiary directly.[35]

This recasting of the congressional purpose for section 165(g)(3) leads the Service in effect to adopt a new standard for when passive source gross receipts will not be treated as royalties, rents, interest, etc., under section 165(g)(3)(B). Rather than employing the test of Rev. Rul. 88-65, *i.e.*, ascertaining whether the subsidiary was actively engaged in a trade or business, the losses from which resulted in its securities becoming worthless, the Service in TAM 9817002 employs a look-through test—it requires the parent to adopt as the character of its worthless securities the character of losses the subsidiary would have reported had it engaged in a hypothetical sale of the assets generating the passive source gross receipts. (The ruling also suggests the Service would impose as a prerequisite to the allowance of ordinary losses under this new look-through approach that the hypothetical sale of the assets generating the passive source income generate net loss.)

> There is no indication in the record that the assets generating the interest, dividends and capital gains of Insurance Company did not constitute capital assets in the hands of Insurance Company. Treating income from these assets as not being from interest, dividends and capital gains within the meaning of section 165(g)(3)(B) would be inappropriate when the disposition of the underlying assets generating that income would give rise to capital rather than ordinary treatment. To do so would have the unacceptable effect of converting what would have been a capital loss to Insurance Company into an ordinary loss to taxpayer.[36]

Because the assets producing passive source gross receipts were capital assets, the insurance company described in TAM 9817002 would have reported any gain or loss on their sale as capital gains or losses. Accordingly, ordinary loss on the worthless securities was denied to the parent.

There is no indication in the record that the assets generating the interest, dividends and capital gains of Insurance Company did not constitute capital assets in the hands of Insurance Company.

Nothing in the statute, its legislative history or Rev. Rul. 88-65 supports this "hypothetical sale, look-through" interpretation of section 165(g)(3), however. And nothing in either the 1995 TAM or the 1998 TAM indicates that the insurance company had built-in losses in its investment portfolio. The underlying facts, set forth in greater detail in TAM 9538005, do indicate, however, that the subsidiary's losses were due to its unfavorable underwriting activities. Had the results of this underwriting activity been reported directly by the parent, it would have produced ordinary loss to the parent and had this book of business been reinsured, it would have produced a net deduction, due to the likely negative ceding commission reinsuring such a book of business would require.[37] This is exactly the situation section 165(g)(3) was enacted to address.

Contrary to the description of congressional purpose in enacting section 165(g)(3) set forth in TAM 9817002, the legislative history of section 165(g)(3) demonstrates (and the GCM underlying Rev. Rul. 88-65 explains) that Congress enacted the ordinary loss rule of section 165(g)(3) because when two companies are closely enough related to file consolidated returns (even when they do not), it is appropriate to treat them as in effect consisting of one operating business. When the subsidiary is merely a passive investment company, its losses are investment losses and the parent's costs of capitalizing the subsidiary should also be treated as investment losses.

When the subsidiary's losses from the active conduct of a trade or business render its securities worthless, the parent's

CONTINUED ON PAGE 24

Maureen Nelson is counsel with the New York, NY law firm of Skadden, Arps, Slate, Meagher & Flom LLP and may be reached at *Maureen.nelson@skadden.com.*

costs of capitalizing the insolvent subsidiary should be treated as the parent's own losses from a trade or business rather than as investment losses of the parent from the sale or exchange of its subsidiary's securities, a result not otherwise provided for under the Code, even for consolidated taxpayers. To distinguish between passive investment subsidiaries and active operating subsidiaries, Congress incorporated into section 165(g)(3) the gross receipts test of section 165(g)(3)(B). But congressional purpose in enacting the predecessor of section 165(g)(3) is only given effect if the gross receipts test is construed as excluding rents, royalties, interest, dividends and capital gains earned as part of the active conduct of a trade or business. This is the foundation on which Rev. Rul. 88-65 is based, not that the income-generating assets themselves are not capital assets.[38]

CONCLUSION

Other recent unpublished guidance applying section 165(g)(3) that could be read as contradicting or being inconsistent with prior unpublished guidance suggests it is time for additional published guidance. For example, in rejecting a taxpayer's argument that the fact that its worthless subsidiary had zero gross receipts and therefore did not have excessive gross receipts from passive sources, the Service has said that "where, as here, Congress has imposed a test for eligibility for a particular tax benefit that 'more than 90 percent of the aggregate of gross receipts…' must come from sources other than those enumerated, it has also imposed a requirement that there be gross receipts."[39] But in TAM 200914021 (April 3, 2009), the Service concluded that a corporation that became worthless in its first year of existence and never had any gross receipts nonetheless satisfied the gross receipts test of section 165(g)(3)(B). While it is true that in the earlier ruling, the worthless subsidiary was described as a holding company, whereas in the later ruling, the subsidiary was described as an operating company, the Service chose to base its disregard of the subsidiary's failure to satisfy the literal requirements of the statute on congressional intent as reflected in the legislative history of section 165(g)(3):

> 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). … 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.

The new focus of LMSB on financial institutions claiming ordinary losses under section 165(g)(3) for worthless securities issued by subsidiaries and the current state of the Service's rulings, which seem to permit owners of rental companies, thrift savings banks and software licensing companies to disregard the passive source gross receipts of their subsidiaries when the subsidiaries were active operating companies but deny such treatment to owners of active insurance companies, presents a situation ripe for controversy and best resolved by published guidance. New guidance from Treasury should be consistent with Rev. Rul. 88-65 and treat passive source gross receipts of an insurance company earned as part of its active insurance business as not constituting royalties, rents, interest, dividends or capital gains as described in section 165(g)(3)(B).

END NOTES

1 *See* "IRS Official Previews Exam Issues Raised by Financial Crisis," *Tax Notes Today*, May 11, 2009 ("An IRS official on May 8 flagged areas in which the Service expects to see an increase in issues raised during examinations of financial services companies as a result of the economic crisis. … Walter Harris, director of the financial services industry at the IRS Large and Midsize Business Division, spoke at the Banking and Savings Institutions session of the American Bar Association Section of Taxation meeting in Washington. He said the IRS is watching developments and anticipating what issues will come up in exams conducted against the background of the economic downturn and resulting moves by financial institutions. The IRS is gearing up to see more issues involving treatment of bad debts under section 166 and worthless stock under section 165(g), Harris said.") This article concerns worthless stock losses under section 165(g).

2 A discussion of the legal standard for ascertaining when securities are considered to have become worthless and a loss may be recognized by the owner of such securities is beyond the scope of this article. *See*, however, Treas. reg. § § 1.165-1(b) and (d) and Treas. reg. § 1.165-5(i).

3 All section references are to the Internal Revenue Code ("Code") of 1986, as amended, unless otherwise specifically stated.

4 *See* section 165(g)(3).

5 *See* Rev. Rul. 88-65, 1988-2 C.B. 32.

6 *See* PLR 9218038 (Jan. 29, 1992), FSA 1159 (Jan. 25, 1994), and TAM 9538005 (Sept. 22, 1995), discussed *infra.*

7 *See* TAM 9817002 (Jan. 5, 1998), discussed *infra.*

END NOTES (CONTINUED)

8 When a security that is a capital asset becomes worthless, the resulting loss must be treated as arising from the sale or exchange of the security. Section 165(g)(1).

9 Excluded from "rents" are rents derived from properties leased to employees in the ordinary course of business and excluded from "interest" is interest received on the deferred purchase price of assets sold. *See* section 165(g)(3(B).

10 Rev. Rul. 75-186, 1975-1 C.B. 72. The regulation under section 165(g)(3)(B), which merely repeats the statutory language describing the gross receipts test, adds nothing to the understanding of the application of the ordinary loss rule of section 165(g)(3). *See* Treas. reg. § 1.165-5(d)(2)(iii).

11 Section 582 allows a bank, as defined in section 581, to report worthless stock of a bank subsidiary as ordinary losses, notwithstanding section 165(g)(3), and to claim a bad debt deduction for worthless debt securities, notwithstanding section 166(e). But when the taxpayer is not a bank, the treatment of worthless securities issued by a bank subsidiary is subject to section 165(g)(3). *See, e.g.*, PLR 9218038 (Jan. 1, 1992).

12 The ruling cites 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.

13 *See* GCM 39746 (Aug. 8, 1988).

14 Pub. L. No. 753, section 123(a)(1), 56 Stat. 798, 820 (1942).

15 S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543.

16 "The legislative history indicates the purpose of section 23(g)(4) [of the Internal Revenue Code of 1939] 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." PLR 200924040 (June 12, 2009), citing S. Rep. No. 77-1631, 77 Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543. In keeping with the idea of treating closely related corporations as one, the initial ownership test, which required at least a 95 percent ownership, was relaxed in 1971 to permit a subsidiary to qualify as an "affiliated corporation" when the ownership test of section 1504(a)(2) (ownership of at least 80 percent of vote and value) for filing consolidated returns is satisfied.

17 GCM 39746, quoting S. Rep. No. 1530, 91st Cong., 2d Sess 2 (1970), part of the legislative history underlying a 1971 amendment to section 165(g)(3).

18 S. Rep. No. 1530, 91st Cong., 2d Sess. 2 (1970).

19 *Id.*, quoting the comments of Senator Davis made in connection with 1944 amendments, sponsored by him, to the predecessor of section 165(g)(3), which added the language still in section 165(g)(3)(B) that excludes from prohibited gross receipts rents from rentals to employees in the corporation's ordinary course of business and interest earned on deferred purchase price of operating assets sold.

20 As originally enacted in 1942, the gross receipts test was expressed as requiring more than 90 percent of the issuer's gross <u>incomes</u> from all taxable years to be other than income from passive sources. When it was enacted as section 165(g)(3)(B) as part of the 1954 Code, "incomes" was changed to "receipts."

21 <u>*Commissioner v. Adam, Meldrum & Anderson Co.*</u>, 215 F.2d 163, 166 (2d Cir. 1954), *aff'g* 19 T.C. 1130 (1953).

22 It may be more accurate to say parents of insurance subsidiaries with worthless securities were admitted to the world of ordinary losses, only to be tossed out a few years later. *See* FSA 1159, Vaughn #1159 (Jan. 25, 1994) and TAM 9538005 (Sept. 22, 1995). *But see* TAM 9723011 (June 6, 1997) in which the Service announced its reconsideration of TAM 9538005 and TAM 9817002 (Jan. 5, 1998) in which the Service revoked TAM 9538005.

23 *Id.*

24 *See* PLR 9218038 (Jan. 29, 1992).

25 *See* PLR 200003039 (Jan. 24, 2000).

26 As the PLR notes, banks that own worthless securities of bank subsidiaries may rely on section 582 to support claiming ordinary losses but nonbank owners must resort to section 165(g)(3).

27 Another example of where the Code treats income normally considered passive in nature as not passive when earned by an insurance company as part of the conduct of its insurance business is found in section 1297, which addresses passive foreign investment companies ("PFICs"). Although a foreign corporation that derives at least 75 percent of its gross income in any taxable year from passive sources such as interest and dividends is subject to the PFIC regime, which generally taxes to the PFIC's shareholders the foreign corporation's undistributed taxable income, passive income "derived in the active conduct of an insurance business by a corporation which is predominately engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation" is not counted as passive source income for purposes of determining if the foreign corporation has derived at least 75 percent of its gross income from passive sources.

28 *See* FSA 1159 (Jan. 25, 1994).

29 TAM 9538005 (Sept. 22, 1995).

30 *Id.*, quoting S. Rep. No. 93-1061, 93d Cong., 2d Sess. 3 (1974).

31 As acknowledged by the Service in TAM 9538005, it is certainly possible that a company claiming to be an insurance company under the Code will be determined to have as its primary and predominant activity the making of investments and not the issuance or reinsurance of insurance contracts. *See, e.g.*, *Inter-American Life Ins. Co. v. Commissioner*, 56 T.C. 497 (1971), *aff'd*, 469 F.2d 697 (9th Cir. 1972). *See also* TAM 200824029 (June 13, 2008). In such a situation, it would be appropriate to treat the receipts from passive sources as excessive passive source gross receipts under section 165(g)(3)(B).

32 TAM 9538005, *infra.*

33 *See* TAM 9723011 (June 6, 1997).

34 TAM 9817002 (April 24, 1998).

35 *Id.*

36 *Id.*

37 *See* Treas. reg. § 1.817-4(d).

38 *Compare* PLR 200924040 (June 12, 2009), in which the Service concluded that, because the purpose of the gross receipts test is to separate operating companies from investment companies, the royalties earned by a software development company for the use of its proprietary software would not be treated as passive source gross receipts for the purpose of the gross receipts test of section 165(g)(3)(B) because the company was engaged in the active conduct of a trade or business of developing, manufacturing, or producing computer software. The "look-through" test of TAM 9817002 was not mentioned or applied.

39 *See* TAM 8939001 (June 9, 1989).