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Person to Contact:

Identifying Number:

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Date:
October 26, 1999

Legend:

D =

F =

P =

Country A =

Dear :

This is in response to a ruling request dated May 13, 1999, submitted on behalf of D, regarding whether certain income earned by its foreign subsidiary F is described in section 165(g)(3)(B) of the Internal Revenue Code.

The following facts have been represented.

D is a second-tier subsidiary within an affiliated group that files a consolidated return. P, the common parent, is primarily a holding company. D grants franchises permitting the operation of vehicle rental businesses. It licenses trade names and other intangibles to franchisees and also provides an array of services in connection with the franchises, including advertising, reservations, and assistance in procuring and maintaining a fleet of vehicles.

F is a wholly-owned Country A subsidiary of D. It does not conduct business in the United States and is not a United States taxpayer. Pursuant to an agreement with D, F holds a master license to operate vehicle rental businesses in Country A. F engages in such business directly at various locations within Country A, but also enters into sublicenses with Country A franchisees. F has operated at a loss for a number of years and is insolvent on a fair market value basis. For purposes of this ruling, we assume that stock in F is worthless.

This ruling request concerns certain categories of income earned by F. The first is rent from short-term vehicle rentals to customers. As noted, F itself engages in the vehicle rental business at certain Country A locations. Accordingly, it rents vehicles to customers. F performs a number of services incident to these arrangements, including providing for maintenance and repair of the rented vehicles.

The second category of income is rent from longer-term leases to Country A franchisees. F assists the franchisees in assembling fleets of vehicles for rental. It purchases vehicles in relatively large quantities and under relatively favorable terms and provides these vehicles to its franchisees under lease agreements. These leases entail various services by F, including assistance in obtaining maintenance and repair work for the vehicles. F also coordinates the reassignment of vehicles among locations, to ensure that each location has an appropriate mix of vehicles.

The third category of income is fees paid by the Country A franchisees. Franchisees pay a license fee, administrative fees and advertising fees. The latter two types of fees are computed as a percentage of franchisee revenues and are paid monthly. The license fee is charged at the inception of the franchise agreement. F performs much the same type of services for its franchisees as are performed by D for its domestic franchisees, i.e., advertising, reservations, and assistance in procuring and maintaining a fleet of vehicles. F also consults with Country A franchisees regarding business methods.

Your request asks that we rule that the foregoing categories of income are not described in Code section 165(g)(3)(B).

Code section 165(g)(1) provides that if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

Code section 165(g)(3) provides that for purposes of section 165(g)(1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset.

Code section 165(g)(3) also sets forth requirements a subsidiary must satisfy in order to be considered affiliated with the taxpayer. Paragraph (A) requires that stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock be owned directly by the taxpayer.

Paragraph (B) of Code section 165(g)(3) requires that more than 90 percent of the aggregate of the gross receipts for all taxable years 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 1.165-5(d) of the Income Tax Regulations further provides that a corporation will be considered affiliated with the taxpayer only if none of the stock of such corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under Code section 165(g)(3).

Section 1.165-5(b) of the regulations provides that if any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss.

Legislative history indicates that Congress enacted the predecessor of Code section 165(g)(3) and permitted an ordinary loss deduction for worthless stock of an affiliated subsidiary, in order to approximate the federal income tax treatment given to an affiliated group with an unprofitable subsidiary:

> Such a parent and subsidiary corporation may file consolidated returns and to this extent the corporate entity is ignored. Thus the losses of the 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.

S. Rep. No. 1631, 77th Cong., 2d Sess. 46-47 (1942). See also B. Bittker, Federal Income Taxation of Income, Estates and Gifts ¶ 52.3 (1990) (tax treatment under section 165(g)(3) approximates that from operation of subsidiary's business as a division).

On the other hand, legislative history also indicates that Congress intended to limit an ordinary loss deduction to circumstances in which the subsidiary is an operating company, so that loss on the worthlessness of stock in an investment or holding company will not qualify for the favorable treatment. In 1944, the statute was amended to modify the definition of interest and rent. Regarding the statute's limitation on passive income, Senator Davis commented:

> The obvious intention of this limitation 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. . . .

90 Cong. Rec. 121-122 (1944).

As noted, Code section 165(g)(3) contains a two-part definition of affiliation. This ruling request requires us to apply the second prong of that test. We are asked to rule that

three categories of income earned by F are not described in section 165(g)(3)(B), i.e., that they do not disqualify F from treatment as an affiliated subsidiary. The first category of income -- rent from short-term vehicle rentals to customers -- is the subject of Rev. Rul. 88-65, 1988-2 C.B. 32. There, the Service concluded that such rent was not described in Code section 165(g)(3)(B), reasoning that the term rent does not include income from transactions involving the provision of significant services and that in the case of the short-term rentals, the significant services included maintenance and repair. Because the rent F receives from short-term vehicle rentals to customers is essentially the same as that described in the ruling, we conclude that it is not described in section 165(g)(3)(B).

We also conclude that F's income from longer-term leases of vehicles to Company A franchisees is not described in Code section 165(g)(3)(B). In Rev. Rul. 76-469, 1976-2 C.B. 252, the Service concluded that income from long-term leases of automobiles was not passive income for purposes of section 1372(e)(5) as then in effect, because the taxpayer provided various services in connection with the leases, such as assistance in selecting the vehicle to be leased, installation of special equipment, and assistance in procuring maintenance and repair services. In this case, F performs very similar services for the Company A franchisees with whom it enters into long-term leases. While the ruling interprets another Code provision (which imposed a passive income limitation on S corporations), the ruling is cited in Rev. Rul. 88-65. In fact, Rev. Rul. 88-65 points out that the statutory language in section 165(g)(3)(B) is similar to that found in a number of additional Code sections, including section 1244, regarding "section 1244 stock," and section 1362, regarding the passive income limitation of S corporations with C corporation earnings and profits. In the ruling, the Service reasons that guidance interpreting those other provisions is relevant in construing section 165(g)(3)(B).

The third category of income described in the ruling request -- fees paid by Company A franchisees -- consists of compensation for various administrative and advertising services, as well as compensation for the use of intangibles such as trade names. To the extent F is compensated for services performed, the income clearly is not described in Code section 165(g)(3)(B). Moreover, the portion of the fees representing compensation for the use of intangibles should not be considered royalties or any other type of disqualifying passive income. In this regard, section 1.1362-2(c)(5)(ii)(A)(2) of the regulations provides relevant guidance in interpreting essentially identical statutory language (see section 1362(d)(3)):

> Royalties does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are derived in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation — (i) Created the property; or (ii) Performed significant services or

incurred substantial costs with respect to the development or marketing of the property.

The income described in the ruling request fits within the regulatory exception. F, in addition to sublicensing trade names and other intangibles, performs an array of services, such as business consulting, that contribute to the value of the licensed intangibles. F, therefore, provides significant services in the development of whatever intangibles are licensed to its franchisees, and we conclude that the fees paid by the Company A franchisees are not described in Code section 165(g)(3)(B).

Caveats:

A copy of this letter must be attached to any income tax return to which it is relevant. 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 ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

By _____

cc: District Director,
Chief, Examination Division

cc: