Internal Revenue Service

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

Telephone Number:

Refer Reply To:
CC:ITA:B01
PLR-101609-25

In Re:

Date:
July 29, 2025

LEGEND

Taxpayer	=
Foreign Sub	=
Corporation A	=
Corporation B	=
Foreign Agency	=
Foreign Tax	=
Foreign Region A	=
Foreign Region B	=
Date 1	=
Date 2	=
Date 3	=
Month 1	=
Month 2	=
Month 3	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
Licenses	=

Business A =

Business B =

Business C =

Activity =

Dear :

This letter responds to a request for a private letter ruling filed by Taxpayer with the Internal Revenue Service (Service). In the letter ruling request and subsequent submissions, Taxpayer seeks the following rulings: (1) the refund interest that Foreign Sub received from Foreign Agency with respect to a Foreign Tax refund is not "interest" for purposes of § 165(g)(3)(B) of the Internal Revenue Code (Code); and (2) as of the end of its taxable year that ended Date 1, despite never generating gross receipts from its intended business activity, Activity related to certain leases in Foreign Region A, Foreign Sub meets the gross receipts test provided by § 165(g)(3)(B). Taxpayer's request was filed with our office on Date 2.

FACTS

Corporation A was a domestic corporation primarily engaged in Business A. Corporation A controlled a group of subsidiaries and primarily operated domestically. Corporation B was a domestic corporation primarily engaged in Business B. In Month 1, Corporation A merged with and into a wholly owned subsidiary of Corporation B (the Merger). Taxpayer is the rebranded combined entity following the Merger.

On Date 3, Corporation A incorporated Foreign Sub under the laws of Foreign Region B as a wholly owned subsidiary. In Month 2, Corporation A successfully bid for Licenses by committing to invest approximately $a over the following three years. Also in Month 2, Corporation A transferred Licenses to Foreign Sub, which was formed for the sole purpose of Business C.

From Date 3 to Date 1, Foreign Sub was able to take some steps in its work plan for Business C but was unable to generate revenue from Activity due to events outside of its control. However, prior to acquiring Licenses, Taxpayer estimated that Foreign Sub would generate revenue in excess of its $b total invested capital. Since Foreign Sub had not commenced revenue generating operations, Foreign Sub did not have any taxable sales or gross receipts from Business C. Foreign Sub did have four positive inclusions to income that it reported on Form 5471 during this time: (1) in Year 1, a

refund from Foreign Agency of Foreign Tax included interest of $c; (2) in Year 2, miscellaneous inclusion of income of $d to reverse additional expense recorded in prior periods; (3) in Year 3, foreign currency translation of $e; and (4) in Year 3, Foreign Tax true-up of $f.

Foreign Sub renewed Licenses in Year 4, Year 5, and Year 6. In Month 3, Foreign Sub submitted its application to formally abandon the Licenses, which was accepted a month later. Taxpayer represents that the abandonment of the leases resulted in the stock of Foreign Sub becoming worthless. Taxpayer represents that Corporation A's stock in Foreign Sub became worthless within the meaning of § 165(g) in Month 3. Taxpayer represents that from Date 3 to Date 1, Corporation A owned 100% of the issued and outstanding stock of Foreign Sub.

LAW AND ANALYSIS

Generally, § 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Generally, losses due to worthlessness are ordinary losses for lack of a sale or exchange under § 1222. However, §165(g)(1) provides that if any security which is a capital asset becomes worthless during the taxable year, the resulting loss is treated as a loss from the sale or exchange of a capital asset on the last day of the taxable year. Section 165(g)(2) defines a security to include stock in a corporation.

An exception to capital loss treatment is provided in § 165(g)(3) which provides that for purposes of § 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. For purposes of § 165(g)(3), a corporation is treated as affiliated with a taxpayer only if—

> (A) the taxpayer owns directly stock in such corporation meeting the requirements of § 1504(a)(2) (Ownership Test); and
>
> (B) more than 90 percent of the aggregate of its 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).

Taxpayer represents that from Date 3 to Date 1, Corporation A owned 100% of the issued and outstanding stock of Foreign Sub. Therefore, in this case, the Ownership Test was met.

In Commissioner v. Adam, Meldrum & Anderson Co., a department store owned stock in a bank that became worthless. The taxpayer argued that the legislative history indicated that the predecessor to the § 165(g)(3)(B) gross receipts test should not

apply to income from active, operating companies, even the interest of a bank. However, the Second Circuit held that the bank's gross receipts, which were comprised mainly of interest, failed the gross receipts test, stating that "the 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, we agree with the Tax Court, is not to be set aside." Commissioner v. Adam, Meldrum & Anderson Co., 215 F.2d 163, 166-67 (2d Cir. 1954).

Rev. Rul. 88-65, 1988-2 C.B. 32 holds that the significant services performed by a corporation in connection with the short term leasing of automobiles and trucks, result in the amounts received under the leases not being "rents," within the meaning of § 165(g)(3)(B). Rev. Rul. 88-65 relies in part on the legislative history of § 165(g)(3), indicating that Congress intended to allow an ordinary loss deduction for worthless securities only when the subsidiary is an operating company, as opposed to an investment or holding company. See 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.

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.

Taxpayer had identified numerous administrative rulings that have not strictly applied the statutory language in § 165(g)(3)(B) and has even suggested that an active/passive test has overtaken the statutory test based on the nature of the gross receipts that the subsidiary derived. We disagree with this interpretation of the administrative guidance; though we do agree that in limited cases the legislative history may have value in interpreting the statute.

Issue 1. Whether the refund interest that Foreign Sub received from Foreign Agency with respect to a Foreign Tax refund is not "interest" for purposes of § 165(g)(3)(B).

Foreign Sub was registered with Foreign Agency as doing business subject to its jurisdiction. As such, Foreign Sub was legally obligated to collect Foreign Tax on its revenues, pay Foreign Tax as part of its purchases of equipment and supplies related to Business C, and remit excess collections to Foreign Agency. Since Foreign Sub was unable to generate revenue, it was entitled to a Foreign Tax refund from Foreign Agency. Foreign Agency paid Foreign Sub interest on the Foreign Tax refund. Therefore, the interest Foreign Sub received from Foreign Agency was related to Foreign Sub's active conduct of a business.

The interest was not passive or investment income and was not a return on an investment. In addition, in comparison to the amount Foreign Sub invested in its operations, the interest amount is de minimis. Therefore, although Foreign Sub received interest from the taxing authority with a tax refund and that amount is interest in a literal sense, it was not the passive return on investments that § 165(g)(3)(B) contemplates and was more incidental to the operating activities of the company.

Issue 2. Whether Foreign Sub meets the Gross Receipts Test as of the end of its taxable year that ended Date 1, despite never generating gross receipts from Activity.

Taxpayer represents that Foreign Sub was formed as an operating entity that was meant to generate revenue from Activity. Foreign Sub's actions demonstrate that Foreign Sub was an active operating company as opposed to an investment or holding company, and that its activities were intended to generate ordinary income. However, Foreign Sub was never able to generate those ordinary gross receipts due to circumstances beyond its control.

Although Foreign Sub did not generate any gross receipts from Activity due to events outside its control, it did take significant steps to try to generate gross receipts from Activity, including obtaining Licenses, buying equipment, and completing some of its work plan. In effect, while not yet collecting income, it was directly engaged in a business. The lack of gross receipts from the business raises an issue under the Gross Receipts Test, and it is arguable that the test is failed in such a case. However, such a result would be contrary to the purpose of the statute. Accordingly, in such a case it is appropriate to look to the legislative

history of the provision, focusing on the distinction between an operating company and a nonoperating or holding company. Because the entity here was an operating company, the deduction under § 165(g)(3) is appropriate.

CONCLUSION

Based on the facts and representations submitted, we conclude that Taxpayer has satisfied the burden associated with claiming an ordinary deduction under § 165(g)(3) with respect to the stock of Foreign Sub. To the extent that Corporation A properly files a short-period return for the taxable year ending on the effective date of the Merger, the worthless securities deduction with respect to the stock of Foreign Sub will be part of Corporation A's short-period return for such taxable year.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by penalty of perjury statements executed by the appropriate parties. Specifically, we have accepted Taxpayer's representation that the stock of Foreign Sub became worthless in Month 3. This office has not verified any of the materials submitted in support of the request for a ruling and the information materials are subject to verification on examination.

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.

A copy of this ruling should be attached to Taxpayer's federal tax returns for the tax years affected. 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,

/s/

Sean M. Dwyer
Senior Technician Reviewer, Branch 1
(Income Tax & Accounting)

cc: