Report No. 1315

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE GROSS RECEIPTS TEST OF SECTION 165(g)(3)(B)

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I. Introduction

This Report[1] provides comments to the Internal Revenue Service (the "**Service**") and the U.S. Department of the Treasury (the "**Treasury Department**") regarding the application of section 165(g)(3)(B) (the "**Gross Receipts Test**").[2] Section 165(g)(3) generally permits an ordinary deduction for a loss sustained by a parent corporation ("**Parent**") on its investment in the stock of a subsidiary ("**Subsidiary**") if (i) Subsidiary's stock becomes worthless during the taxable year, (ii) Parent owns stock of Subsidiary meeting the requirements of section 1504(a)(2), and (iii) Subsidiary satisfies the Gross Receipts Test. The aim of the Report is to consider and recommend rules that would help to clarify and make more administrable the application of the Gross Receipts Test.[3]

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[1] The principal drafters of this Report are Rebecca Burch, Lawrence Garrett, Andrew Herman, Kristie Khaw, and Brian Peabody. Substantial contributions or helpful comments were received from Kim Blanchard, James Ferguson, Stephen Land, Vadim Mahmoudov, Deborah Paul, Yaron Reich, Michael Schler, David Schnabel, David Sicular, Eric Solomon, and Diana Wollman. This report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] All "**section**" or "**§**" references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), or to the Treasury Regulations ("**Reg.**" or "**Regulations**") thereunder.

[3] Accordingly, this Report focuses only on the Gross Receipts Test and does not address broader questions relating to the worthless stock deduction under section 165(g). For a discussion of whether a worthless stock deduction should be recognized upon certain intercompany liquidations or reorganizations, *see* New York State Bar Association, Tax Section, *Report on Reorganizations Involving Insolvent Subsidiaries* (Oct. 29, 2003), *reprinted in* 101 Tax Notes 761 (Nov. 10, 2003), *supplemented by* New York State Bar Association, Tax Section, *Claiming Worthlessness for a Failed Subsidiary Within a Consolidated Group* (Jan. 28, 2011), *reprinted in* 2011 TNT 20-81. For a discussion of the appropriateness of ordinary loss treatment regarding a worthless foreign subsidiary, *see* Paul, *Another Look through the Worthless Stock Deduction: Section 165(g)(3) as Applied to Foreign Subsidiaries*, 32 Va. Tax Rev. 367 (Fall 2012). For other analyses of the Gross Receipts Test, *see, e.g.*, Braithwaite, *Section 165(g)(3) Gross Receipts Test for Stock of a Worthless Consolidated Subsidiary: To Infinity and Beyond (or Not)*, 39 J. Corp. Tax'n 11 (2012); Madden, *Worthless Stock and the Gross Receipts Test: In for a Penny, In for a Pound*, 37 J. Corp. Tax'n 42 (2010); Peabody, *Continuing Questions Regarding Worthless Securities*, 121 Tax Notes 705 (Nov. 10, 2008).

II. Summary of Recommendations

We do not advocate far-reaching changes to the rules governing the Gross Receipts Tests that applies in determining eligibility for a worthless securities deduction under section 165(g)(3) (a "**WSD**"). Rather, we recommend relatively modest changes to Regulations and the Service's procedures governing the application of the Gross Receipts Test to improve visibility and consistency and to promote administrability. Accordingly, this Report makes the following recommendations.

A. The Service and the Treasury Department should issue a revenue procedure to (a) confirm that Parent can establish Subsidiary's gross receipts history using the best available evidence for as many years as evidence is available using reasonable efforts; and (b) provide factors for applying that standard. We believe that these factors should include whether a year precedes (a) the normal record retention period (say, seven years); and (b) an acquisition of the stock of Subsidiary from an unrelated person. It may be appropriate for the guidance to give this latter factor additional weight where the acquisition resulted in Parent having a cost basis in Subsidiary stock, thereby providing a cleaner break between the shareholder claiming the WSD and Subsidiary's pre-acquisition operations.

B. The Service and the Treasury Department should issue guidance as to whether certain common items create receipts for purposes of the Gross Receipts Test (e.g., proceeds from a stock issuance, receipt of loan proceeds, stock and "boot" received in tax-free or partially tax-free exchanges, etc.). Such guidance should confirm the treatment of these items which, based on our experience, generally have been applied by taxpayers and the Service in practice.

C. The Service and Treasury Department should publish guidance clarifying that receipts which would otherwise be characterized as passive will instead be considered to be active if the provision of business services or a business product developed, manufactured, distributed, or marketed by Subsidiary to the payor is a material factor in the generation of the receipts.

D. The Service and the Treasury Department should consider issuing guidance characterizing otherwise passive receipts as active in certain other circumstances. For example, such guidance could provide for receipts to be treated as active where disposition of the underlying right to receive the receipts would generate ordinary gain or loss. In addition, consideration should be given to issuing guidance definitively addressing the treatment of investment income of banks and insurance Subsidiaries as active or passive receipts.

E. The Service and the Treasury Department should issue guidance confirming that a successor succeeds to the gross receipts history of a predecessor and defining a successor as the acquiring corporation in a section 381 transaction as defined in Reg. § 1.381-1(b)(2). Further, guidance should be considered clarifying how the duplication of gross receipts is eliminated following a section 381 transaction, for example by treating the successor and the predecessor as if they had always been a single corporation and disregarding prior transactions between them.

F. The Service and the Treasury Department should issue guidance confirming that the Distributive Share Approach (as defined below) is applied to allocate partnership gross receipts to the partners. Such guidance also should specify that, applying anti-duplication principles, distributions from partnerships do not create gross receipts, except potentially to the extent that the partner recognizes gain upon the distribution pursuant to section 731. Consideration should be given as to whether and to what extent, at least in certain circumstances, the disposition of a partnership interest should be treated as the disposition of an allocable share of the partnership's assets or as the disposition of a security within the meaning of section 165(g)(2) for Gross Receipts Test purposes. One construct which seems appropriate is to apply rules similar to the rules of section 731(c), varying the treatment of a disposition of a partnership interest depending on the proportion of passive or active assets held by the partnership.

G. The Service and the Treasury Department should issue Regulations providing rules specifying whether, in what circumstances, and how the "Look-Through Approach" (defined below) applied by the Service in several private letter rulings ("**PLRs**") should be applied in the context of intercompany transactions between members of a consolidated group.

H. We believe that a limited Look-Through Approach for all intercompany distributions (whether dividends or distributions in excess of earnings and profits ("**E&P**")) is justifiable and administrable. However, the Service and the Treasury Department should adopt a Receipts Approach (as defined below) rather than an Earnings Approach (as defined below) when applying the Look-Through Approach to intercompany distributions.

I. We do not favor the adoption of a broad Look-Through Approach to all intercompany transactions, principally because of adminstrability concerns. If, contrary to our recommendation, a Look-Through Approach for all intercompany transactions is generally adopted, we believe that there should be an exception for ordinary course transactions (such as product sales between a manufacturing member and a distributor member). In addition, it would be appropriate to provide a further exception from the Look-Through Approach for consolidated groups that, as a whole, have only a small amount of passive receipts from transactions with non-members.

J. We do not favor applying a Look-Through Approach to intercompany transactions outside of the consolidated group context.

K. The Service and Treasury Department should consider adopting a subgroup approach to applying the Gross Receipts Test to a consolidated Subsidiary, treating the applicable subgroup of consolidated members of which the Subsidiary is the subgroup parent as if it were a single corporation.

III. Background

A. Summary of the Statutory Framework

Section 165(g)(1) generally allows a deductible loss for a security which is a capital asset and which becomes worthless during the taxable year and generally treats such loss as being from a sale or exchange of the security, thereby resulting in capital treatment.[4] A "security" means a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.[5]

Section 165(g)(3) allows as an ordinary WSD on any security in a corporation (*i.e.,* Subsidiary) affiliated with a taxpayer which is a domestic corporation (*i.e*., Parent) by treating the security as if it were not a capital asset. Subsidiary is "affiliated" with a Parent if (i) Parent owns directly stock in the Subsidiary meeting the requirements of section 1504(a)(2) (the "**Ownership Test**"), and (ii) more than 90 percent of its aggregate 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 (i.e., the Gross Receipts Test). In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities are taken into account only to the extent of gains therefrom.

[4] Regulations issued in 2008 generally treat the abandonment of securities as an event of worthlessness. Reg. § 1.165-5(i) (T.D. 9386).

[5] Section 165(g)(2).

B. Purpose of the Ordinary Loss Deduction

i. Legislative history

Prior to 1938, Regulations permitted an ordinary WSD for all losses sustained upon the worthlessness of stock owned by a taxpayer.[6] In connection with the enactment of the 1938 Revenue Act, Congress debated the proper treatment of WSDs. The House of Representatives was concerned that taxpayers could convert capital loss into ordinary loss by not selling devalued securities, but waiting until either (i) the investment was extinguished in bankruptcy, or (ii) became eligible for a partial bad debt deduction (in the case of a bond). The House proposed to eliminate this anomaly by treating all losses on securities as capital items without regard to how the loss was incurred.[7] The Senate agreed the rule was sound with respect to non-corporate taxpayers but proposed a different rule for corporation taxpayers, which the Senate believed should be entitled to ordinary deductions upon worthlessness because such stock losses "are customarily a part of their ordinary business expense."[8] In the end, the House prevailed and the result was the enactment of a provision, the predecessor to the general rule in section 165(g)(1), providing that the worthlessness of stock was treated as a sale or exchange of a capital asset.

Congress revisited the character of a WSD in 1942 when the predecessor to section 165(g)(3) (section 23(g)(4)) was enacted. The new provision provided that stock of an affiliated corporation is treated as a noncapital asset upon its worthlessness (though still treated as a capital asset upon an actual sale or exchange). The determination of affiliation was similar to section 165(g)(3), requiring both an ownership test and gross receipts test be satisfied as is required today.[9] The legislative history indicates that Congress believed that ordinary deduction treatment was appropriate for worthless stock of an affiliated 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.[10] In effect, ordinary loss treatment for the worthlessness of subsidiary stock was grounded in a "look-through" principle.

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[6] Article 144 of the Regulation 45 provided that "[i]f the stock of a corporation becomes worthless, its cost … may be deducted by the owner in the taxable year in which the stock became worthless, provided a satisfactory showing of its worthlessness be made as in the case of bad debts." Article 561 of Regulation 45 applied this rule to corporations. For a more extensive tracing of the legislative history of the WSD, *see* Paul, "Another Look Through the Worthless Stock Deduction: Section 165(g)(3) as Applied to Foreign Subsidiaries," 32 Va. Tax Rev. 367 (Fall 2012).

[7] Revenue Act of 1938, Pub. L. No. 554 23(g)(2), 52 Stat. 447, reprinted in J.S. Seidman, Seidman's Legislative History of Federal Income Tax Law 1938-1861, at 12 (1938) (hereafter "**Seidman**").

[8] *Id*.

[9] Seidman at 1334. As enacted, the ownership test required the taxpayer to be domestic and own 95 percent of each class of the Subsidiary's stock. The gross receipts test was similar to current law in that 90 percent of aggregate gross income of all years must have been from non-passive sources (i.e. royalties, rents, dividends, interest, annuities or gains from sales or exchanges of stock and securities).

[10] The Senate Finance Committee characterized the reasons for the change as follows:

> 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 by the

Congress further refined the treatment of a WSD for a subsidiary in 1944 by excluding certain rents and interest from passive receipts for purposes of the Gross Receipts Test. The legislative history indicates that, in excluding particular rents and interest from being treated as passive receipts, Congress was motivated by a somewhat different perspective – *i.e.,* that an ordinary loss is appropriate where the Subsidiary is an operating company (an "operating company" principle): "the ordinary loss deduction of section 165(g)(3) is intended only when the subsidiary is an operating company as opposed to an investment or holding company and that the loss, in effect, is regarded as a loss of part of the business of the parent corporation rather than a loss on an investment."[11]

ii. Service authority citing congressional intent

The Service has relied on congressional intent to apply the Gross Receipts Test in revenue rulings, internal guidance, and PLRs issued to taxpayers in a manner that permits Parent to take a WSD where Subsidiary is an operating company.[12] For example, the Service has concluded certain royalties, rents, and interest can qualify as active gross receipts even though the statute designates such receipts as passive, where the fees are attributable to significant business activity or the Subsidiary performs significant services to produce the receipts.[13] The Service has also treated dividends received by a Subsidiary from another member of the consolidated group as active receipts, where the member distributing the dividend actively earned the receipts.[14] Even where a Subsidiary has had no gross receipts, the Service has interpreted the Gross Receipts Test broadly to conclude the lack of receipts should not deny a WSD, where the Subsidiary is truly an operating company.[15] In contrast, the Service has denied a WSD in cases where other Code sections precluded interpreting the gross receipts as active, or where the Subsidiary lacked gross receipts because it was actually a holding company of a lower-tier subsidiary that was an operating company.[16]

> parent if it owns directly 95 percent of each class of stock of the subsidiary. Such a parent and subsidiary may file consolidated returns and to this extent the corporate entity is ignored. Thus the losses of one may offset against the income of the other. It is deemed desirable and equitable, therefore, to allow the parent to take in full the losses attributable to the complete worthless of the investment in the subsidiary.

Seidman at 1334.

[11] S. Rep. No. 1631, 77th Cong., 2d Sess. 46-47 (1944), Statement of Senator Davis.

[12] Internal guidance and PLRs may not be used or cited as precedential authority. See *section 6110(k)(3)*. Nevertheless, courts consider such guidance as potentially persuasive if and to the extent that they reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws. *Davis v. Comm'r*, 716 F.3d 560, 569 (n. 26) (11th Cir. 2013), quoting *Hanover Bank v. Comm'r*, 369 U.S. 672 (1962).

[13] *See*, *e.g.*, PLR 201325007 (Mar. 18, 2013) (royalties); PLR 201347002 (Nov. 22, 2013) (interest), and Rev. Rul. 88-65, 1988-32 (rents) (each is discussed more fully below).

[14] PLR 200710004 (Mar. 9. 2007) (discussed more fully below).

[15] TAM 200914021 (Dec. 8, 2008).

[16] TAM 200727016 (July 6, 2007) (distinguishing the interpretation of rents from dividends that are specifically defined by the Code); TAM 8939001 (Sept, 29, 1989) (In the TAM, Parent (corporation A) was seeking a WSD for its subsidiary (corporation B), which owned operating company (corporation C) that had become worthless).

C. Analytical Framework Guiding This Report

The legislative history to section 165(g)(3)(B) does not adopt a single, unifying theory which can guide the Service and Treasury Department in implementation. Two principles seem to be at play. First, there are indications that Congress was motivated by a "look through" principle in which an ordinary WSD was thought to be appropriate to approximate the federal income tax treatment which would have resulted where Parent and Subsidiary are members of a consolidated group and Subsidiary's assets became worthless. Second, it appears that Congress wished to permit an ordinary WSD in circumstances in which the Subsidiary is an operating company, using the Gross Receipts Test as a proxy for determining operating company status and avoiding determinations about the character of the underlying assets.

These theories do not always coincide with the scope of section 165(g)(3)(B) pursuant to its terms. The "look through" principle referenced in the legislative history is not uniformly adopted. As one example, the Gross Receipts Test measures Subsidiary's receipts and does not test the percentage of Subsidiary's assets which would generate ordinary loss if disposed. Moreover, the amount of the WSD is measured by reference to Parent's basis in Subsidiary stock, not by reference to Subsidiary's basis in its assets. In addition, an ordinary WSD is available even if Subsidiary is ineligible to consolidate with Parent. On the other hand, ordinary WSD treatment has not been extended to certain operating companies (such as insurance Subsidiaries) in accordance with the "operating company" principle in the legislative history (indicating that the "look through" principle has retained some vitality).

To an extent, section 165(g)(3)(B) also can be viewed as being out of step with more recent trends governing the treatment of stock dispositions. It is no longer true that devalued stock which was acquired for business, rather than investment, purposes can generate an ordinary loss upon its disposition.[17] Moreover, developments in the consolidated return context demonstrate that member stock generally is respected as a separate company asset, albeit with some exceptions and accommodations.[18]

Given this platform, this Report generally does not advocate far-reaching changes to the rules governing the determination of the character of a WSD. Although we believe that the government should consider such changes (e.g., the potential adoption of a subgrouping rule in the context of consolidated groups), for the most part, we recommend more modest changes to improve visibility and consistency and promote administrability and do not endeavor to "perfect" an "imperfect" statute.

[17] *Arkansas Best Corp v. Comm'r*, 485 US 212 (1988).

[18] *See, e.g.,* Reg. § 1.1502-36.

IV. Applying the Gross Receipts Test

A. Determining Historical Gross Receipts: Meeting the Evidentiary Burden

The Gross Receipts Test places a heavy evidentiary burden on taxpayers seeking an ordinary WSD. To be entitled to a WSD, Parent must determine the Subsidiary's amount and type of gross receipts *for all years during which the Subsidiary (and any predecessor) has been in existence*.[19] In Rev. Rul. 75-186,[20] the Service clarified that the Gross Receipts Test is applied for all taxable years of the Subsidiary's existence and not determined separately for each year.[21]

In general, taxpayers are required to satisfy record keeping and substantiation requirements for tax benefits they claim.[22] Even though the documentation to substantiate a deduction may be extensive in many cases, the courts have required taxpayers to meet their evidentiary burden to prove entitlement to deductions.[23] Nevertheless, taxpayers and courts sometimes employ a reasonable approach, based on the best available evidence, to substantiate of the amount of expense otherwise entitled to deduction. By way of example, in *Cohan v. Comm'r*[24] the taxpayer (Cohan) was in the theater business and obligated to entertain and travel much, resulting in substantial sums being expended. The taxpayer in *Cohan* did not keep or produce written accounts of the expenses. The Board of Tax Appeals denied any deductions on the basis that the taxpayer failed to meet his burden of proof. The Second Circuit reversed that decision, reasoning as follows:

> The Board refused to allow him any part of [the amount of expenses that the taxpayer estimated at trial], on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for computation, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result

[19] Reg. § 1.165-5(d)(2)(iii).

[20] 1975-1 C.B. 72.

[21] *Accord* TAM 7412209840A (Dec. 20, 1974), which looks to the use of the word "aggregate" in determining capital loss deduction under Reg. § 1.1211-1(a)(1)) and TAM 7412199560A (Dec. 19, 1974) (same conclusion based on same reasoning).

[22] See Reg. § 1.6001-1 (a).

[23] *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934).

[24] 39 F.2d 540 (2d Cir. 1930).

> will inevitably be speculative; many important decisions must be such. We think that the Board was in error as to this and must reconsider the evidence.[25]

For the reasons discussed below, we believe that the Service and the Treasury Department should, by Regulation or revenue procedure, adopt similar principles in applying the Gross Receipts Test.

i. Practical difficulties in meeting Parent's evidentiary burden

1. Old years

The requirement that Parent evaluate all years of Subsidiary's existence means that the inquiry likely extends beyond the time for which business records are typically kept and before a taxpayer knows such records should be retained longer. A WSD may become available long after tax returns, supporting items, and financial statements have been discarded under normal records retention policies for many businesses. Uncovering comprehensive information becomes even more challenging when predecessors to Subsidiary have had gross receipts that must be taken into account as a part of determining the gross receipts for all years of Subsidiary's existence.

Tax returns and records supporting an item of income or deduction on tax returns generally are maintained until the period of limitations for that return expires. In general, the statute of limitation expires after 3 years from the filing of the return but can be extended to 6 years if the return reflects a substantial omission.[26] Financial statements and work papers related to review of financial statements are maintained for SEC reporting for seven years after an audit or review of an issuer's financial statements.[27]

In many cases, Subsidiary will become worthless well after these retention periods have expired for a portion of Subsidiary's records. As a result, in such cases, even if Subsidiary's business operations are of a nature that it is, as a matter of common sense, very likely that Subsidiary's gross receipts were overwhelmingly active in prior years, Parent will not be in a position to prove definitively that the Gross Receipts Test, as measured throughout the entire corporate existence of the Subsidiary, is actually satisfied.

2. Pre-acquisition years

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[25] 39 F.2d at 543-544. The *Cohan* rule has been applied in numerous situations beyond expense deductions such as in estimating the amount of income inclusion, determining stock basis by estimating the amount of capitalized expenses incurred with respect thereto, estimating stock basis following a reorganization described in section 368(a)(1)(B), estimating qualifying gross receipts for purposes of computing the production activity deduction under section 199, and estimating the weight to be allocated between "going-concern" and "liquidation" valuations of stock of a closely held corporation. *See Nitto v. Comm'r*, 13 T.C. 858 (1949); *Serianni v. Comm'r*, 80 T.C. 1090 (1983), *aff'd*, 765 F.2d 1051 (11th Cir. 1985); Rev. Proc. 81-70, 1981-2 C.B. 729; Rev. Proc. 2007-35, 2007-1 C.B. 1349; *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002).

[26] Section 6501(e).

[27] SEC Rule 210.2-06 to Regulation S-X.

Pre-acquisition years involve taxable years prior to a Subsidiary being acquired by the taxpayer and subsequently becoming worthless. At the time of the acquisition, not expecting that its investment in Subsidiary will become worthless in the future, Parent may not seek to uncover or preserve information necessary to establish the gross receipts history of the Subsidiary during pre-acquisition years. It often will be not until long after the acquisition when the WSD becomes possible – in fact, long after it is possible to recreate the records establishing Subsidiary's gross receipts history for pre-acquisition years.

As a conceptual matter, it is not clear why pre-acquisition years – at least years prior to a taxable acquisition of the stock of Subsidiary – should be relevant to Parent's ability to qualify for an ordinary WSD. Following the 'look-through" principle or "operating company" principle which underlies ordinary loss treatment under Section 165(g)(3)(B), it would seem sufficient to measure the post-acquisition activity of Subsidiary, at least where Parent obtains a cost basis in the stock of Subsidiary upon acquisition from an unrelated party. The WSD is taken by Parent based on its investment in Subsidiary that is represented by stock basis. When the investment is new, obtained through a taxable acquisition of Subsidiary's stock, the cost basis relevant for any future WSD bears no meaningful correlation to the gross receipts generated in pre-acquisition years of Subsidiary. In fact, it could be argued that, applying this principle, a more accurate gauge of whether Subsidiary is active or passive would be reached if pre-acquisition activity of Subsidiary did not influence, one way or the other, the outcome of the Gross Receipt Test. Current law appears not to validate this policy concern, instead requiring that Subsidiary's past operations be considered without regard to whether the Subsidiary was recently acquired (in a taxable or tax-free transaction).

ii. Recommendations:

We believe that the Service and the Treasury Department should issue guidance addressing the practical difficulties faced by taxpayers and the Service alike in applying the Gross Receipts Test to pre-acquisition or older years. We recommend that the Service and the Treasury Department issue a revenue procedure affirming that Parent may make the Gross Receipts Test determination based on the best available evidence. The revenue procedure would (a) confirm that Parent can establish Subsidiary's gross receipts history using the best evidence for as many years as such evidence is available using reasonable efforts; (b) provide factors determining the application of that standard; and (c) allow Parent to assume that Subsidiary's gross receipts for all prior years (that is, year for which evidence is not available using reasonable efforts) are consistent with results for the known years. In other areas, the Service has published revenue procedures to decrease the administrative burden imposed by substantiation requirements. For example Rev. Proc. 2011-29 allows taxpayers to make a safe harbor election for allocating success-based fees paid in business acquisitions or reorganizations described in Reg. §1.263(a)-5(e)(3). [28] Rev. Proc. 2011-35 is another example that allows taxpayers to elect one of four methods for

[28] 2011-1 C.B. 746.

establishing basis in the shares surrendered by or on behalf of target shareholders in a reorganization under section 368(a)(1)(B).[29]

We believe that the factors determining the years for which evidence is available using reasonable efforts should be aimed at easing the compliance burden relating to establishing gross receipts for older or pre-acquisition years. We believe that factors which should be identified as relevant to determining the years for which evidence is available using reasonable efforts should include whether a year precedes (a) the normal record retention period (say, seven years), or (b) an acquisition of the stock of the Subsidiary from an unrelated person. The latter factor may be given additional weight where the acquisition resulted in Parent having a cost basis in Subsidiary stock, thereby providing a cleaner break between the shareholder claiming the WSD and Subsidiary's pre-acquisition operations.

B. Identifying the Proper Scope of Gross Receipts

The term "gross receipts" is fundamental to the application of section 165(g)(3)(B), but is not comprehensively defined. As a result, common transactions may introduce uncertainty as to the application of the Gross Receipts Test.

i. The Code, Legislative History, and Regulations

The Code says little about the definition of "gross receipts," merely providing the strong implication that the term includes the proceeds of royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks and securities (with this latter item being computationally limited to gains). Some clarification may be found in the legislative history. In particular, the 1954 Code changed the Gross Receipts Test from one based on "gross income" to one based on "gross receipts." In making this change, the legislative history notes that since "gross income" is computed *after* the deduction for cost of goods sold, and since "gross receipts" is computed *before* the deduction for cost of goods sold, the current Gross Receipts Test is "somewhat less restrictive" than it was under the gross income standard.[30] Based on this legislative change, the term "gross receipts" may simply be intended to equal gross income plus the cost of goods sold,[31] although one may assert that the reference to cost of goods sold is merely one difference in the computation of gross receipts and of gross income.

The Regulations do little to add clarity around this point, stating that the term "gross receipts" means total receipts determined without any deduction for cost of goods sold.[32] That is, not only

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[29] 2011-1 C.B. 890.

[30] S. Rept. No. 1622, 83d Cong., 2d Sess., pp. 24, 199 (1954).

[31] *See also Burks v. U.S.*, 633 F.3d 347 (5th Cir. 2011) (citing section 61(a) in stating that, "[u]nder the Code, gross income of a trade or business is usually calculated by subtracting the cost of goods sold from the gross receipts of the sale").

[32] Reg. § 1.165-5(d)(2)(iii). The Regulations also repeat the aforementioned computational limitation on gross receipts from sales or exchanges of stocks and securities. *Id.* The reference to "cost of goods sold" should include the adjusted basis of assets disposed of by the taxpayer. *Cf. Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767, 772 (9th Cir. 2009) (citing section 61(a) and Reg. § 1.61-1(a) in stating that "gross income" [means] the total amount of money received (i.e., 'gross receipts') minus basis").

do the Regulations maintain silence as to whether cost of goods sold is the sole distinction between gross receipts and gross income, they also introduce a new term – "total receipts" – which is not defined.

Under the most recent Gross Receipts Test guidance, Service has implicitly and consistently taken the position that "total receipts" is a broader concept than merely gross income plus cost of goods sold. Specifically, it appears that at least certain items which are excluded from gross income are nevertheless included within gross receipts. As one example, dividends paid from one member of a consolidated group to another such member ("**intercompany dividends**") are expressly excluded from "gross income" under Reg. § 1.1502-13(f)(2)(ii), but the Service has taken intercompany dividends into account in applying the Gross Receipts Test.[33] Because of the express exclusion from gross income and the absence of a costs of goods sold in the case of an intercompany dividend, it would seem that the Service must view "total receipts" as a separate – and as of yet undefined – concept.

To resolve these unanswered issues in the absence of specific guidance, it is possible that taxpayers could look to any of the numerous other provisions in the Code and Regulations that define the term "gross receipts" for their own particular purposes. Among these various provisions, two in particular stand out as having a gross receipts definition most closely designed to address situations to which the Gross Receipts Test may be applicable. First, the term "gross receipts" is defined for purposes of determining whether stock is "section 1244 stock," with section 1244 stock being limited, in part, to stock of active corporations. For this purpose, and in relevant part:

> The term "gross receipts"…is not synonymous with "gross income." Gross receipts means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Thus, the total amount of receipts is not reduced by returns and allowances, cost, or deductions. For example, gross receipts will include the total amount received or accrued during the corporation's taxable year from the sale or exchange…of any kind of property, from investments, and for services rendered by the corporation. However, gross receipts does not include amounts received in nontaxable sales or exchanges…, except to the extent that gain is recognized by the corporation, nor does that term include amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.[34]

Second, section 1362(d)(3), which causes the termination of a subchapter S election when the corporation has excessive passive gross receipts, employs a standard similar to the Gross Receipts Test. For this purpose, and in relevant part:

> [G]ross receipts generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced

[33] A similar point may be made with respect to interest on State or local bonds which are excluded from gross income under section 103(a) but which nevertheless seems properly includible as interest for the Gross Receipts Test.

[34] Reg. § 1.1244(c)-1(e)(1)(i)(a).

> by returns and allowances, cost of goods sold, or deductions….[35] [G]ross receipts do not include (A) Amounts received in nontaxable sales or exchanges except to the extent that gain is recognized by the corporation on the sale or exchange; or (B) Amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.[36]

Due to the lack of clarity in the Code, the legislative history, and the Regulations as to an overarching theme for determining gross receipts in the section 165(g)(3)(B), taxpayers may encounter difficulties in computing gross receipts even in simple fact patterns. Should loan proceeds be excluded from gross receipts, as they are excluded from gross income under section 61?[37] Should amounts received in nonrecognition transactions be excluded from gross receipts because they are excluded from gross income?[38] Should the same treatment be accorded to cancellation of indebtedness income ("**COD income**") excluded from gross income under section 108(a)? [39] On the other hand, should taxable events in which no amount is actually received (e.g., gains taken into account under section 311(b), losses taken into account under section 311(a) and Reg. § 1.1502-13(f)(2)(iii)) produce gross income since they result in taxable income under section 63(a), a component of which is gross income? Outside of dispositions of stock and securities (which are directly addressed by section 165(g)(3)(B)), should basis recovery transactions generate gross receipts even though basis recovery generally is excluded from gross income?[40]

ii. Recommendations:

We believe that the Service and the Treasury Department should issue guidance providing additional definition to the term "gross receipts" for purposes of applying the Gross Receipts Test. Although we acknowledge the potential difficulty involved in developing a comprehensive definition, guidance might be provided for certain commonly occurring items, such as amounts arising from nonrecognition transactions, borrowings, loan repayments, COD income, tax-exempt income, sales of property other than stocks or securities, as well as the treatment of returns and allowances. We believe that such guidance generally should confirm what, in our experience, is the treatment of these items commonly applied by taxpayers and the Service in

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[35] Reg. § 1.1362-2(c)(4)(i).

[36] Reg. § 1.1362-2(c)(4)(iii).

[37] *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *James v. U.S.*, 366 U.S. 213 (1961).

[38] Reg. § 1.61-6(a) (gain realized on the sale or exchange of property is included in gross income, unless excluded by law); Reg. § 1.61-6(b) (certain realized gains or losses on the sale or exchange of property are not recognized and are not included in or deducted from gross income at the time the transaction occurs; also listing, in part, as examples of such exchanges (i) certain formations, reorganizations, and liquidations of corporations under sections 331, 333, 337, 351, 354, 355, and 361; (ii) certain formations and distributions of partnerships under sections 721 and 731; (iii) exchanges of certain property held for productive use or investment for property of like kind under section 1031; (iv) a corporation's exchange of its stock for property under section 1032; (v) certain involuntary conversions of property if replaced under section 1033; and (vi) certain exchanges of stock for stock in the same corporation under section 1036).

[39] Section 61(a)(12); Reg. § 1.61-12.

[40] Reg. § 1.61-6(a).

practice. So, for example, gross receipts would not be created from the receipt of qualifying consideration in nonrecognition transactions, proceeds of borrowings, and loan repayments. Gross receipts would be generated from the receipt of tax-exempt income, but no gross receipts would be generated through the realization of excluded COD income.[41] Guidance should also confirm that the entire amount realized from the sale of property not constituting stock or securities constitutes gross receipts without regard to basis recovery[42] and that, as with cost of goods sold, gross receipts is not reduced by returns and allowances.[43]

C. Treating Certain Passive Receipts as Active

i. Existing authority

The language of section 165(g)(3)(B) itself permits treating as active receipts certain types of receipts that would otherwise be viewed as passive. Rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business are treated as active income, as is interest received on deferred purchase price of operating assets sold. The Service, in the course of its administration of section 165(g)(3)(B), has expanded the types of otherwise passive receipts which are treated as active receipts under certain circumstances.

Generally, outside of a limited "look-through" rule which the Service has applied where Parent and Subsidiary file consolidated returns (discussed further below), dividends constitute passive receipts and cannot be treated as active, even if it is possible to trace such dividends to receipts generating active earnings.[44] The rationale is that the term "dividends," unlike other passive receipts which may be treated as active, is specifically defined in the tax law without reference to

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[41] *Cf*. Reg. § 1.1244(c)-1(e)(1)(i)(a) and Reg. § 1.1362-2(c)(4)(iii) (excluding from gross receipts, in situations analogous to the Gross Receipts Test, amounts received as a loan or as a repayment of a loan). For example, assume P, a newly formed holding corporation with a corporate shareholder, borrows $100 from its shareholder to purchase the stock of S, and S subsequently drops in value to $75. If P, which is now insolvent, converts to disregarded entity status, it should incur $25 of COD income, its sole "receipt." Because COD income is not a proscribed receipt under the exclusive list of section 165(g)(3)(B), including the COD income for P's Gross Receipts Test would lead to an ordinary deduction for P's shareholder because 100 percent of P's gross receipts were "active." Only through excluding the COD income altogether from the Gross Receipts Test is the proper, capital loss treatment under section 165(g)(1) accorded to the loss arising from P's worthlessness.

[42] *Cf. B.C. Cook & Sons, Inc. v. Comm'r*, 65 T.C. 422, 428 (1975), *affd*. 584 F.2d 53 (5th Cir. 1978) (equating cost of goods sold and basis); *Goodenow v. Comm'r*, 238 F.2d 20 (8th Cir. 1956) (similar); *Byerlyte Corp. v. Williams*, 170 F. Supp. 48, 57-58 (N. Dist. OH 1959), *revd*, 286 F.2d 285 (6th Cir. 1960) (in positing an example in which a corporation has significant gross revenue from sales but all such sales are at a loss, and the corporation also has a small amount of rental income, court observed that if the computation of gross receipts were limited to gains, the corporation would have received no gross income from its operations and all its gross receipts would be received as rent and that "[a] construction capable of producing such capricious and incongruous results must be rejected;" presumably the same "'capricious and incongruous" results would obtain if the loss was due to a higher "basis" rather than "cost of goods sold" and, indeed, the court noted that "Congress was not unmindful that an operating company whose stock became worthless might not realize any gross profits and that conceivably the lack of such profits might be the primary cause of the corporation's insolvency").

[43] *Cf.* Reg. § 1.1362-2(c)(4)(i) (total receipts are not reduced by returns and allowances); Reg. § 1.1244(c)-1(e)(1)(i)(a) (similar); *Friedmann v. Comm'r,* 82 T.C.M. 381 (2001).

[44] *See* TAM 200727016 (Jan. 11, 2007).

the underlying activities that gave rise to the dividends.[45] However, the Service has provided that other passive receipts, such as royalties, rents, and interest, may be treated as active if significant services are provided in connection with these passive receipts.

In Rev. Rul. 88-65,[46] the Service addressed whether amounts received by a subsidiary corporation which leased automobiles and trucks on a daily basis were "rents" within the meaning of section 165(g)(3)(B). In connection with leasing vehicles, the subsidiary corporation performed or arranged for all necessary maintenance and repair services on the leased vehicles. The revenue ruling provides that "[i]f significant services are performed by a corporation in connection with the leasing of automobiles and trucks, the amounts received under the leases are not rents within the meaning of section 165(g)(3)(B) of the Code." Because the term "rents" as used in this section is not defined, the Service relied on both the legislative history and similar Code sections to reach its conclusion. First, the Service found that the legislative history indicated 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."[47] Second, the investment income listed under section 165(g)(3)(B) is similar to the types of passive investment income specified in section 1244(c)(1)(c)[48] and former section 1372(e)(5)(C), the predecessor to section 1362(d)(3)(D)(i).[49] In both sections, there is a distinction between amounts received from the active conduct of a business and passive or investment income.[50] Therefore, the Service held that it is also "appropriate to distinguish between active and passive rental income" for purposes of section 165(g)(3)(B). Because the subsidiary corporation performed significant services through maintenance and repair of the leased vehicles, the amounts received from the leases were not "rents" under section 165(g)(3)(B).

Consistent with the analysis in Rev. Rul. 88-65, the Service has issued several private letter rulings which find that ordinarily passive receipts may be characterized as active receipts if they are in connection with significant services. Rents are one type of disqualifying passive income

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[45] *Id.*

[46] 1988-2 C.B. 32.

[47] *See also* GCM 39746 (July 20, 1988) (responding to the proposed issuance of Rev. Rul. 88-65). The GCM states that "section 23(g)(4) of the 1939 Code, the predecessor of section 165(g)(3)(B) of the 1954 Code, was not intended to deny an ordinary loss where a subsidiary actively conducts a trade or business." *See* 90 Cong. Rec. 121 (1944) (statement of Sen. Davis).

[48] Section 1244(c)(1)(c) defines "section 1244 stock" to include, if additional requirements are met, stock in a domestic corporation if such corporation derived more than 50 percent of its "aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities."

[49] Section 1362(d)(3)(D)(i) was removed. Section 1362(d)(3)(C) defines passive investment income for S corporations as "gross receipts derived from royalties, rents, dividends, interest, and annuities."

[50] For example, the revenue ruling cites Reg. § 1.1244(c)-1(e)(1)(iii), which stated that payments "for the use of personal property do not constitute rents if significant services are rendered in connection with such payments" and which now defines "rents" to exclude "payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant." Furthermore, Rev. Rul. 65-40, 1965-1 C.B. 429 and Rev. Rul. 76-469, 1976-2 C.B. 252, both relying on former section 1372(e)(5), concluded that short-term rents for motor vehicles are not "rents" if significant services are provided.

listed in section 165(g)(3)(B) which may be treated as active receipts.[51] In PLR 200003039,[52] the subsidiary corporation operated a vehicle rental business and performed vehicle maintenance and repair. The subsidiary had two forms of rental income: rent from short-term vehicle rentals to customers and rent from longer-term leases to franchisees. Because the rent from short-term vehicle rentals was the same type of income in Rev. Rul. 88-65 and the subsidiary performed similar significant services as in the revenue ruling, including vehicle maintenance and repair, the rental income did not constitute rent for purposes of section 165(g)(3)(B). The analysis was the same for the rent from longer-term leases to franchisees because the subsidiary also provided significant maintenance and repair work for the franchisees in connection with the long-term leases.

Royalties are another type of disqualifying passive income which may be characterized as active.[53] In PLR 200003039, the subsidiary corporation, in addition to operating a vehicle rental business, also had sublicenses under which it provided vehicles to franchisees. The franchise fees consisted of licensing, administrative, and advertising fees. To the extent the fees were compensation for services performed, the fees did not fall under section 165(g)(3)(B). To the extent the fees represented compensation for the use of intangibles, the Service looked to relevant guidance in Reg. § 1.1362-2(c)(5)(ii)(A)(2),[54] which states that royalties "are derived in the ordinary course of a trade or business of franchising or licensing property only if . . . the corporation – (i) Created the property; or (ii) Performed significant services or incurred substantial costs with respect to the marketing of the property." Because the subsidiary performed an array of services "such as business consulting that contribute[d] to the value of the licensed intangibles," the subsidiary corporation "provide[d] significant services in the development of whatever intangibles are licensed to its franchisees." Therefore, the Service concluded that the fees paid by franchisees were not treated as royalties.

PLR 201325007[55] provides additional examples of the types of "significant services" the Service finds sufficient to treat passive royalty receipts as active receipts. The subsidiary was a research and development corporation that commercialized its patented products through licensing with other major companies. Under the licensing arrangements, the subsidiary generally continued to develop the product through pre-clinical research and assist in the performance of clinical trials. If the clinical trials were successful, the product was submitted for regulatory approval to bring the product to market. The Service concluded that the license fees were "attributable to the

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[51] *See also* PLR 8618035 (Feb. 4, 1986) (gross receipts in connection with consumer and commercial rental operations are not passive receipts provided that the subsidiary renders significant services to its customers in connection with its rental operations); PLR 7405311140A (May 31, 1974) (gross receipts from truck and trailer one-way rental leasing operations that are in connection with substantial services are not rents, royalties, or interest, but gross receipts from financing leases fees are disqualified passive income).

[52] (Oct. 26, 1999).

[53] *See also* PLR 200924040 (Mar. 6, 2009) (gross receipts from software licensing fees "arising from sources that are integral to the development, manufacture, production, or support of customized software applications . . . should be excluded from the definition of 'royalties' within the meaning of section 165(g)(3)(B)").

[54] Note that section 1362 is the successor to former section 1372(e)(5), one of the sections similar to section 165(g)(3)(B) which the Service relied on in Rev. Rul. 88-65.

[55] (Mar. 18, 2013).

[subsidiary's] significant business activities in the research and development of [the] products for [regulatory] approval and [arose] as a direct result of its activities as an operating . . . company." Therefore, such licensee fees "should be excluded from the definition of 'royalties' within the meaning of section 165(g)(3)(B)."

ii. Banks and insurance companies

The Service generally appears to apply a similar construct in characterizing interest income as generating active or passive gross receipts. That is, interest income earned in connection with a lending business is treated as active receipts. On the other hand, outside of interest received on deferred purchase price for the sale of operating assets, the Service generally will treat interest earned on investments held as part of an operating business as passive receipts. This distinction seems clearest in the different treatment of banking and insurance Subsidiaries.

In *Adam, Meldrum, and Andersen, Co. v. Commissioner*,[56] the Second Circuit held that a non-bank parent corporation was not entitled to an ordinary WSD with respect to its banking subsidiary. The court reasoned that the statutory language of section 165(g)(3)(B) was clear on its face in treating interest income as a passive receipt. The Service, however, has not followed the strict reading of the statutory language adopted in the case. For example, in PLR 9218038,[57] the Service permitted the parent non-bank holding company to take an ordinary WSD, citing Rev. Rul. 88-65 and the legislative history underlying section 165(g)(3)(B) to support its position.

The Service continues to treat interest income derived from banking operations as active receipts if the banking subsidiary performs significant services in connection with such receipts. In PLR 201347002,[58] the subsidiary corporation was in the business of making loans. The Service analyzed the subsidiary's receipts under Rev. Rul. 88-65 and found that receipts derived from its retail lending business which were earned in connection with the performance of significant services did not constitute interest for purposes of section 165(g)(3)(B). The subsidiary "operated and maintained a significant number of retail locations, accepted and processed loan requests at those locations, appraised collateral, provided customers with loan agreements, provided customers with loan proceeds, and collected principal and fee payments." In addition, the subsidiary took possession of collateral and stored and monitored it. If a customer repaid the loan in full, the subsidiary returned the collateral to the customer. Otherwise, the subsidiary sold the collateral and applied the proceeds to the outstanding balance and fees. Because the subsidiary performed "significant services in its retail lending activities that resulted in generating gross receipts in the form of fee income and commissions," the amounts that the subsidiary earned did not constitute interest under section 165(g)(3)(B).[59]

[56] 215 F.2d 163 (2nd Cir. 1954), *cert. denied*, 348 U.S. 913 (1955).

[57] (Jan. 29, 1992).

[58] (Aug. 26, 2013).

[59] *See also* PLR 201108001 (Nov. 19, 2010) (applying the analysis of Rev. Rul. 88-65 to gross receipts received by an operating company in the banking business in the form of interest income on, and gains from the sale of, real estate and consumer loans).

In contrast, the Service has treated interest income on investments made by an insurance subsidiary as passive receipts, notwithstanding the close connection between these investments and the subsidiary's business operations. Initially, the Service viewed interest received by insurance Subsidiaries as active receipts. In TAM 9538005,[60] the Service compared the treatment of interest from banks and insurance companies and stated that "[a]s with banks, investments are an integral part of an insurance company's business and are a principal source of its income." Furthermore, "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." The Service concluded that because the insurance company actively sold its insurance policies and earned significant premiums in connection with such sales which it then invested, it was not a passive holding company that was intended to be excluded from section 165(g)(3). However, two years later the Service withdrew TAM 9538005[61] and eventually revoked it in TAM 9817002.[62] There, the Service analyzed the legislative history of section 165(g)(3)(B) and determined that "an ordinary loss was only intended to be allowed for the worthlessness of an operating company as opposed to an investment or holding company subsidiary. . . . 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." Because there was no indication that the assets generating the passive receipts did not constitute capital assets in the hands of the insurance company, the Service determined that treating the income as "not being from interest, dividends and capital gains" 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, the Service reasoned, "would have the unacceptable effect of converting what would have been a capital loss to [the insurance company] into an ordinary loss to taxpayer." Therefore, the Service concluded that such receipts constituted passive disqualifying income under section 165(g)(3)(B).

iii. Recommendations

We believe that the Service and the Treasury Department should publish guidance clarifying that receipts which would otherwise be characterized as passive will instead be considered to be active if the provision of business services or a business product developed, manufactured, distributed, or marketed by Subsidiary to the payor is a material factor in the generation of the receipts. The principle established by Rev. Rul. 88-65 seems fundamentally sound. If gross receipts are generated in material part through Subsidiary's provision of services to its customers or clients (that is, the otherwise passive gross receipt is simply how the Subsidiary is compensated for its business activities), it should not matter that the receipts are in the form of rent, royalties, or interest. In such case, the receipts are, in fact, business income. We believe that this principle ought to be extended to situations in which Subsidiary is providing to its

[60] (June 1, 1995).

[61] TAM 9723011 (Feb. 27, 1997).

[62] (Jan. 5, 1998).

customer a product that it develops, manufactures, distributes, or markets (rather than services), as the Service did in PLR 201325007. In such case, the fact that business income is in the form of, for example, royalties does not meaningfully detract from their essence as business receipts. Thus, a software company which overwhelmingly earns its business income through licensing of its software ought to be considered to be active for section 165(g)(3)(B) purposes.

It would similarly be helpful if such guidance addressed the treatment of investment-related receipts by financial corporations, such as banks and insurance companies, whose ownership of such investments are integrally linked to their core business operations. Such corporations generally are neither investment corporations nor holding companies in a real world sense. Rather, they are real operating companies. If the underlying legislative intent of the Gross Receipts Test is to distinguish between operating companies and investment companies, then the Parent of bank or insurance Subsidiary generally should benefit from the ordinary WSD. However, if the underlying legislative intent is to look through to the underlying assets of the worthless Subsidiary, then it may not be appropriate for the Parent to benefit from an ordinary WSD.

One advantage of having a special rule for banks and insurance companies is that it would be administrable.[63] Furthermore, a special rule for banks and insurance companies would be consistent with other areas of the tax law that broadly attempt to distinguish active income from passive income. For example, the "passive foreign investment company" ("**PFIC**") rules impose a special taxing regime on US shareholders with respect to certain foreign corporations deemed to be passive under either an assets test or an income test. For purposes of such tests, passive income does not include any income derived in the active conduct of a banking business by a licensed bank or an insurance business by a corporation which is predominantly engaged in an insurance business.[64] Similarly, the "Subpart F" rules, which generally attempt to tax income that is perceived to have a high degree of "mobility," treat interest earned by insurance companies differently; while insurance income is still subject to Subpart F, exemptions are provided for a foreign insurance company that, in general terms, has a close business nexus to its home jurisdiction and that earns income that similarly has such a nexus.[65]

On the other hand, having a special rule for banks and insurance companies would not be without administrative challenges, creating the need to define which types of companies qualify for an exemption for insurance companies, since section 165(g)(3)(B) can apply to foreign subsidiaries not subject to U.S. regulatory regimes. Another administration issue which would come into play if a special rule for banks and insurance companies were promulgated is whether favorable treatment of investment income would apply to all of the investment receipts or just a

[63] An "insurance company" is any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by other insurance companies. Sections 831(c) and 816(a) (flush language).

[64] Section 1297(b)(2)(B).

[65] *See* section 953(e). *See also*, section 954(i) (exclusion of certain insurance income from "foreign personal holding income").

certain portion of receipts generated from investment assets the ownership of which is clearly associated with maintaining sufficient investment assets to support reserves.[66]

We note that, as pointed out in TAM 9817002, extending favorable treatment to insurance companies would seem to have the effect of converting what would have been a capital loss to Subsidiary into an ordinary loss of Parent. It is true that interest income earned by insurance companies is closely connected to their business operations. But, unlike banks, an insurance company generally does not get an ordinary deduction on losses from dispositions of investments in capital assets (such as portfolio debt instruments).[67] Neither do insurance companies generally provide active services with respect to assets generating investment returns (loan origination, servicing, etc.), though this is not always the case; to the extent that they do provide such services, Rev. Rul. 88-65 could be applied to treat such receipts as active. A special rule for insurance companies is a broader proposition, however, and raises questions, as a conceptual matter, as to why insurance companies should be treated differently from other companies having a close relationship between their ownership of investment assets and their business activities.

A related issue, as a conceptual matter, is whether favorable treatment generally should be accorded to investment income which is generated as an integral part of an active business. As alluded to above, similar to investment income earned by insurance companies, it can be argued that interest earned on working capital should be treated as active receipts because the maintenance and deployment of working capital is integral to conduct of an active business. Nevertheless, we are not prepared at this time to recommend extending favorable treatment this broadly with respect to working capital investments. As an initial matter, such an exception is not consistent with the "look-through" principle referenced in the legislative history. It would also engender definitional challenges in setting the boundaries of whether and to what extent investments are integral to the conduct of an active business. Finally, the Code already provides a 10 percent basket for passive receipts, which typically affords operating Subsidiaries sufficient leeway to absorb passive receipts from working capital investments.

D. Succession to Gross Receipts under Section 381

Successor receipts, as used here, refer to gross receipts that have not been directly earned by Subsidiary, but are taken into account for purpose of determining if Subsidiary satisfies the Gross Receipts Test, because of a corporate transaction engaged in by the Subsidiary with a predecessor entity. The Service has issued PLRs that require Subsidiary, as the acquiring corporation in a section 381 transaction, to take into account the gross receipts of a transferor corporation that actually generated the gross receipts. Although the PLRs typically involve a

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[66] For example, active receipts treatment could be limited to investments up to a percentage of an insurance Subsidiary's legal reserves. *Cf.* section 954(i) (providing that, under certain conditions, investment income earned by a qualifying insurance company is excluded from foreign personal holding company income if such income arises from investments that represent a certain proportion of such company's reserves (or represents up to 80 percent of such company's unearned premiums) allocable to exempt contracts).

[67] *See* Reg. § 1.582-1(d) (treating gain or loss from the sale of a security, which is defined essentially to be any indebtedness issued by any person, as not being from the sale or exchange of a capital asset).

consolidated group, the Service's determinations to take into account gross receipts arising from section 381 transactions do not appear to require prior consolidation. However, where Subsidiary takes into account successor receipts of another member, the Service requires that any duplication in gross receipts be eliminated.

For example, in PLR 200710004,[68] Taxpayer (the common parent of the group) owned Holding (a member of group) for which a WSD was sought. Prior to Holding becoming insolvent, Holding owned several subsidiaries that had previously acquired assets from other directly or indirectly owned subsidiaries (which were previously acquired by purchase from unrelated parties) through internal group restructurings (the Internal Restructurings). Holdings sold a substantial portion of its operations and subsidiaries to pay down some of its intercompany debt. The sales involved qualified stock purchases under section 338(h)(10), and asset sales by first-tier subsidiaries of Holding that were characterized as either section 332 liquidations or de facto liquidations. Taxpayer represented that the Internal Restructurings were tax-free under section 332 or section 368. The Internal Restructurings and the liquidations were defined collectively as the Section 381 Transactions. For purposes of the Gross Receipts Test, the Service ruled Holding will take into account the historic gross receipts of the transferors in the Section 381 Transactions provided, however, that Holding will eliminate intercompany distributions from the transferor corporations, as appropriate, to prevent duplication.[69]

In general, the Service does not cite section 381 as direct authority for taking into account successor receipts. Nonetheless, the facts or the taxpayer representations in the PLRs indicate the Service is relying on section 381 as the underlying authority to treat the successor receipts as moving to Subsidiary.

i. Appropriateness of succession to gross receipts history in a section 381 transaction

The Service's position that an acquirer in a section 381 transaction succeeds to the target corporation's or liquidating corporation's gross receipts for purposes of the Gross Receipts Test seems reasonable. Section 381 provides that a corporation that acquires the assets of another

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68 (Dec. 5, 2006).

69 The Service has continued to issue PLRs with similar rulings. *See* PLR 200932018 (Apr. 14, 2009) (taxpayer represented that Subsidiary would satisfy the Gross Receipts Test if successor receipts from section 381 transactions were taken into account, and the ruling provided that the character of the WSD would be determined by taking into account the successor receipts, and that gross receipts included dividends from members to the extent attributable to the member's gross receipts from passive sources); PLR 201006003 (Oct. 28, 2009) (taxpayer acquired Subsidiary (the common parent of its own consolidated group) in a prior transaction, prior to claiming a WSD multiple levels of lower-tier corporations merged or liquidated into Subsidiary, which the taxpayer represented each qualified as tax-free under section 332 or section 368; the Service ruled that the gross receipts of each transferor would be taken into account in applying the Gross Receipts Test, provided intercompany distributions are eliminated); PLR 201011003 (Nov. 30, 2009) (section 332 liquidations into Subsidiary resulted from section 338(h)(10) elections and provided Subsidiary with successor receipts from the liquidated corporations, provided Subsidiary eliminate gross receipts from Intercompany Transactions to prevent duplication); PLR 201149015 (Aug. 31, 2011) (without identifying a specific transaction in the facts, the ruling provides that successor receipts of any transferor in a section 381 transaction will be taken into account in applying the Gross Receipts Test, requiring any duplicated gross receipts from Intercompany Transactions be eliminated).

corporation in certain reorganizations and liquidations succeeds to, and takes into account, as of the close of the date of distribution or transfer, the items described in section 381(c) of the distributor or transferor corporation. Specifically, the transferor's assets must be received in a liquidation that qualifies under section 332, or in connection with reorganizations described in section 368(a)(1)(A), (C), (D), (F), or (G).[70] The items listed in section 381(c) do not include section 165(g)(3)(B) gross receipts. Nonetheless, the Service allowed the successor receipts to be taken into account for section 165(g)(3)(B) purposes, where the assets related to the gross receipts were transferred in section 381 transactions.

The items listed in section 381(c) are required to be taken into account, but the language of the Regulations, which is supported by the Senate committee report accompanying the 1954 enactment of section 381, does not establish that the list of items in section 381(c) are the only items that can be carried over.[71] Reg. § 1.381(a)-1(a)(1) requires the acquiring corporation to "succeed to, and take into account" the section 381(c) items, but Reg. 1.381(a)-1(b)(3)(i) makes clear no inference is to be drawn from the provisions of section 381 as to whether any item or tax attribute shall be taken into account by the successor corporation. The language of the Regulations mirrors the Senate committee report that also explained "no inference is to be drawn from the enactment of [section 381] whether any item or tax attribute may be utilized by a successor or a predecessor corporation under existing law."[72] The Service and the courts have found that transferees in section 381 transactions succeed to a number of attributes not enumerated in section 381.[73]

ii. Scope of the successor concept for purposes of the Gross Receipts Test

While Reg. § 1.381(a)-1(b)(3) refers to "the successor corporation" that may succeed to a tax item or attribute, the term "successor" is not defined by section 381 or the regulations other than by inference from the statutory language that provides "the acquiring corporation shall succeed" to the section 381(c) items. The Code also refers regularly to successors but without a specific definition.[74] Definitions of successor can be found in regulations outside section 381 and

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[70] Section 381(a)(1) (liquidations) and (a)(2) (reorganizations).

[71] *See* Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders*, ¶ 14.20[2]]

[72] S. Rep. No. 1622, 83d Cong., 2d Sess. 52,277 (1954).

[73] *See, e.g.*, Rev. Rul. 72-356, 1972-2 C.B. 452 (X acquired all the assets of Y in a statutory merger described in section 381(a). Before the merger, X was a western hemisphere trade corporation (WHTC) under former *section 921*. To be a WHTC, a corporation was required to satisfy an active trade test and a source test, both of which are determined by reference to gross income during the three-year period ending in the subject year. In determining whether these tests were met for X for the acquisition year, X was required to include Y's gross income during 1968 and 1969 (as well as its own in those years and in 1970), even though gross income for purposes of applying the tests is not an item described in section 381(c)).

[74] *See, e.g.*, section 355(e)(4)(D) (requiring, for purposes of applying section 355(e), that references to a distributing or controlled corporation include references to a predecessor or successor); section 1504(a)(3)(A) (disallowing a corporation (and any successor of such corporation) from being included in any consolidated return filed by the affiliated group (or by another affiliated group with the same common parent or a successor of such common parent) before the 61st month beginning after its first taxable year in which it ceased to be a member of such affiliated group).

generally provide that a successor is the recipient of assets in a transaction to which section 381(a) applies, or in which the successor's basis for the assets is determined, directly or indirectly, in whole or in part, by reference to the basis of the transferor or distributor.[75]

Although the PLRs discussed above do not affirmatively limit the successor concept to an acquiring corporation in a section 381 transaction, an implication could be drawn from the Service's reliance on section 381 that the successor of the gross receipts must coincide with the definition of an acquiring corporation under Reg. § 1.381(a)-1(b)(2)(i). This Regulation now defines the acquiring corporation as the initial recipient of the transferor corporation's or distributing corporation's assets in a section 381 transaction without regard to subsequent transfers.[76]

Strictly adhering to the acquiring corporation definition for section 381 purposes may be viewed as producing questionable results under the Gross Receipts Test in certain cases where the gross receipts are separated from the assets which gave rise to the receipts. Consider the case where Subsidiary is the section 381 acquirer and then transfers all or substantially all of the assets received in the section 381(a)(2) transaction to a single subsidiary or to more than one subsidiary. As the direct acquirer, Subsidiary is the acquiring corporation under the section 381 regulations because it is the initial recipient of the transferor corporation's assets. After the transfer, however, it would appear that Subsidiary, as the acquiring corporation that received the transferor's assets in the first instance takes into account the transferor's gross receipts history even though Subsidiary holds very few, if any, of the acquired assets related to those gross receipts. Allowing the gross receipts to remain with the direct recipient while most of the assets are held by the transferee seems to provide Subsidiary gross receipts generated from assets held in a lower-tier corporation that would not be taken into account (absent section 381) for purposes of determining Subsidiary's gross receipts.

Consider a different case where Parent acquired all of the assets of a predecessor and transferred all or substantially all of the acquired assets to Subsidiary. As a result, Parent (and not Subsidiary) would have succeeded to the gross receipts history of predecessor. If Subsidiary's stock later becomes worthless, Subsidiary would not take into account predecessor's gross receipts history even though it acquired all or substantially all of the assets that generated such gross receipts.

Outside of the section 381 transaction context, similar issues may exist. For example, assume that Parent historically conducted a business and then decides to transfer the business to a newly formed Subsidiary in a section 351 exchange. A transferee in a section 351 is treated as

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[75] *See, e.g.,* Reg. § 1. 338-8 (defining predecessor and successor for purposes of the consistency rules of sections 338(e) and (f)), Reg. 1.367(a)-8T(a)(3)(i) (defining successor US transferor for purposes of exceptions from triggering events for certain transactions), Reg. 1.382-2(a)(5) (defining a successor corporation for purposes of applying rules under sections 382 and 383), and Reg. 1.1502-13(j)(2) and -32(f) (defining predecessor and ***successor*** for applying consolidated return rules applicable to intercompany transactions and investment adjustment).

[76] Reg. § 1.381(a)-1(b)(2), which was finalized in 79 FR 66616, *Allocation of Earnings and Profits in Tax-Free Transfers From One Corporation to Another; Acquiring Corporation for Purposes of Section 381* (Nov. 10, 2014).

successor of the transferor for some, but certainly not all, purposes.[77] Should a transferee in a section 351 transaction be treated as the successor of the transferor for section 165(g)(3)(B) and, as such, inherit the gross receipts history (in part or in whole) of the business? Should the answer turn on whether the transferred assets constitute all or substantially all of the transferor's assets? [78]

Divisive reorganizations under sections 355 and 368(a)(1)(D) represent another example of a corporate transaction where successor status may be appropriate. Viewing the transaction as a division of the distributing corporation, it can be argued that its gross receipts should be divided between the distributing and controlled corporations. A similar division of the distributing corporation's E&P is provided for by Reg. § 1.312-10(a). However, conceptual and practical difficulties would exist. For example, no allocation of gross receipts may be appropriate if and to the extent that the controlled corporation is a pre-existing subsidiary with its own gross receipts or the assets contributed to the controlled corporation consist of one or more subsidiaries of the distributing corporation with their own gross receipts. [79]

The scope of the successor principle under section 165(g)(3)(B), therefore, remains unclear. Furthermore, there is no guidance beyond PLRs providing rules that taxpayers can rely on to address such issues without seeking a PLR.

iii. Duplication of gross receipts from periods prior to the section 381 transaction creating successor status

Without additional rules, succession to gross receipts in a section 381 transaction can result in duplication of receipts resulting from prior transactions between the successor and the predecessor. Duplication results because the amounts are being counted twice: once when the prior transaction occurred and once when the successor succeeds to the predecessor's historic gross receipts. The PLRs that require Subsidiary to take into account successor receipts for purposes of section 165(g)(3)(B) also require that prior intercompany distributions and other intercompany transactions between the successor and the predecessor be eliminated to prevent duplication.

[77] *See, e.g.,* Rev. Rul. 70-565, 1970-2 C.B. 110 (requiring the transferee in a section 351 transaction that used the LIFO method and received LIFO inventories from the transferor to integrate the acquired LIFO inventories into the transferee's own monthly LIFO layers retaining the original acquisition dates and costs of the transferor); section 357(c)(3) (excluding deductible liabilities received by a transferee in a section 351 transaction for purposes of determining whether liabilities exceed basis).

[78] The Service appears to be of the view that the gross receipts history of a transferor is not transferred in a section 351 transaction. In PLR 201314005, no gross receipts of disregarded entities were counted towards Subsidiary's gross receipts following their elections to be taxed as corporations. Although not addressed by the PLR, the election to convert from a disregarded entity ("**DRE**") to a corporation typically qualifies as a section 351 transfer because the election is treated by Reg. § 301.7701-3(g)(3)(iii) as if the owner of the DRE contributes all of the assets and liabilities of the disregarded entity to a newly formed corporation in exchange for stock. The gross receipts earned by the DREs before incorporation were counted by the transferor, Subsidiary. Consistent with section 351 not being a section 381 transaction, the gross receipts of the transferor, Subsidiary, apparently were not carried over to the newly formed corporation.

[79] *Cf.* Reg. § 1.312-10(b).

1. Intercompany distributions

As an example, assume P owns FS. FS earns $100 giving rise to gross receipts in FS. FS then distributes the $100 to P giving rise to passive gross receipts in P. If FS merges into P and P takes into account the gross receipts of FS, then P will have $200 of gross receipts ($100 from FS's distribution and $100 of successor receipts inherited from FS in the merger). In this simple example, it is clear the $200 of gross receipts is attributable to the same $100 of gross receipts received by FS, and the Service's requirement that the duplication be eliminated seems correct. Open questions remain, however, as to how the elimination of duplication is accomplished. Which gross receipts should be eliminated: (a) the gross receipts of the successor generated from the intercompany transaction or (b) a portion of the historic gross receipts of the predecessor? If the latter, how is the eliminated portion of the predecessor's gross receipts determined? Beginning with PLR 200710004, the Service appears to prefer to eliminate the gross receipts resulting from the intercompany distribution.

2. Other intercompany transactions

Affiliated corporations engage in transactions with each other that can also produce gross receipts. The corporations can sell goods, provide services, make loans, and enter into any other commercial arrangements with each other. Generally, gross receipts will result and, if those same members later engage in a section 381 transaction, duplication of the gross receipts will occur unless anti-duplication rules are adopted. As an initial matter, these intercompany transactions raise the same questions addressed above with respect to intercompany distributions – *i.e.*, which gross receipts are eliminated? As with intercompany dividends, the Service's preferred answer appears to be that the gross receipts from the intercompany transactions are to be eliminated, as it ruled in PLR 201011013. Nevertheless, it should be noted that, once the scope of the anti-duplication rules are extended to a broad range of intercompany transactions, which may be numerous and may occur in the ordinary course of business (e.g., intercompany sales between a manufacturer and a distributor), the administrative burden of identifying which receipts need to be eliminated is likely to be challenging. Where tiers of successors and predecessors exist, the difficulty is likely to be compounded.

iv. Recommendations

We recommend that the Service and the Treasury Department issue guidance, in the form of either a revenue ruling or Regulations, confirming that a successor succeeds to the gross receipts history of a predecessor[80] and defining a successor as the acquiring corporation in a section 381 transaction as defined in Reg. § 1.381-1(b)(2). We also recommend that guidance be considered clarifying how the duplication of gross receipts is eliminated following a section 381 transaction. One potential approach would be that the successor and the predecessor be treated as if there were always a single corporation and all prior intercompany transactions between them be

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[80] Such guidance should confirm that the successor succeeds to both the amount of the predecessor's gross receipts and to the character of such gross receipts as determined in the hands of the predecessor. Thus, for example, the fact that a successor ceases to provide significant services to payors of royalties following the acquisition should impact the character of royalties it receives after the acquisition but not the character of the gross receipts inherited from the predecessor.

disregarded in determining the successor's gross receipts. Such an approach has the advantage of providing a clear conceptual model for eliminating duplication. On the other hand, there could be significant difficulty as a practical matter in identifying and sorting out prior intercompany transactions in certain cases. Moreover, it can be argued that eliminating prior intercompany transactions simply because the two parties later merge may be distortive where the parties previously interacted as would unrelated entities and the character of their prior dealings are a good indicator of whether a party really was engaged in an active business. These arguments would support an approach requiring succession by the successor to the predecessor's gross receipts without making adjustments aimed at preventing duplication. [81] We favor adoption of one of these two approaches and do not favor more complex approaches (e.g., eliminating duplication in certain forms or circumstances, but not others).

A broader successor rule also could be adopted, such as a rule extending successor status to a transferee of substantially all of the assets of a transferor in a section 351 transaction, or treating a controlled corporation as a successor to the distributing corporation in a divisive reorganization under sections 355 and 368(a)(1)(D) and requiring an allocation of the distributing corporation's gross receipt. On balance, we question whether, in this particular area, the benefits of arguably improving the accuracy of the Gross Receipts Test in a relatively few cases justifies the inherent technical and administrative complexity in broadening out the successor principle in a manner which may require additional judgments and calculations to be made in many cases. As a conceptual matter, it is not clear that better results are achieved by a rule providing that a transferor's gross receipts history follows substantially all of its assets. For example, it would not seem appropriate for a seller's gross receipts history to be succeeded to by a buyer of substantially all of seller's assets. Moreover, a broader successor rule would likely require judgments to be made as to what constitutes substantially all of the assets of a transferor in a section 351 transaction and might require an anti-abuse rule to prevent a section 351 transfer from being employed to cleanse an unfavorable gross receipts history.

E. Gross Receipts derived from a Partnership in which Subsidiary is a Partner

In PLR 201314005,[82] the Service ruled that a partner, Subsidiary, should include its "distributive share" of a partnership's gross receipts for purposes of computing the Gross Receipts Test and the character of such gross receipts in Subsidiary's hands passed through as if directly earned by Subsidiary. The Service cited Section 702(a) and (b) and Reg. §§ 1.701-1(a)(8)(ii) and 1.702-1(a) in support of the basic proposition that a partner in a partnership must take into account its 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

[81] Further, to the extent that Section 165(g)(3) determines gross proceeds without regard to the tax basis recovered in a sale or exchange (i.e., in the case of a sale or exchange of assets other than "stock and securities"), it seems to allow for what is essentially unlimited duplication. For example, if a taxpayer buys an asset (other than stock and securities) for $100, sells the asset for $100, uses the proceeds to buy another asset (other than stock and securities) for $100 and then sells that asset for $100, the taxpayer has $200 of "gross receipts" even though it has no gross income.

[82] (Dec. 21, 2012)

that partner did not take the item into account separately. The Service further referred to Rev. Rul. 71-455[83], which held that, for purposes of applying the passive investment income test under Section 1372(e)(5), an S corporation which was a partner in a partnership must take into account its distributive share of partnership gross receipts, which flow through to the partner under Section 702 and Reg. § 1.701-1(a)(8)(ii).

In PLR 201314005, Subsidiary's principal asset is its interest in the partnership, and Subsidiary can only meet the Gross Receipts Test if it can take into account its distributive share of the partnership's gross receipts. Parent's percentage ownership interest in the partnership is redacted. It is not clear whether the fact that Subsidiary derived much of its revenue from the partnership, or the size of Subsidiary's percentage ownership interest in the partnership, is a necessary ingredient to the holding. It is possible that a minority partner with a diversified asset-base would be a less sympathetic candidate for a flow-through approach as such partner's activities with respect to the partnership in most, but not all, cases would be more in the nature of a passive investor. However, even in such case, the rules of sections 701 and 702 and the Regulations thereunder would seem to require a flow-through approach.[84]

Two issues not addressed by PLR 201314005 are the treatment of partnership distributions and the treatment of dispositions of dispositions of partnership interests.

i. Treatment of Receipts of a Partnership

As described above, PLR 201314005 provides that the partner includes its "distributive share" of the partnership's gross receipts, apparently whether or not such receipts are distributed to the partner (the "**Distributive Share Approach**"). It is not entirely clear what distributive share means in this context. Reg. § 1.702-1(a) provides generally that each partner takes into account its distributive share of each class or item of partnership income, gain, loss, deduction or credit. Gross receipts are not specifically enumerated as an item allocated in accordance with a partner's distributive share and typically are not subject to the rigors of Subchapter K, so allocating them to partners for this single purpose engenders some uncertainty in applying in practice a concept that appears to be straightforward on the surface.

In the case of a partnership with "straight-up" allocations, determining a partner's distributive share of gross receipts should be a reasonably straight-forward calculation based on the partner's percentage ownership interest in the partnership. One issue with respect to partnership distributions in the context of such a partnership is how to avoid duplication of gross receipts. If the partners take into account their distributive share of partnership gross receipts as received by the partnership, then they should not have a second inclusion of gross receipts upon a distribution from the partnership. An alternative analysis would seem to be inconsistent with the aggregate approach taken in PLR 201314005. Distributions from the partnership not sourced in partnership

[83] 1972-1 C.B. 318.

[84] Other tax attributes are similarly flowed through to partners. For example, each partner takes into account separately its distributive share of taxes paid or accrued by the partnership to foreign countries. *See* sections 702(a)(6) and 902(c)(7); Reg. § 1.702-1(a)(6). *See also* Rev. Rul. 71-141, 1971-1 CB 211 (providing such an approach prior to enactment of the relevant statutory provisions).

gross receipts also should not generate gross receipts at the partner level under an aggregate approach to the extent that the underlying activity would not have generated gross receipts if engaged in directly by the partner. For example, a debt-funded distribution should not generate partner gross receipts because a direct borrowing by the partners would not generate gross receipts.

More complex partnerships with allocations that are not "straight up," not surprisingly, generate more complicated issues. As an initial matter, as with distributions from simpler partnerships, anti-duplication principles should apply such that partnership distributions do not result in duplication of gross receipts. A more difficult question is whether partnership distributions in the context of more complicated partnerships should impact the determination of a partner's distributive share of partnership gross receipts.

In the case of a partnership with special allocations or different classes of partnership interests, the amount of gross receipts to be allocated to each partner for this purpose may be unclear. In the context of investment fund partnerships, cash waterfalls often, at first (to be reversed later), result in a limited partner becoming entitled to cash distributions from the partnership in excess of the amount of taxable income of the partnership allocated to the limited partner under section 704. Under one approach, distributions should not influence the determination of a partner's distributive share of partnership gross receipts – i.e., gross receipts should follow the allocation of related items of income, gain, loss, or deduction. However, since gross receipts are generally a cash-based item, taking into account partnership distributions in determining a partner's distributive share of partnership gross receipts arguably is more consistent with the cash-based general nature of gross receipts (a "**Cash Trace Approach**").

EXAMPLE 1

Subsidiary is a limited partner in an investment fund partnership with a cash-based waterfall. Subsidiary has contributed $100 cash to the partnership, representing 10 percent of the $1,000 aggregate capital contributions to the partnership. Pursuant to the partnership agreement, prior to the general partner becoming entitled to any partnership distributions, each limited partner is entitled to partnership distributions sufficient to return all of its capital invested, and thereafter, the general partner is ultimately entitled to 20 percent of the cash profit of each limited partner on its investment in the partnership. In each of Years 1 and 2, the partnership earns $500 of dividend income. In Year 3, the partnership earns $500 of active services income. At the beginning of Year 4, Subsidiary's affiliated parent takes a WSD with respect to its Subsidiary stock.

Under the partnership agreement, in Years 1 and 2, Subsidiary receives a $50 cash distribution from the dividend income, and in Year 3, Subsidiary receives a $40 cash distribution from the services income (*i.e.,* $10 goes to the general partner such that the general partner gets 20 percent of Subsidiary's $50 aggregate cash profit on its investment in the partnership -- $150 total cash distributions minus Subsidiary's $100 capital contribution). For purposes of the Gross Receipts Test, is it more appropriate to follow the cash and treat Subsidiary as receiving $100 as passive receipts and $40 as active receipts (with the general partner receiving $10 of active receipts)? Or is it more appropriate to use section 704 tax allocation principles, which on these facts would generally allocate to Subsidiary $40 of passive receipts in Years 1 and 2 ($80 total), and $40 of active receipts in Year 3 (with the general partner receiving a total of $30 of gross receipts, $20 of which are passive and $10 of which are active)?

The example demonstrates that, in more complex partnerships, the Distributive Share Approach may generate results which are not wholly satisfying. In the example, Subsidiary receives $140 of cash flow but is allocated only $120 of gross receipts. Nevertheless, the example also implies the complexity of a Cash Trace Approach. The example posits a simple pattern of partnership receipts, all passive in Years 1 and 2, and all active in Year 3. In reality, partnership cash flow often will be derived from a mixture of active and passive receipts and even activity which does not generate receipts (*e.g.*, borrowings). Accordingly, there would have to be a convention employed to trace receipts to distributions. In addition, the example posits a situation in which distributions in each year equal partnership receipts. In reality, there may not be a close relationship between the two in any year, so that there would be a need for a method of allocating undistributed receipts. Finally, the example does not posit scenarios in which there are temporal differences in distribution patterns (*e.g.*, where distributions in earlier years to one partner are economically offset by distributions in later years to another partner). In such a case, it seems inappropriate to source distributions made in one year only out of partnership receipts for that year, in part because such a method may be susceptible to manipulation if Subsidiary or Parent has the ability to influence the timing of the distribution.[85]

ii. Treatment of Dispositions of Partnership Interests

Taxable dispositions of partnership interests raise at least three issues under the Gross Receipts Test. First, to the extent that the value of the partnership interest is attributable to undistributed partnership receipts already allocated to the disposing partner pursuant to the Distributive Share Approach, it can be argued that a disposition of the partnership interest should not result in any additional gross receipts for the disposing partner. The reason is that the partner already has accounted for the underlying gross receipts and treating the disposition as generating additional gross receipts, in effect, would be double counting. To deal with this issue, receipts generated from the disposition of a partnership could be reduced by the aggregate gross receipts previously allocated to the disposing partner net of aggregate distributions made to the disposing partner. However, this adds complexity that may not be justified. For example, distributions may be funded, in whole or in part, through partnership activities which did not create gross receipts

[85] To be sure, alternatives to the two approaches, including potential hybrid approaches, are possible. One potential solution is to use the Distributive Share Approach to the extent that partnership distributions to the partner do not exceed taxable income previously allocated to the partner, and then to use a supplementary method to allocate remaining gross receipts to any remaining amount of the partnership distributions received by the partner that does not represent the partner's share of previously-allocated income. So in Example 1, the Distributive Share Approach could be applied to $120 of the $150 distribution, representing the $120 of taxable income previously allocated to Subsidiary. $80 of the partnership distribution would be treated as passive receipts (corresponding to the $40 of taxable dividend income allocated to Subsidiary in Year 1 and Year 2) and $40 of the partnership distribution would be treated as active receipts (corresponding to the $40 of services income allocated to Subsidiary in Year 3). The remaining $20 of the distribution would be treated under the supplementary method in proportion to the partnership's aggregate historic gross receipts, namely 2/3 passive ($100 out of $150) and 1/3 active ($50 out of $150), resulting in $13.33 of the $20 remaining distribution being treated as passive receipts and $6.67 of the $20 remaining distribution being treated as active receipts.

(*i.e.*, through borrowings) and thus an anti-duplication rule would need to adopt conventions to source distributions from various partnership activities.

Second, to the extent that the taxable disposition of a partnership interest is considered to generate gross receipts, there is a question as to the amount and characterization of such receipts. Should aggregate principles apply broadly to characterize the receipts by reference to the character of receipts which would be generated if the partnership sold the partner's share of partnership property?[86] Should aggregate treatment apply to the limited extent that section 751(a) applies (on the theory that, at least to this extent, aggregate principles apply to the disposition of a partnership interest)? Should entity treatment prevail in its entirety, with the disposition of a partnership interest either (i) generating active receipts to the full extent of proceeds received by the disposing partner (*i.e.*, because a partnership interest is not a security as defined in section 165(g)(2), which refers only to instruments issued by a corporation or government), or (ii) generating passive receipts but only to the extent of any gain recognized (*i.e.*, by treating partnership interests as securities)?

The flush language of section 165(g)(3) is clear that only the receipts from the disposition of stock and securities are limited to gain. Partnership interests are not mentioned, and it seems clear that a partnership interest is not a security under section 165(g)(2). However, to the extent entity treatment is applied with respect to a disposition of a partnership interest, perhaps the limitation should be extended to partnership interests (*i.e.*, by analogy to the treatment of stock as an equity interest in an entity).

iii. Recommendations

We recommend that the Service and the Treasury Department issue Regulations confirming that the Distributive Share Approach is applied to allocate partnership gross receipts to the partners. Such Regulations also should specify that, applying anti-duplication principles, distributions from partnerships do not create gross receipts, at least to the extent that the partner does not recognize gain upon the distribution pursuant to section 731.

With respect to the disposition of a partnership interest, one solution is an entity approach, except in cases of abuse, which can be policed by the anti-abuse rules of Reg. § 1.701-2. Applying a full or modified aggregate approach to characterizing gross receipts arising from the disposition of a partnership interest could create conceptual and administrative challenges (*e.g.*, determining the disposing partner's share of specific partnership assets in the context of complex partnerships) and, correspondingly, could require the Service and the Treasury Department to adopt a complicated set of operating rules. In the context of a statute as imprecise as section 165(g)(3)(B), this does not seem necessary or appropriate.

On the other hand, adopting a subjective, purpose-based anti-abuse rule would engender further uncertainty and complication. Another, and likely preferable, approach would be to apply rules

[86] *Cf*. Rev. Rul. 91-32, 1991-1 C.B. 107 (generally, characterizing gain or loss on the disposition as effectively connected to the conduct of a U.S. trade or business if, and to the extent that, the partner's share of gain or loss on the disposition of partnership property would have been effectively connected to the conduct of a U.S. trade or business).

analogous to the rules of section 731(c).[87] Under this regime, if less than 20% of a partnership's assets are of a type generating passive receipts, then none of the proceeds from a disposition of the partnership interest are treated as from sales of stock or securities and all of the proceeds are treated as active receipts. Conversely, if more than 80% of the partnership's assets are of a type generating passive receipts, the partnership interest would be treated as a security and all of the proceeds would be treated as from the sale of a security (generating passive receipts to the extent of any recognized gain). If 20 – 80% of the partnership's assets are of such type, then a ratable portion of the proceeds from the disposition of the partnership interest would be treated as active receipts and as the proceeds from the disposition of a security.

F. Look-Through Approach

In some cases, it may be appropriate to analyze certain of Subsidiary's gross receipts by looking to the activities of the *payor* of such gross receipts, and by determining whether the *payor's* gross receipts are active or passive for purposes of section 165(g)(3)(B) (a "**Look-Through Approach**"). A Look-Through Approach may or may not be advantageous to Subsidiary depending on the nature of the direct receipts which would be subject to a Look-Through Approach. For example, recharacterizing intercompany dividends received based on the gross receipts of the payor generally will be favorable to Parent in that, due to a dividend ordinarily being passive in full, Parent's gross receipt position relative to the dividend cannot get worse under the Look-Through Approach. Recharacterizing receipts from intercompany sales generally could be favorable or unfavorable to Parent in that, depending on the nature of the sales *(e.g*., whether the intercompany sales were of products or of stock or securities), as well as the activities of the payor.

The overall appropriateness, as well as the appropriate scope, of any Look-Through Approach is unclear. Neither the Code nor the Regulations under section 165 provide for a Look-Through Approach. As described below, the Service has to date applied a Look-Through Approach only to intercompany transactions between members of a consolidated group,[88] apparently grounding its analysis in the intercompany transaction rules of Reg. § 1.1502-13(a), (b), and (c), which includes the attribute redetermination rule of Reg. § 1.1502-13(c)(1)(i). This Regulation generally provides that attributes of intercompany items "are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if [the members engaging in the intercompany transaction] were divisions of a single corporation…."

[87] *See* Reg. § 1.731-2(c)(3) (providing rules for the determination of whether the distribution by a partnership of interests in an entity that owns marketable securities and money is treated as a distribution of marketable securities for purposes of calculating partner-level gain under section 731).

[88] The Service has expressed flexibility in accepting reasonable methods for applying the Look-Through Approach, potentially implying that the choice between using or not using a Look-Through Approach could be elective. *See, e.g.*, Amy S. Elliott, *Practitioners Question IRS Approach in Stock Loss Ruling*, 129 Tax Notes 517 ("Dismissing the argument that the IRS lacked authority for applying the method, William Alexander, IRS associate chief counsel (corporate), hinted that taxpayers who would prefer not to use the method may choose not to without fear of challenge because it is unlikely that the difference in their tax liability would be a material adjustment in favor of the government.")

i. Look-Through Approach for intercompany dividends between members of a consolidated group

In PLR 200710004, the Service provides for a Look-Through Approach for intercompany dividends between members of a consolidated group. For purposes of the Gross Receipts Test, Subsidiary will include in its aggregate gross receipts all dividends received from lower-tier subsidiary members of its consolidated group, and such dividends will be treated as arising from passive sources to the extent they are attributable to the respective distributing member's gross receipts from passive sources. The ruling also provides a mechanism for determining which receipts of the paying member relate to the dividends received by Subsidiary (a "**Receipts Allocation Method**"): the dividends received by Subsidiary will be attributed pro rata to the gross receipts that gave rise to the *earnings* from which the dividend was distributed (the "**Earnings Approach**").[89] This is in contrast to attributing dividends received by Subsidiary pro rata to the aggregate *gross receipts* of the paying member regardless of whether such receipts gave rise to earnings (the "**Receipts Approach**"). Finally, PLR 200710004 provides a tiering concept. In the event a distributing consolidated group member has in turn received a dividend from a directly or indirectly owned lower-tier subsidiary member, the determination of whether the dividend will be treated as arising from active or passive sources will be made by applying the principles of the Look-Through Approach at the level of the lowest-tier subsidiary member and then at each subsequent higher-tier level to characterize the dividend received by such member from its subsidiary member.

An issue seemingly not addressed by PLR 200710004 is whether the Look-Through Approach extends to intercompany distributions in excess of the distributing corporation's E&P. The ruling only addresses the treatment of "dividends." As with distributions treated as dividends, distributions in excess of E&P are excluded from gross income under the consolidated return regulations.[90] In the first instance, in the separate return context, it is not obvious that return of capital distributions under section 301(c)(2) constitutes gross receipts. Section 165(g)(3)(B) refers to dividends and gains from sales or exchanges of stocks and securities. Because gross receipts from sales or exchanges of stocks and securities are taken into account only to the extent of gains, there is a strong argument that section 301(c)(2) amounts are excluded from gross receipts altogether. Accordingly, outside of consolidation, section 301(c)(2) distributions should not be considered to be a gross receipt, while a distribution in excess of basis resulting in gain under section 301(c)(3) would seem to constitute gain from the sale or exchange of stock (*i.e.,* a passive receipt). Within a consolidated group, however, there does not seem to be any reason to cover only dividends, and not distributions in excess of E&P under section 301(c)(2) or (c)(3), under a Look-Through Approach. Nevertheless, this remains an open question.

[89] PLR 200932018 also provides a partial Look-Through Approach, similar to that of PLR 200710004. However, this ruling does not provide a Receipts Allocation Method. Rather, it does not address which receipts of the payor flow through to Subsidiary. It is not clear if the Service remained silent on this issue because they did not agree with the taxpayer's proposed approach, or whether a Receipts Allocation Method was simply not relevant on the facts of the ruling because, for example, the payor entity had only a single type of gross receipts.

[90] Reg. § 1.1502-13(f)(2)(ii).

In addition, it should be noted that the Look-Through Approach envisioned by PLR 200710004 does not utilize pure single entity principles. Gross receipts of a lower-tier subsidiary attributable to *undistributed* earnings of such lower-tier subsidiary are not taken into account in the Look-Through Approach for purposes of determining Subsidiary's gross receipts, notwithstanding the fact that such lower-tier undistributed earnings are taken into account currently by the consolidated group for determining the group's tax liability whether or not they are distributed and are reflected in Parent's basis in the stock of Subsidiary.[91] The ruling's Look-Through Approach only applies to lower-tier earnings actually distributed as dividends to Subsidiary, and thus is in effect a partial Look-Through Approach.

While PLR 200710004 is merely administrative guidance that cannot be relied upon except by the taxpayer which is the subject of the ruling,[92] the principles underlying the ruling can be evaluated for the purpose of potentially basing future guidance on such principles

ii. Look-Through Approach for other intercompany transactions

After the issuance of PLR 200710004, the Service has expanded its single-entity approach to the application of the Gross Receipts Test in the consolidated group context by applying a Look-Through Approach to *all* intercompany transactions. For example, in PLR 201149015, the Service ruled that a Subsidiary must characterize its gross receipts from all intercompany transactions by reference to the gross receipts of its counterparty. Furthermore, for this purpose, the counterparty must determine the character of its gross receipts under a similar Look-Through Approach for its intercompany transactions. In fact, each counterparty in chains of intercompany transactions must apply a Look-Through Approach until the ultimate counterparty is reached.[93]

iii. Intercompany transactions outside of the consolidated group context

All of the PLRs providing a Look-Through Approach do so only with respect to intercompany transactions between members of a consolidated group. For example, PLR 200710004 does not, by its terms, extend to dividends received from a non-consolidated affiliate.[94] Similarly, PLR 201149015 does not provide a Look-Through Approach for other intercompany transactions between non-consolidated affiliates.

[91] Reg. § 1.1502-32.

[92] *See* section 6110(k)(3).

[93] *See also* PLR 201011003 (providing a similar ruling).

[94] *Cf.* TAM 200727016 (Jan. 11, 2007) provides that dividends, unlike other passive receipts which may be treated as active, are specifically defined in the tax law without reference to the underlying activities that gave rise to the dividends. This strict definitional approach seems to be at odds with extending a Look-Through Approach to non-consolidated dividends.

iv. Analysis of the Look-Through Approach

a. Analytical foundations

In PLR 200710004, the Service cited three subsections of the intercompany transaction regulations, Reg. § 1.1502-13(a), (b) and (c),[95] for applying the Look-Through Approach to dividends from other members of Subsidiary's consolidated group. It is not entirely clear why the intercompany transaction regulations serve as sufficient justification for the application of the Look-Through Approach to intercompany dividends or other intercompany transactions. The purposes of the intercompany transaction regime described in Reg. § 1.1502-13(a) (and as implemented by the matching rules of Reg. § 1.1502-13(c) using the definitions of Reg. § 1.1502-13(b)) appear to provide, in the Service's view, a persuasive rationale for applying the Look-Through Approach. Namely, with respect to any tax item from an intercompany transaction other than amount and location, which are determined on a separate entity basis, all other tax attributes, including timing, character and source (although initially determined on a separate entity basis) are ultimately determined on a single entity basis (*i.e.,* by treating the parties to the intercompany transaction as if they were divisions of a single corporation) under Reg. § 1.1502-13(c)(1)(i). Consistent with the principle of determining attributes as if the parties to an intercompany transaction were a single entity (*i.e.,* were divisions of a single corporation), the Look-Through Approach attempts to characterize receipts from intercompany dividends and other intercompany transactions by reference to the underlying economic activities of the consolidated subsidiary which generated receipts out of which the dividend or intercompany transaction can be funded.

A potential argument against applying a broad Look-Through Approach to intercompany transactions, particularly intercompany transactions other than intercompany dividends, is that the recognition of stock gain or loss is essentially a separate company issue. The consolidated return Regulations generally treat member stock as a separate company asset, and a sale of member stock is not treated as sale of its assets absent an election under section 338(h)(10) or section 336(e) to treat it as such. A leading commentator on consolidated return matters has noted that: "It is unclear why a look-through approach for all intercompany transactions, essentially a broad single-entity approach that likely takes into account receipts bearing no relationship to the equity for which the IRC Section 165(g)(3) determination is made, is appropriate for characterizing loss on member stock, essentially a separate-entity issue. Moreover, the extensive body of regulatory examples fails to acknowledge this approach."[96]

With respect to intercompany dividends, it is arguable that the consolidated returns Regulations do not mandate application of a Look-Through Approach. For instance, intercompany dividends are excluded altogether from gross income under Reg. § 1.1502-13(f)(2)(ii), which could support

[95] In PLR 201006003 (Oct. 28, 2009), the Service ruled that the subsidiary must treat as a dividend the full amount of any intercompany distributions made out of earnings and profits, and received in a taxable year beginning prior to July 12, 1995. The implication is that the pre-1995 intercompany transaction regulations might not embody the same principles used to justify the Look-Through Approach.

[96] Dubroff, Blanchard, Countryman, and Teplinsky, Federal Income Taxation of Corporations Filing Consolidated Returns, § 31.03 (hereafter referred to as "**Dubroff**").

the view that such dividends should be excluded from gross receipts as well. On the other hand, in certain other contexts, intercompany dividends are taken into account as dividends, notwithstanding their exclusion from gross income. For purposes of determining the status of a member of consolidated group under certain other separate company regimes, such as the personal holding company rules or the rules for so-called "80-20 companies" under section 861(a)(2)(A), intercompany dividends are treated as "dividends" notwithstanding the exclusion or elimination of intercompany dividends in determining consolidated taxable income.[97] Nevertheless, a Look-Through Approach may be viewed as not being inconsistent with the rules in consolidation, and the treatment of intercompany distributions in other areas may be viewed as distinguishable on policy grounds from section 165(g)(3)(B).[98]

Another objection to a broad Look-Through Approach is the mechanical complexity of applying such an approach. As discussed below, applying a Look-Through Approach to intercompany dividends raises the question of whether to characterize the distribution by reference to an Earnings Approach or a Receipts Approach. Expanding a Look-Through Approach to all intercompany transactions adds substantial complexity:

> The Service's expansion of its approach correspondingly expands the mechanical issues. For example, there is no guidance for identifying the payor's gross receipts to which its intercompany payment or distribution is attributable (e.g., first from the payor's current-year gross receipts, or from a blended average of the payor's cumulative history of gross receipts that might have funded the payment), how distributions and payments are ordered (e.g., should distributions that reduce E&P be associated with underlying gross receipts based on the sourcing principles of Reg. § 1.316-2, and have a priority claim on those gross receipts so that they are only shifted once), does the payor retain its gross receipts that flow through (e.g., for purposes of subsequent payments and distributions or a later IRC Section 381(a) transaction). Moreover, the potential for members to routinely interact in multiple ways quickly escalates the administrability challenges (e.g., tax-sharing agreements could cause every member to interact to some degree with every other member to the extent of amounts due and owing), and the relevance of the intercompany transaction's form (e.g., whether an intercompany sale of stock or a security shifts gross receipts to the extent of the sale proceeds, or only to the extent of gain recognized as applies in the separate-return context under Reg. § 1.165-5(d)(2)(iii),

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[97] *See* Rev. Rul. 79-60, 1979-1 C.B. 211 (when the then-current intercompany transaction regulations eliminated intercompany dividends in computing the recipient's separate taxable income, the recipient's separate personal holding company income nevertheless includes the dividend provided the distributing corporation claimed a dividends paid deduction); Rev. Rul. 72-230, 1972-1 C.B. 209 (in which M, a common parent with significant foreign-source income, paid dividends to its shareholders, M was required to include in its gross income for purposes of section 861(a)(2)(A) any intercompany dividends received, even though such dividends otherwise were eliminated under the then-current intercompany transaction regulations); CO-11-91 (1994) (indicating that the new intercompany transactions regulations are not intended to affect the holding of Rev. Rul. 79-60 and Rev. Rul. 72-230).

[98] For example, the issue considered in Rev. Rul. 72-230 was whether to exclude intercompany dividends in their entirety from the 80-20 determination and a Look-Through Approach would have achieved essentially the same result as a rule taking into account the intercompany dividends as dividends in that context.

whether any gain limitation takes into account the potential for stock to have an ELA, and how distributions are treated to the extent that they exceed the distributor's E&P). [99]

However, if the Look-Through Approach were not applied to intercompany transactions, it might be easier for taxpayers to manipulate the Gross Receipts Test by engaging in intercompany transactions with an eye towards increasing Subsidiary's active receipts. In the absence of a Look-Through Approach, an anti-abuse rule addressing such intercompany transactions seems appropriate.

b. Receipts Allocation Method: the Receipts Approach vs. the Earnings Approach

PLR 200710004, as noted above, provides a method for sourcing the receipts received by Subsidiary pursuant to an intercompany dividend to the activities of the distributing member. Pursuant to the Earnings Approach, dividends will be attributed pro rata to the gross receipts that gave rise to the E&P from which the dividend was distributed.[100] It is noteworthy that this concept does not to take into account a slice of all receipts of the distributing member, but rather takes into account a slice of only the receipts that "gave rise to" the earnings from which the dividend was distributed. If the PLR's articulation of the Earnings Approach applies literally to capture only receipts from activities that contribute towards the positive E&P account (which there must be in the case of a dividend), then the approach may distort the treatment of the subsidiary's overall activities.

Example 2

Subsidiary wholly owns a consolidated subsidiary, S1, which has no gross receipts and no accumulated E&P prior to Year 1. In Year 1, S1 has $100 of passive rental receipts from a net lease of an office building. For tax purposes (including E&P calculations), the rental receipts are fully offset by $100 of depreciation deductions, with the result that S1 has no E&P. During Year 1, S1 distributes $100 to Subsidiary in a section 301(c)(2) distribution. At the end of Year 1, Subsidiary is worthless and its parent claims a WSD.

Applying the Earnings Approach, the Year 1 distribution would not appear to bring up any of S1's receipts to Subsidiary because S1 has no E&P. If S1's gross receipts did not give rise to E&P, then how can the distribution bring up receipts which gave rise to earnings? If, instead, one applied a Look-Through Approach to all distributions from a consolidated subsidiary regardless of the existence of E&P and adopted the Receipts Approach, one would look to *all* of the gross receipts of S1 and conclude that, because 100 percent of such gross receipts were passive, 100 percent of the distribution to Subsidiary is attributed to passive receipts.

[99] *Dubroff* at § 31.03.

[100] PLR 201149015, discussed above, similarly provides a pro rata sourcing method for intercompany transactions other than dividends.

Example 3

Same as Example 2, except that S1 only has $90 of depreciation deductions and therefore has $10 of positive E&P.

Under the Earnings Approach, all of the $10 of E&P distributed is the result of the passive receipts generated by S1, and so the entire $10 of the intercompany dividend is treated as a passive receipt. While the issue is not free from doubt, it would appear that remaining $90 of the intercompany distribution cannot be characterized as a passive receipt under the Earnings Approach and is simply excluded from Subsidiary's gross receipts analysis under Reg. § 1.1502-13(f)(2)(ii). Again, the Receipts Approach would treat the entire $100 distribution as generating passive receipts to Subsidiary.

Example 4:

Same as Example 2, except that, S1 does not make an intercompany distribution in Year 1. In Year 2, S1 has $100 of fee income from the provision of services, resulting in aggregate of $100 of current E&P. In Year 2, S1 makes a $100 intercompany dividend to Subsidiary. At the end of Year 2, Subsidiary is worthless and Parent claims a WSD.

Under the Earnings Approach, it appears that one would ignore the passive rental income and associated depreciation deductions because they did not contribute to S1's current year E&P in Year 2 out of which the Year 2 intercompany dividend is paid. The Earnings Approach thus would conclude that the entire $100 distribution is attributable to the $100 active fee income. Is this approach appropriate?

On one hand, without the fee income, the distribution would have been a different transaction for tax purposes – a return of capital instead of a dividend. Furthermore, it is possible that S1 would not have had the financial capacity to make the distribution without the fee income, whereas (assuming tax depreciation reflects actual economic depreciation), the Year 1 activity would have, on net basis, had no effect on S1's financial position. Therefore, it can be argued that the Earnings Approach reaches an appropriate result in this example.

On the other hand, it is not clear why the existence or timing of S1's deductions should impact Subsidiary's treatment under the Look-Through Approach. Had all of the fee income been earned in Year 1, then presumably under the Earnings Approach 50 percent of the Year 2 intercompany dividend would have passive and 50 percent would have been active. Because gross receipts are, in fact, determined based on gross, rather than net, items, it would seem better to disregard deduction items in determining the character of a distribution under the Look-Through Approach. This is the foundation of the Receipts Approach, which would treat only 50 percent of the $100 distribution from S1 as an active receipt, because looking at all of S1's receipts 50 percent are active and 50 percent are passive.

v. Recommendations relating to the Look-Through Approach

As an initial matter, we believe that the Service and the Treasury Department should issue Regulations providing clear rules specifying whether, in what circumstances, and how the Look-Through Approach should be applied in the context of intercompany transactions. At the present time, substantial uncertainty exists as to these matters. It is not clear, the absence of a PLR, (i) whether the application of a Look-Through Approach is mandatory or elective,[101] (ii) whether a Look-Through Approach can be applied only to intercompany dividends or must be applied to other intercompany transactions (including distribution in excess of E&P, payments of interest on intercompany debt, and intercompany sales of property or provisions of services), and (iii) how the intercompany receipts are sourced to underlying receipts of the payor. For taxpayers and the Service alike, this uncertainty under current law makes section 165(g)(3)(B) difficult to apply in the absence of obtaining a PLR. For example, it is difficult for tax advisors to opine on these matters in the absence of more definitive guidance and for financial auditors to reach definitive conclusions.

We do not favor the adoption of a broad Look-Through Approach to all intercompany transactions. As discussed above, it is not at all clear to us that such a rule is mandated by the attribute redetermination rules of Reg. § 1.1502-13(c)(1)(i). Moreover, in our view, the complexity of administering such a rule outweighs its benefits – that is, determining the character of the gross receipts of the ultimate counterparty and allocating or tracing such receipts to various intercompany transactions between group members is likely to prove difficult to apply in numerous cases, given the "spider web" of intercompany transactions which are undertaken by many consolidated groups. If Regulations do not apply a broad Look-Through Approach to all intercompany transactions, they should provide for an anti-abuse rule to prevent manipulation, perhaps by adding an example addressing the matter in the anti-abuse rule in Reg. § 1.1502-13(h).

If, contrary to our recommendation, a Look-Through Approach for intercompany transactions is generally adopted, we believe that there should be an exception for ordinary course transactions (such as product sales between a manufacturing member and a distributor member). In addition, it would be appropriate to provide a further exception from the Look-Through Approach for consolidated groups that, as a whole, has only a small amount of passive receipts from transactions with non-members.

The question of whether to apply a Look-Through Approach to intercompany distributions between members of a consolidated group requires a closer judgment. We believe that a limited Look-Through Approach for all intercompany distributions (whether dividends or distributions in excess of E&P) is justifiable and administrable because, for example, lower-tier taxable income and E&P already tier up a chain of consolidated subsidiaries under Reg. §§ 1.1502-32 and 1.1502-33. In our view, however, the Service and Treasury Department should adopt a Receipts Approach rather than an Earnings Approach when applying the Look-Through Approach to intercompany distributions.

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[101] As noted above, the Service's public comments have indicated flexibility with respect to the application of the Look-Through Approach.

We do not favor applying a Look-Through Approach to intercompany transactions outside of the consolidated group context.

G. Consideration of a Subgrouping Rule in Consolidation

Although the legislative history underlying section 165(g)(3)(B) indicates that Congress did not intend to permit an ordinary WSD for holding companies, it is not entirely clear what type of corporation Congress viewed as a holding company for this purpose. For example, it is not clear that Congress intended to deny an ordinary WSD for a consolidated subsidiary that is the parent of a *subgroup* of corporations where the subsidiary itself does not actually engage in active business operations but owns lower-tier operating subsidiaries. By applying a Look-Through Approach to determine the gross receipts of Subsidiary, including in respect of dividends received from its operating subsidiaries, the Service's current ruling policy appears to allow the Parent of such a Subsidiary to qualify for an ordinary WSD. A similar result could be achieved for a subgroup of consolidated subsidiaries with a similar configuration by treating the subgroup as a single corporation.[102]

We believe that the Service and the Treasury Department should consider adopting a subgroup approach to applying the Gross Receipts Test for a consolidated Subsidiary, treating the applicable subgroup as if it were a single corporation. A subgroup for this purpose would consist of Subsidiary and each consolidated subsidiary directly or indirectly owned by Subsidiary within the meaning of section 1504(a)(2), perhaps with an anti-abuse provision aimed at planning into or out of this ownership threshold for purposes of applying or avoiding the subgroup rule. Each subgroup member's separate gross receipts would become a part of Subsidiary's overall gross receipts. However, all gross receipts from intercompany transactions (distributions, interest payments, sales, etc.) would be disregarded for this purpose. The character of gross receipts as active or passive receipts would be determined taking into account the activities of the subgroup as a whole. Because the subgroup would be treated as a single corporation, section 381 transactions between subgroup members would be ignored; predecessor receipts would not have to be inherited from an intra-subgroup reorganization or liquidation because each member's gross receipts would be counted in group's overall gross receipts.

i. Areas where subgrouping currently exists

Subgrouping currently exists in other areas of tax law. As one example, Section 355(b)(3)(A) provides that, for purposes of determining whether a corporation meet the active trade or business requirements of section 355(b), all members of the distributing or controlled corporation's separate affiliated group shall be treated as one corporation (the "**SAG rule**"). The Service explained that the SAG rule addressed Congress's concern that corporate groups conducting business in separate corporate entities often had to undergo elaborate restructurings

[102] We believe that the Service and the Treasury Department have ample authority under the grant of authority in section 1502 to provide for a subgrouping approach within a consolidated group. Indeed, Regulations already modify the application of section 165(g)(3) in the context of members of a consolidated group. Reg. § 1.1502-34 provides that the Ownership Test of section 165(g)(3)(A) is determined by aggregating all stock ownership in Subsidiary by members of a consolidated group.

to place active businesses in the proper entities to satisfy the active trade or business requirement.[103]

As another example, in determining the consolidated taxable income of the group, subgroups have been established to determine the availability of losses and credits under section 382 and for the SRLY rules. The SRLY rules calculate a SRLY limitation based on the aggregate, cumulative contribution to consolidated taxable income of all subgroup members.[104] The calculation "effectively treats the corporations comprising a SRLY subgroup as a single entity."[105] Similar subgrouping rules are provided for purposes of applying section 382 to consolidated groups.[106]

ii. Problems avoided or lessened

The subgroup concept would avoid complexities and problems associated with applying a Look-Through Approach to intercompany transactions between members of the subgroup. As described above, such intercompany transactions would be disregarded and there would be no need to characterize receipts from them by sourcing them out of the gross receipts of the payor member. Treating the subgroup as a single corporation, the character of gross receipts with third parties already would take into account the activities of all subgroup members. Similarly, a subgrouping rule would reduce the need for anti-duplication rules associated with section 381 transactions between subgroup members. As described above, since the subgroup members would be treated as one corporation, there would be no need to apply a successor receipts concept or to eliminate prior intercompany transactions (which would already be disregarded).

iii. Problems that will persist or be created

While applying a subgroup approach would lessen or eliminate certain problems associated with the Gross Receipts Test, it would leave in place other problems and create some new issues and complexities. For example, a subgrouping rule would not reduce the evidentiary burden imposed by section 165(g)(3)(B), discussed above, which requires the taxpayer to determine the gross receipts of the Subsidiary for all years during which the subsidiary has been in existence.[107] Similarly, a subgrouping approach would not eliminate the need for rules to address how the subgroup interacts with non-subgroup members (e.g., successor receipts and anti-duplication rules where a subgroup member acquires the assets and liabilities of a non-subgroup member) or (subject to our recommendations above) Look-Through Rules for intercompany transactions between subgroup members and non-subgroup members.

[103] *See Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B)*, 73 FR 75946 (December 15, 2008) *citing* H.R. Rep. No. 109-304, at 53, 54 (2005).

[104] *See* Reg. § 1.1502-21(c)(2).

[105] Dubroff at § 42.02(b)(3) (discussing the "Cumulative Contribution to Consolidated Taxable Income").

[106] *See* Reg. §§ 1.1502-91 – 1.1502-96.

[107] *See* Reg. § 1.165-5(d)(2)(iii).

The principal complexity created by adopting a subgroup approach will be the need to develop rules for members joining and leaving the subgroup. A basic question will be whether subgroup members who leave the group will take with them a share of the subgroup's gross receipts and, if so, which share. With respect to members joining a subgroup, an issue will be whether its new member's historic gross receipts would simply be added to the gross receipts register of the subgroup, effectively treating the new member as if it merged into the subgroup in a section 381 transaction. With respect to departing members, an issue would be whether the departing member takes with it some of the subgroup's gross receipts and, if so, what portion.[108] We note that addressing issues associated with members joining and departing a subgroup likely would involve considerable complexity in implementing a subgroup approach in practice.

V. Conclusion

The thrust of this Report is to recommend relatively modest changes to Regulations and the Service's procedures governing the application of the Gross Receipts Test of section 165(g)(3)(B) to improve visibility and consistency and to promote administrability. Such changes, if adopted, should significantly enhance the ability of taxpayers and the Service alike to administer the Gross Receipts Test.

[108] The single entity rules applicable to consolidated groups engaging in a corporate equity reduction transaction ("**CERT**") may provide a useful frame of reference. Section 172(h)(4)(C) provides that all members of an affiliated group filing a consolidated return under section 1501 shall be treated as one taxpayer for purposes of determining the corporate equity reduction interest losses and the carry back period for net operating losses that arise from a corporate equity reduction transaction. Proposed CERT Regulations further the single entity principle by treating the entire group as a single applicable corporation for purposes tracking transactions and expenditures undertaken by a particular member.[108] The group's intercompany transactions (including interest accruals and payments on intercompany obligations) are generally disregarded. The Proposed CERT Regulations provide detailed rules for new members and departing members. These rules were discussed in detail in New York State Bar Association, Tax Section, *Report on Proposed Regulations Under Section 172(h) Relating to Corporate Equity Reduction Transactions* (Sept. 9, 2013), *reprinted in* Tax Notes, 2013 TNT 175-17 (Sept 10, 2013),

See, e.g., Reg. 1.1502-21 (addressing computations for apportioning a consolidated net operating loss to a member that will be carried back to a member's separate return year).