

Internal Revenue Service

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August 26, 2013

TY:

Legend

Taxpayer =
Group =
Subsidiary =
Sub 1 =

Country A =
Country B =
State A =
State B =

Type 1 =

A =
B =
C =
D =
E =

Period 1 =
Period 2 =

X =

Year 1 =
Year 2 =
Month 1 =

Month 2 =

Date 1 =

Dear

This responds to a letter dated February 26, 2013, submitted on behalf of Taxpayer, requesting a ruling that the income derived by its wholly-owned subsidiary, Subsidiary, from its retail lending business does not constitute interest for purposes of § 165(g)(3)(B) of the Internal Revenue Code.

Taxpayer, a State A corporation, is the parent of a group of domestic and international entities.

Taxpayer, through certain of its subsidiaries (the "Group"), provides specialty financial services to individuals through retail locations and through electronic distribution platforms (i.e. the online lending business). The Group offers nonrecourse, short-term loans that are secured by the pledge of tangible personal property to customers through its retail locations in Country A and Country B.

Subsidiary is a Type 1 entity.

Sub 1, a State B corporation, is a wholly-owned subsidiary of Taxpayer. Taxpayer represents that Sub 1 wholly owns Subsidiary for U.S. federal income tax purposes.

In Year 1, Sub 1 acquired A% of the stock of Subsidiary from two entrepreneurs (the "Former Minority Shareholders"). The Former Minority Shareholders retained the remaining B% of the stock of Subsidiary.

Subsidiary provided nonrecourse, short-term loans that were secured by the pledge of tangible personal property to customers through its retail lending locations in Country B. As of Month 1, Subsidiary had approximately C retail stores in Country B operating under the name X.

In order to obtain a loan from Subsidiary, an individual would request a loan from one of Subsidiary's retail locations in person and offer personal property to serve as security for the loan. After a customer applied for a loan, Subsidiary would evaluate the loan request and collateral and then either approve or deny the loan. The decision to make a loan and, if so, the amount, was primarily based on the appraised value of the collateral. If Subsidiary approved the loan, it would provide a loan agreement, along with the loan proceeds, to the customer and would maintain possession of the collateral until the loan was repaid.

Subsidiary was responsible for keeping a customer's collateral safe and in good condition. In order to protect the collateral, Subsidiary would store the collateral in a

secure area and monitor access to the collateral. Subsidiary would also document and keep track of the collateral to ensure that any collateral it received could be returned to the appropriate customer upon the customer's repayment of the loan or sold on the appropriate customer's behalf upon the customer's default.

The loans granted by Subsidiary generally ranged from Period 1 and Period 2, unless the loans were renewed, extended, or repaid prior to maturity. Subsidiary charged a "fee" to the customer on the loans in accordance with current market conditions and applicable local law. (The taxpayer refers to this fee as "interest.")

Subsidiary accepted and processed payments of principal and the fee made by customers, and if a customer repaid its loan in full, Subsidiary would return the collateral to the customer. If a customer did not repay a loan in full, Subsidiary was authorized under the terms of the loan agreement to sell the collateral in order to repay the outstanding principal and fee balance of the loan. Subsidiary also charged its customers an additional commission for selling the collateral.

Pursuant to the terms of Subsidiary's loan agreement, the collateral never became Subsidiary's property. Rather, Subsidiary served as the customer's agent and sold the collateral on the customer's behalf. Consequently, if the sales proceeds exceeded the outstanding principal and fee balance on the loan and Subsidiary's sales commission, the customer was entitled to, and had several months to claim, the excess proceeds. If the sales proceeds were less than the outstanding principal and fee balance on the loan and sales commission, Subsidiary bore the loss and had no recourse against the customer.

More than 90 percent of Subsidiary's aggregate gross receipts for all relevant taxable years have been from fee income on the secured, nonrecourse loans that it made and from commissions derived from the sale of collateral in connection with these loans.

The retail, secured lending business operated by certain members of the Group in Country A is broadly similar to the operations in Country B, provided that, in Country A, all of the retail locations accept general merchandise and jewelry as collateral and if a customer defaults, the Group can foreclose on, and take title to, the collateral.

In sum, Subsidiary was directly and actively involved in the short-term, secured lending business. 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. Subsidiary took possession of the collateral, documented and kept track of the collateral, stored the collateral in a secure area, and monitored access to the collateral. If a customer paid its loan in full, Subsidiary would return the collateral to the customer. If a customer defaulted, Subsidiary would sell or dispose of the collateral, apply the proceeds to the outstanding principal and fee balances, and its

sales commission, document any excess amounts received on the sale of the collateral, return the excess if claimed by the customer, and bear the economic loss if the sales proceeds were not sufficient to cover the outstanding principal and fee balances and commission charges. Subsidiary maintained the appropriate licenses to operate its retail lending business, and it engaged in other similar compliance activities.

On Date 1, Sub 1 acquired the remaining B% of the stock of Subsidiary from the Former Minority Shareholders.

Taxpayer represents that no stock of Subsidiary was acquired by Taxpayer or Sub 1 for purposes of converting a capital loss into an ordinary loss.

Following the purchase of the Former Minority Shareholders' remaining interest in Subsidiary, the Board of Directors of Taxpayer approved a substantial reorganization of the Country B-based lending operations to include only full-service retail locations that offer loans based on the pledge of general merchandise and jewelry collateral, and the discontinuance of the operations of more than D jewelry-only Country B-based lending locations.

By the beginning of Month 2, Subsidiary had closed (or was in the process of closing) or sold approximately E% of its retail lending locations in Country B.

Taxpayer represents that, in Month 2, Subsidiary was liquidated for U.S. federal income tax purposes. Taxpayer represents that at the time of the liquidation Sub 1's stock in Subsidiary was worthless for purposes of § 165(g). Taxpayer represents that Subsidiary was a controlled foreign corporation within the meaning of § 957(a).

RULING REQUESTED:

The amounts earned by Subsidiary from its retail lending business that are described in the FACTS section of this letter do not constitute interest for purposes of § 165(g)(3)(B).

LAW AND ANALYSIS:

Section 165(a) of the Code allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(g)(1) of the Code provides the general rule that if any security which is a capital asset becomes worthless during the taxable year, the resulting loss is treated as a loss from the sale or exchange of a capital asset. Section 165(g)(2) defines a security to include a share of stock in a corporation.

Section 165(g)(3) of the Code provides an exception to the general capital loss rule and

allows a taxpayer that is a domestic corporation to claim an ordinary loss for worthless securities of an “affiliated” corporation.

Under § 165(g)(3), a corporation is treated as affiliated with a taxpayer only if—

(A) the taxpayer owns directly stock in the corporation meeting the requirements of § 1504(a)(2) (i.e., at least 80 percent of the voting power and value of the corporation's stock) [“ownership test”], and

(B) more than 90 percent of the aggregate of the corporation's gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities [“gross receipts test”]. See also § 1.165-5(d)(2)(iii) of the Income Tax Regulations, which provides that the gross receipts test applies for all the taxable years during which the subsidiary has been in existence.

For purposes of the exception for affiliated corporations, a corporation will only be treated as affiliated with a taxpayer if none of the stock of the corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under § 165(g)(3). Section 1.165-5(d)(2)(ii).

Section 1.165-5(d)(1) of the Income Tax Regulations provides that the exception for affiliated corporations applies to “any security of a domestic or foreign corporation.”

Rev. Rul. 88-65, 1988-2 C.B. 32, concerned the application the gross receipts test to a subsidiary that derived its gross receipts solely from the leasing of automobiles and trucks. Rev. Rul. 88-65 states,

The legislative history of section 165(g)(3) of the Code and its predecessors indicates 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. See S. Rep. No. 91-1530, 91st Cong., 2d Sess. 2 (1970), 1971-1 C.B. 617, 618; S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543.

Rev. Rul. 88-65 held that if 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 § 165(g)(3)(B).

Taxpayer represents that more than 90 percent of Subsidiary's aggregate gross receipts for all relevant taxable years have been from fee income on the secured, nonrecourse loans that it made and from commissions derived from the sale of collateral in connection with these loans. Subsidiary was clearly an operating company, and not an investment or holding company, and performed significant services in its retail lending activities that resulted in generating gross receipts in the form of fee income and commissions. Since Subsidiary was in the business of making loans, the active or passive analysis of Rev. Rul. 88-65 applies to the fee earned by Subsidiary in its retail lending business.

Therefore we hold the amounts earned by Subsidiary from its retail lending business that are described in the FACTS section of this letter do not constitute interest for purposes of § 165(g)(3)(B).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. For instance, we are not ruling on whether any stock of Subsidiary was acquired by Taxpayer or Sub 1 for purposes of converting a capital loss into an ordinary loss, and we are not ruling on whether in Month 2, Subsidiary was liquidated for U.S. federal income tax purposes. We also are not ruling on whether any payment received by Subsidiary constitutes interest for purposes of any section of the Code other than § 165(g)(3).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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

Sincerely,

Thomas D. Moffitt
Branch Chief, Branch 2
(Income Tax & Accounting)