

§ 1.165-5 Worthless securities.

(a) *Definition of security.* As used in section 165(g) and this section, the term "security" means:

- (1) A share of stock in a corporation;
- (2) A right to subscribe for, or to receive, a share of stock in a corporation; or
- (3) A bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued with interest coupons or in registered form by a domestic or foreign corporation or by any government or political subdivision thereof.

(b) *Ordinary loss.* If any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss.

(c) *Capital loss.* If any security which is a capital asset becomes wholly worthless at any time during the taxable year, the loss resulting therefrom may be deducted under section 165(a) but only as though it were a loss from a sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g)(1). The amount so allowed as a deduction shall be subject to the limitations upon capital losses described in paragraph (c)(3) of § 1.165-1.

(d) *Loss on worthless securities of an affiliated corporation.*—(1) *Deductible as an ordinary loss.* If a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer within the meaning of subparagraph (2) of this paragraph and such security becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss in accordance with paragraph (b) of this section. The fact that the security is in fact a capital asset of the taxpayer is immaterial for this purpose, since section 165(g)(3) provides that such security shall be treated as though it were not a capital asset for the purposes of section 165(g)(1). A debt which becomes wholly worthless during the taxable year shall be as an ordinary loss in accordance with the provisions of this subparagraph, to the extent that such

debt is a security within the meaning of paragraph (a)(3) of this section.

(2) *Affiliated corporation defined.* For purposes of this paragraph, a corporation shall be treated as affiliated with the taxpayer owning the security if—

(i)(a) In the case of a taxable year beginning on or after January 1, 1970, the taxpayer owns directly—

(1) Stock possessing at least 80 percent of the voting power of all classes of such corporation's stock, and

(2) At least 80 percent of each class of such corporation's nonvoting stock excluding for purposes of this subdivision (i)(a) nonvoting stock which is limited and preferred as to dividends (see section 1504(a)), or

(b) In the case of a taxable year beginning before January 1, 1970, the taxpayer owns directly at least 95 percent of each class of the stock of such corporation;

(ii) None of the stock of such corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under section 165(g)(3), and

(iii) More than 90 percent of the aggregate of the gross receipts of such corporation for all the taxable years during which it has been in existence has been from sources other than royalties, rents (except rents derived from rental of properties to employees of such corporation in the ordinary course of its operating business), dividends, interest (except interest received on the deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities. For this purpose, the term "gross receipts" means total receipts determined without any deduction for cost of goods sold, and gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains from such sales or exchanges.

(e) *Bonds issued by an insolvent corporation.* A bond of an insolvent corporation secured only by a mortgage from which nothing is realized for the bondholders on foreclosure shall be regarded as having become worthless not later than the year of the foreclosure sale, and no deduction in respect of the

loss shall be allowed under section 165(a) in computing a bondholder's taxable income for a subsequent year. See also paragraph (d) of § 1.165-1.

(f) *Decline in market value.* A taxpayer possessing a security to which this section relates shall not be allowed any deduction under section 165(a) on account of mere market fluctuation in the value of such security. See also § 1.165-4.

(g) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any security reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471-5.

(h) *Special rules for banks.* For special rules applicable under this section to worthless securities of a bank, including securities issued by an affiliated bank, see § 1.582-1.

(i) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 100 percent of each class of the stock of Y Corporation; and, in addition, 19 percent of the common stock (the only class of stock) of Z Corporation, which it acquired in 1948. Y Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 81 percent of the common stock of Z Corporation, which it acquired in 1946. It is established that the stock of Z Corporation, which has from its inception derived all of its gross receipts from manufacturing operations, became worthless during 1971.

(ii) Since the stock of Z Corporation which is owned by X Corporation is a capital asset and since X Corporation does not directly own at least 80 percent of the stock of Z Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1971, of a capital asset. The loss so sustained by X Corporation shall be considered a long-term capital loss under the provisions of section 1222(4), since the stock was held by that corporation for more than 6 months.

(iii) Since Z Corporation is considered to be affiliated with Y Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by Y Corporation upon the worthlessness of the stock of Z Corporation shall be deducted in 1971 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss.

Example (2). (i) On January 1, 1971, X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 60 percent of each class of the stock of Y Corporation, a foreign corporation, which it acquired in 1950. Y Corporation has, from the date of its incorporation, derived all of its gross receipts from manufacturing operations. It is established that the stock of Y Corporation became worthless on June 30, 1971. On August 1, 1971, X Corporation acquires the balance of the stock of Y Corporation for the purpose of obtaining the benefit of section 165(g)(3) with respect to the loss it has sustained on the worthlessness of the stock of Y Corporation.

(ii) Since the stock of Y Corporation which is owned by X Corporation is a capital asset and since Y Corporation is not to be treated as affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, notwithstanding the fact that, at the close of 1971, X Corporation owns 100 percent of each class of stock of Y Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under the provisions of section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1971, of a capital asset.

Example (3). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 80 percent of each class of the stock of Y Corporation, which from its inception has derived all of its gross receipts from manufacturing operations. As one of its capital assets, X Corporation owns \$100,000 in registered bonds issued by Y Corporation payable at maturity on December 31, 1974. It is established that these bonds became worthless during 1971.

(ii) Since Y Corporation is considered to be affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by X Corporation upon the worthlessness of these bonds may be deducted in 1971 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss. The loss may not be deducted under section 166 as a bad debt. See section 166(e).

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§ 1.165-6 Farming losses.

(a) *Allowance of losses.* (1) Except as otherwise provided in this section, any loss incurred in the operation of a farm as a trade or business shall be allowed as a deduction under section 165(a) or