Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: May 21, 2007

to: Territory Director, Gulf States Area
(Examination, PSP)

from: Branch Chief, Branch 2
(Passthroughs & Special Industries)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Trust =

X =

A =

Date 1 =

Date 2 =

Date 3

ISSUE

Will a net operating loss (NOL) carryover to which Trust succeeded pursuant to

§ 642(h)(1) of the Internal Revenue Code be permitted as a deduction of "the S portion" of that Trust following its election to be an Electing Small Business Trust (ESBT).

CONCLUSION

Trust is not entitled to deduct any amount attributable to the NOL, to which it succeeded pursuant to § 642(h)(1), from "the S portion" of Trust following its ESBT election.

FACTS

Trust was created pursuant to the last will and testament of A, who died on Date 1. Trust, a residuary testamentary trust, was funded on Date 2 with various assets including the stock of X, an S corporation. Prior to A's death, A held the X stock directly. During the administration of A's estate, the estate did not have sufficient income to absorb losses attributable to the X stock which gave rise to a NOL as defined under § 172.

The NOL carryover remained unused upon the termination of A's estate on Date 2, the same date that Trust was funded. As a residuary testamentary beneficiary of A's estate, Trust succeeded to the NOL carryover that was unused by A's estate at the time of its termination under § 642(h)(1).

Trust qualified as a permissible S corporation shareholder under § 1361(c)(2)(A)(iii) during the 2-year period beginning on Date 2, the date the X stock was transferred to it pursuant to A's will. In order to remain an eligible trust following the 2-year period, the trustee made an election for Trust to be an ESBT under § 1361(c)(3), effective Date 3.

LAW AND ANALYSIS

Section 642(h)(1) provides that a NOL carryover under § 172 or a capital loss carryover under § 1212 shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary to the beneficiaries succeeding to the property of the estate or trust.

Section 1.642(h)-3(a) of the Income Tax Regulations provides that the phrase "beneficiaries succeeding to the property of the estate or trust" means those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income for which a deduction is allowed, under § 642(h).

Section 1.642(h)-3(c) provides that in the case of a testate estate, the phrase normally means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary beneficiaries.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that the term small business corporation is a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2) or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(c)(2)(A)(i) provides that a trust all of which is treated (under subpart E of part 1 of subchapter J of chapter 1) as owned by an individual who is a resident of the United States is an eligible shareholder. Section 1361(c)(2)(A)(iii) provides that for purposes of § 1361(b)(1)(B), a trust with respect to stock transferred to it pursuant to the terms of a will may be a shareholder, but only for the 2-year period beginning on the day on which such stock is transferred to it. Section 1361(c)(2)(A)(v) provides that an ESBT is an eligible shareholder.

Section 1361(e) defines an ESBT. Section 1361(e)(1)(A) provides that, except as provided in § 1361(e)(1)(B), an ESBT means any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in § 170(c)(2), (3), (4), or (5), or (IV) an organization described in § 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary, (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust. Section 1361(e)(3) provides that an election under § 1361(e) shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

Section 1.641(c)-1(a) provides that an ESBT is treated as two separate trusts for purposes of determining income tax. The portion of an ESBT that consists of stock in one or more S corporations ("the S portion") is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust ("the non-S portion").

Section 641(c)(2)(C) provides that the taxable income of the S portion is determined by taking into account only items of income, loss, deduction, or credit that are (i) the items required to be taken into account under § 1366, (ii) any gain or loss from the disposition of stock in an S corporation, and (iii) to the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in § 641(c)(2)(C)(i) or § 641(c)(2)(C)(ii). No deduction or credit shall be allowed for any amount not described in § 641(c)(2)(C), and no item described in § 641(c)(2)(C) shall be apportioned to any beneficiary.

We conclude that § 641(c)(2)(C) provides a complete list of the items of income, loss, deduction, or credit that the S portion of an ESBT may take into account. Section 642(c)(2)(C), flush language, provides that "no deduction or credit shall be allowed for any amount not described in this paragraph." The NOLs that Trust succeeded to under § 642(h)(1) are not described in § 641(c)(2)(C); therefore, the S portion of Trust is precluded from taking deductions attributable to those NOLs. However, the NOLs should be available as a deduction to the non-S portion Trust following Trust's ESBT election.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

This memorandum responds to a private letter ruling request from Trust, requesting a ruling that the NOLs to which it succeeded from the terminating estate will be available to Trust following the ESBT election. After we informed the taxpayer's representative that this office would require, as part of the private letter ruling, that no portion of the NOLs shall be available as a deduction to the S portion of Trust, the taxpayer withdrew its ruling request. This memorandum is necessary to inform your office of our position on the transaction.

The taxpayer does not agree that the NOLs should not be available to the S portion of Trust. The taxpayer argues that the NOL should be allocated to the S portion of Trust because the NOL is attributable to losses sustained by X, an S corporation whose stock is held within the S portion of the Trust. We disagree with this interpretation. We conclude that the plain language of § 641(c)(2)(C) excludes the NOL from being available to the S portion of Trust.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-3060 if you have any further questions.