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Office of Chief Counsel
Internal Revenue Service

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memorandum

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to: District Counsel, CC:NER:BRK

from: Assistant Chief Counsel, CC:DOM:IT&A /s/ by R W Casey

subject: Significant Service Center Advice
TL-N-5312-97

This responds to your request for Significant Advice in connection with a question posed by the Technical Unit at the Brookhaven Service Center.

Disclosure Statement

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Issues

1. May an estate deduct a loss incurred on the sale of the decedent’s personal residence?

2. If an estate may deduct a loss incurred on the sale of the decedent’s personal residence, how does the estate determine its basis in the property, does the loss flow through to the beneficiary or beneficiaries, and how does the estate report the proceeds from the sale?

Conclusions

1. Two significant obstacles prevent the deduction of a loss by an estate. First, under §§641(b) and 165(c) of the Internal

Revenue Code, an estate generally may not deduct a loss incurred on the sale of the decedent’s personal residence unless it has been converted to an income-producing purpose. Second, in many cases, the loss should not be treated as an item taken into account in determining the taxable income of the estate and reported on Form 1041 because the estate is not treated as the owner of the decedent’s personal residence under state law.

2. Assuming the loss is properly reported on the estate’s Form 1041, an estate’s loss on the decedent’s personal residence that is converted to an income producing purpose is the excess of the adjusted basis prescribed in §1.1011-1 of the Income Tax Regulations for determining loss over the amount realized. The loss is used by the estate in determining its taxable income. Losses do not flow directly from an estate to the beneficiaries. Rather, the beneficiaries of an estate must include in income, to the extent of distributable net income ("DNI"), the amounts that are paid, credited, or required to be distributed to them by the estate. The personal representative must determine whether the loss is properly included in the calculation of DNI.

Facts

The Technical Unit at the Brookhaven Service Center has seen a number of Forms 1041, U.S. Income Tax Return for Estates and Trusts, reporting a loss from the sale of the decedent's personal residence. In these cases, the losses are flowing through to the beneficiaries listed on Schedule K-1 (Form 1041). Because this Advice is being directed to the Brookhaven Service Center, we have discussed the effect of New York and New Jersey state law on our issue when relevant.

Discussion

<u>Issue 1</u>

Two significant obstacles prevent the deduction of a loss on the sale of the decedent's personal residence by an estate. Consequently, in most situations, a decedent's estate may not claim the loss.

First, section 641(b) provides that an estate shall compute its taxable income in the same manner as in the case of an individual. Though §165(a) permits a deduction for uncompensated losses sustained during the taxable year, §165(c) provides that individuals may deduct losses only in three situations (two of which are irrelevant for this discussion). An estate may deduct a loss incurred in any transaction entered into for profit, though not connected with a trade or business. Section 165(c)(2). This provision may apply when the estate establishes that it converted the decedent's personal residence to an income-producing purpose.

We believe that the conversion of the decedent's personal residence is not necessarily unusual, especially if the administration of the estate is prolonged. Nevertheless, since the loss is only appropriately deductible if the estate can prove that the property was converted to income producing property, estate returns should be examined on a case-by-case basis to determine whether the estate has converted the personal residence to rental property.

Second, if the loss is properly deductible under §165, the next issue is whether the loss should be treated as an item taken into account in determining the estate's taxable income. Both the form of ownership and applicable state law concerning the devolution of real property upon the owner's death affect whether the loss on the sale of the decedent's personal residence is an item that should be taken into account in determining the estate's taxable income. In many cases it is not. In these cases, the loss should be reported by the person treated as the owner of the property under state law rather than by the estate on Form 1041.

If the decedent's interest in his personal residence was owned as a joint tenant with a right of survivorship or as a tenant by the entirety, the decedent's interest in the property was extinguished upon his death, and the survivor becomes the sole owner of the property, not by descent, but by virtue of the form of ownership. Therefore, a loss on the sale of the decedent's jointly owned personal residence would be recognized by the surviving tenant and not by the estate on Form 1041. <u>See</u> <u>Petersen v. Commissioner</u>, 35 T.C. 962 (1961), <u>acq</u>. 1962-1 C.B. 4.

State law concerning the devolution of real property also affects whether the loss on the sale of the decedent's personal residence is an item that should be taken into account in determining the income of the estate. Under common law and under the laws of many states, title to real property vests in the heirs or devisees immediately upon the death of a decedent. This is true, in most situations, in New Jersey and in New York. <u>See</u> <u>Egner v. Egner</u>, 443 A.2d 1104 (N.J. Super. Ct. Ch. Div.), <u>aff'd</u>, 447 A.2d 182 (N.J. Super. Ct. App. Div. 1982), discussing New Jersey law, and <u>In re Estate of Phelps</u>, 359 N.Y.S. 2d 614 (1974), discussing New York law. Traditionally, because title passes directly to the heirs and devisees, the estate's personal representative had little or no power or obligations with respect to the decedent's realty as compared to the decedent's personal estate. In addition, the personal representative could not sell the decedent's realty to satisfy the obligations of the estate until all the decedent's personal assets had been exhausted.

In New York and New Jersey, title to real property ordinarily continues to pass to heirs or devisees upon a decedent's death, but both states have revised their laws to essentially eliminate their former distinction between real and personal property in the administration of estates. In New York and New Jersey personal representatives have broad powers over a decedent's realty, except where the property is specifically devised. In addition, under the current law in these states, personal representatives do not have to distinguish between real property and personal property in choosing assets to satisfy the estate's obligations.[1] Personal representatives, however, are not given control over specifically devised real property. Specifically devised real property also cannot be sold to satisfy estate obligations until assets passing under other types of dispositions have been exhausted. As a result of these revisions, only specifically devised real property, in New York and New Jersey, continues to enjoy the special treatment traditionally accorded real property. Although title to real property not specifically devised, continues to pass to heirs or devisees under the current state laws, these laws no longer accord real property that has not been specifically devised the special treatment it has been traditionally accorded.

Our rulings and regulations concerning the federal income tax treatment of a decedent's real property reflect the special treatment traditionally accorded real property under state law. Real property is specifically excluded by regulation from the DNI of an estate. Section 1.661(a)-2(e) provides, in part, that there shall be excluded from the term "any other amounts properly paid or credited or required to be distributed" the value of any interest in real estate owned by the decedent, title to which under local law passes directly from the decedent to his heirs or devisees.

Rev. Rul. 59-375, 1959-2 C.B. 161, deals with a situation where a court ordered the sale of an intestate decedent's real property, partly in order to satisfy estate obligations, and partly to partition the property for distribution to the heirs. Under state law, the property descended directly to numerous heirs, and partition of the property in kind among them was impracticable. The court ordered that the surplus of proceeds over those needed by the administrator to satisfy the estate's obligations were to be held for distribution to the heirs. Under state law, the surplus proceeds were considered to be real assets and not personalty for the purpose of distribution. To the extent that the property was sold for the purpose of providing funds to satisfy the estate's obligations, the proceeds were considered personalty and subject to administration. The revenue ruling holds that only the portion of the gain equal to the portion of the proceeds paid to the administrator for satisfaction of the estate's obligations is required to be included in the gross income of the estate. The remainder of the gain, which arose from the partition

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[1] Pursuant to New York Estates, Powers and Trusts Law (EPTL) §11-1.1(b)(5)(McKinney 1967), an estate's personal representative has the right to possess, rent, manage, sell, lease and mortgage the decedent's real property that has not been specifically devised. Similar powers are given to a personal representative in New Jersey under N.J. STAT. ANN. §3B:14-23 (West 1983). New York EPTL §13-1.3 eliminates the former distinction made between real and personal property in applying estate assets to the satisfaction of estate obligations. N.J. STAT. ANN. §3B:22-3 provides that the property of the decedent's estate shall abate for the purposes of paying debts and claims without any preference or priority between real and personal property.

suit, does not constitute an amount taken into account in determining the estate’s taxable income.

Rev. Rul. 68-49, 1968-1 C.B. 304, holds that the distribution of real property that comprises part of the residuary estate, is not deductible by the estate under §661, nor is it includible in the distributee's gross income under §662, because under local law, title to such property passes directly from the decedent to his heirs or devisees. Such distribution is subject to the general provisions of §102 (relating to gifts and inheritances). Section 1.661(a)-2(e) applies even though the real property is in the possession of the executor or administrator during the period of administration.

The Third Circuit, in Radin v. Commissioner, 33 F.2d 39 (3d Cir. 1929), acq. VII-1 C.B. 26, held that classification of an interest in land as real property under New Jersey law resulted in removing the administratrix from liability for the income tax on the gain from the sale of the interest because the interest descended to the heirs as real property.

As a result of the revisions to the New York and New Jersey estate laws, only specifically devised real property is accorded under the laws of these states the special treatment on which the above regulation, rulings, and court case are based. Applying this authority to the treatment of a loss on the sale of specifically devised real property, an estate should report on Form 1041 only the percentage of the loss recognized on the sale of the decedent's specifically devised real property that equals the percentage of the proceeds used by the estate to satisfy the estate's obligations. The balance should be reported directly by the heirs or devisees. For example, if fifty percent of the proceeds from the sale of the decedent's personal residence are used to satisfy obligations of the estate, the estate should report fifty percent of the loss recognized on the sale and the heirs or devisees should report the remaining fifty percent.

As a consequence of the power and control given the personal representative, under current New York and New Jersey estate law, over real property that is not specifically devised and the apparent blending of the proceeds from the sale of such property with those from the sale of personal property to create one fund, it may be more appropriate for an estate to report the loss from the sale of such real property on its Form 1041, despite the fact that title to the realty has technically passed to the heir or devisee. This result would be especially appropriate where both the decedent’s real and personal property is liquidated and the proceeds placed in one fund used for the payment of estate obligations and distributions to the heirs or devisees. Other factual situations, however, may require a different result. The federal income tax treatment of the gain or loss on the sale of the decedent’s real property, however, has not, to our knowledge, been formally addressed since the current New York and New Jersey estate laws.

It should be noted that under the law of both New York and New Jersey, if the decedent’s will contains a mandatory direction to sell the real property and distribute the proceeds, title to the real property will not vest in the decedent’s devisees upon his death. New York and New Jersey state law treats the real property as having been converted into personalty as of the date of the testator’s death, such that the property passes to the estate and not the devisees. See Fidelity Union Trust Co. v. Green, 131 A. 208 (N.J. Super. Ct. Ch. Div. 1925), and Deegan v. Deegan, 287 N.Y.S. 230 (N.Y. App. Div. 1936), discussing New Jersey and New York law respectively on this subject. As a result of property passing to the estate and not the heirs or devisees, the gain or loss realized on such sale should be reported by the estate on Form 1041. See Brown v. Commissioner, 20 T.C. 73 (1953), acq. 1953-2 C.B. 3 (holding that the will of the decedent did not equitably convert the decedent’s real property into personalty which would have caused the title to the real property to vest in the estate of the decedent so that the loss would have been a loss of the estate rather than the loss of the residuary beneficiaries).

Issue 2

The answer to the second question is divided into three parts.

(a) How does the estate determine the amount of its loss?

To determine the amount of loss, the estate would have to establish the property’s fair market value at the time of conversion. Gilbert Wilkes v. Commissioner, 17 T.C. 865 (1951). Under §1.165-9(b)(2) of the Income Tax Regulations, an estate's loss on the sale of the decedent's personal residence converted from personal use is the excess of the adjusted basis prescribed in §1.1011-1 for determining loss over the amount realized. For this purpose, the adjusted basis for determining loss shall be the lesser of the following amounts (adjusted as prescribed in §1.1011-1 for the period subsequent to the conversion of the property to income-producing purposes): the fair market value of the property at the time of conversion or the adjusted basis for loss at the time of conversion, determined under §1.1011-1 but determined without reference to the fair market value. Please note that the adjusted basis of the property at the time of conversion will likely be, as a result of the application of §1014, the fair market value of the decedent's property as of the date of the decedent's death, adjusted for any alterations to the property between the date of death and the date of conversion.

(b) Do the losses taken into account in determining the estate’s taxable income flow through to the beneficiaries?

Losses do not flow directly from an estate to the beneficiaries. Losses are used in determining the estate’s taxable income.

Section 641(b) provides that an estate shall compute its taxable income in the same manner as in the case of an individual. In addition to the deductions otherwise allowable to an individual, an estate is allowed a deduction in computing its taxable income for amounts that are paid, credited, or required to be distributed to its beneficiaries. Section 661. This deduction is limited, however, to the amount of the estate's DNI as defined in §643.

The beneficiaries of an estate must include in income, to the extent of DNI, the amounts that are paid, credited, or required to be distributed to them by the estate. Section 662(a). Amounts distributed to beneficiaries shall have the same character in the hands of the beneficiary as in the hands of the estate. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the calculation of DNI as the total of each class bears to the total DNI of the estate unless the governing instrument specifically allocates different classes of income to different beneficiaries. Section 662(b).

DNI is the taxable income of the estate computed with certain modifications. Gains from the sale of capital assets are excluded from DNI to the extent those gains are allocated to corpus and are not paid, credited or required to be distributed to any beneficiary. Losses from the sale of capital assets are also excluded from DNI except to the extent such losses are taken into account in determining the amount of capital gains that are paid, credited or required to be distributed to any beneficiary during the year. Section 643(a)(3). To the extent that the estate's loss on the sale of the decedent's personal residence is properly included in the calculation of DNI, thereby reducing the estate's DNI (but not below zero), the loss "flows through" to the beneficiary.

Under §642(h), the beneficiary of an estate may succeed to the estate's unused capital loss carryovers and net operating loss carryovers upon termination of the estate.

(c) How should the loss from the sale be reported?

As discussed previously, to the extent that a loss is treated as an item taken into account in determining the estate's taxable income, it should be reported on the estate's Form 1041. To the extent it is not, it should be reported directly on the federal income tax returns filed by the surviving joint tenants, heirs or devisees in the year of the sale who are treated as the owners of the property under state law.

If it is determined that the loss should be reported on Form 1041, the personal representative must determine whether it should be included in the calculation of DNI and make the appropriate adjustments to the estate's adjusted total income on Schedule B of the Form 1041.

If you have any questions concerning the discussion of whether the loss is an item that should be taken into account in determining the estate's taxable income and the treatment of the loss by the estate under part I of subchapter J or to discuss the facts of a specific case, please call Faith Colson at (202) 622-3060. If you have any questions concerning the discussion of the determination of the amount of the loss and the deductibility of the loss under §165, please call Leo Nolan at (202) 622-4960.