OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

SUBJECT: Request for Field Service Advice

This Field Service Advice responds to your memorandum dated September 22, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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official tax administration duties with respect to the case <u>and</u> the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

H =
W =
X =
Date 1 =
Date 2 =
Date 3 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

ISSUE

May a surviving spouse filing a joint return with a decedent for the decedent's year of death use accumulated net operating losses (NOL) arising pre-bankruptcy when the individual debtor dies before (but in the same calendar year as) his bankruptcy estate is terminated?

CONCLUSION

If a bankruptcy estate is terminated after a debtor dies, the debtor's surviving spouse may not use unused NOL carryovers that the bankruptcy estate succeeded to by virtue of I.R.C. § 1398(g) and that the debtor would have succeeded to under section 1398(i) if he had lived.

FACTS

On Date 1 in Year 2, H and X both filed Chapter 11 bankruptcy petitions. H owned 100% of the stock of X, an "S" corporation. H, who was married to W, died on Date 2 in Year 5. On Date 3, which was also in Year 5, the joint Chapter 11 plan for the debtors was confirmed and the bankruptcy estate terminated. W filed a joint return with H for Year 5 claiming NOL carryovers arising from losses passed through from X. X had filed Form 1120-S showing losses for Years 1, 2, 3, 4, and 5.

While the discharges granted by creditors of the debtors in year 4, and by the bankruptcy court in year 5, reduced the amount of the NOL carryovers available to the bankruptcy estate pursuant to I.R.C. § 108(b), there were NOLs remaining after

the reduction prescribed in that provision. Additionally, X reported an additional loss in year 4 that was passed through to H's bankruptcy estate.

LAW AND ANALYSIS

I.R.C. § 172(a) allows a deduction in computing taxable income of the aggregate of a taxpayer's NOL carryovers and carrybacks to the taxable year. Under section 172(b) as in effect for the years in question, an individual could carry losses back three years and forward 15 years.

I.R.C. § 1398 provides rules for treatment of tax attributes for years in which individuals are in bankruptcy under chapters 7 or 11 of Title 11. Section 1398(a) provides that a bankruptcy estate is a separate taxable entity from the debtor. Section 1398(g) provides that when an individual commences a bankruptcy case, the bankruptcy estate succeeds and takes into account the individual's tax attributes, including net operating loss carryovers. Section 1398(i) provides that when a bankruptcy estate terminates, the debtor succeeds to and takes into account any tax attributes of the estate, including net operating loss carryovers.

I.R.C. § 108(a)(1)(A) provides that gross income does not include discharge of indebtedness income if the discharge occurs in a Title 11 case. However, section 108(b) provides that certain tax attributes, including NOLs, of a taxpayer are reduced if the taxpayer is entitled to an exclusion under section 108(a). Section 108(d)(8) provides that the reduction in tax attributes is made by the bankruptcy estate in the case of an individual bankruptcy.

Under § 541(a)(1) of the Bankruptcy Code, the bankruptcy estate consists of all assets of the debtor. Accordingly, H's bankruptcy estate became the owner of X on Date 1 and was the proper party to claim a passthrough of any income or loss of X for the duration of the bankruptcy estate.

Thus, while the discharge reduced the amount of the NOL carryovers under I.R.C. § 108(b), it appears there were NOLs remaining after the reduction prescribed in that provision. Additionally, X reported additional losses that were properly passed through to H's bankruptcy estate.

In the absence of any express statutory language, only the taxpayer who sustains a loss is entitled to take the deduction. Mellott v. United States, 257 F.2d 798 (3d Cir.), cert. denied, 358 U.S. 264 (1958); Calvin v. United States, 354 F.2d 202 (10th Cir. 1965); Rev. Rul. 74-175, 1974-1 C.B. 52. In this case, H sustained NOLs in pre-petition years and H's bankruptcy estate sustained NOLs after the petition. Rev. Rul. 74-175 and the analysis therein make it clear that H's decedent estate is not entitled to use those deductions. Moreover, I.R.C. § 172 and Treas. Reg.

§ 1.172-7 make it clear that this entitlement does not change merely because W filed a joint return for the year in which H died.

While H's bankruptcy estate can use the NOLs for periods during the pendency of the bankruptcy, this is due solely to the statutory language in I.R.C. § 1398(g) and not for any other reason. In the absence of section 1398, there is no such entitlement. See., e.g., Richardson v. United States, 386 F. Supp. 424 (C.D. Cal. 1974), aff'd 552 F.2d 291 (9th Cir. 1977). Similarly, losses properly accruing to the bankruptcy estate or losses that pass from the debtor to the estate and then back to the debtor only pass back to the debtor because of operation of section 1398(i) and not because the debtor and the estate are the same taxpayer.

This analysis does not change because H and W filed joint returns. The filing of the joint returns does not change the fact that the NOL's were H's. See Treas. Reg.
§ 1.172-7. Pursuant to I.R.C. § 1398(i), H could only have become entitled to the NOLs upon termination of the bankruptcy estate, or on Date 3. In this case, H died on Date 2 and his tax year terminated then. While W was allowed to file a joint return, the joint return encompassed the entire Year 5 for W but only the short year ending on Date 2 for H--any income or loss sustained after Date 2 should have been reported on the return of H's decedent estate and not on H and W's joint return. As noted above, the analysis in Rev. Rul. 74-175 precludes H's decedent estate from claiming any NOL carryover.

I.R.C. § 443(a)(2) provides that a return for a period of less than 12 months shall be made when the taxpayer is in existence during only part of what would otherwise be his taxable year. Treas. Reg. § 1.443-1(a)(2) provides that although the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death, the filing of a return and the payment of tax for a decedent may be made as though the decedent had lived throughout his last taxable year. I.R.C. § 6013(c) and Treas. Reg. § 1.6013-3 provide that, for purposes of I.R.C. § 443, where husband and wife have different taxable years because of the death of either spouse, the joint return shall be treated as if the taxable years of both spouses ended on the date of the closing of the surviving spouse's taxable year.

If H and W had not made a joint return for Year 3, H would not be entitled to claim the NOL on his short-year return for the period ending Date 2, because H's bankruptcy estate had not yet terminated and I.R.C. § 1398(i) would not have applied. H's estate would not be entitled to use it because it was a different taxpayer. Rev. Rul. 74-175.

The question, therefore, is whether W filing a joint return for year 5 allows her to claim the NOL deduction when H was not entitled to it as of his death. We think the

answer to this is no because, while W's joint return may encompass the entire calendar year for her, it only includes H's year through the date of death. Treas. Reg. § 1.6013-1(d)(1) provides:

> Section 6013(a)(2) provides that a joint return may be made for the survivor and the deceased spouse or for both deceased spouses if the taxable years of such spouses begin on the same day and end on different days only because of the death of either or both. Thus, if a husband and wife make their returns on a calendar year basis, and the wife dies on August 1, 1956, a joint return may be made with respect to the calendar year 1956 of the husband and the taxable year of the wife beginning on January 1, 1956, and ending with her death on August 1, 1956.

In other words, the joint return made by W on behalf of her and H was a joint return encompassing all of calendar Year 3 with respect to her but only the short taxable year ending on Date 2 with respect to H. While the return should have reflected all of W's transactions for Year 5, it could only cover H's transactions through Date 2. This point is reinforced by Treas. Reg. § 1.6012-3(b)(1), which provides "For the decedent's taxable year which ends with the date of his death, the return shall cover the period during which he was alive."

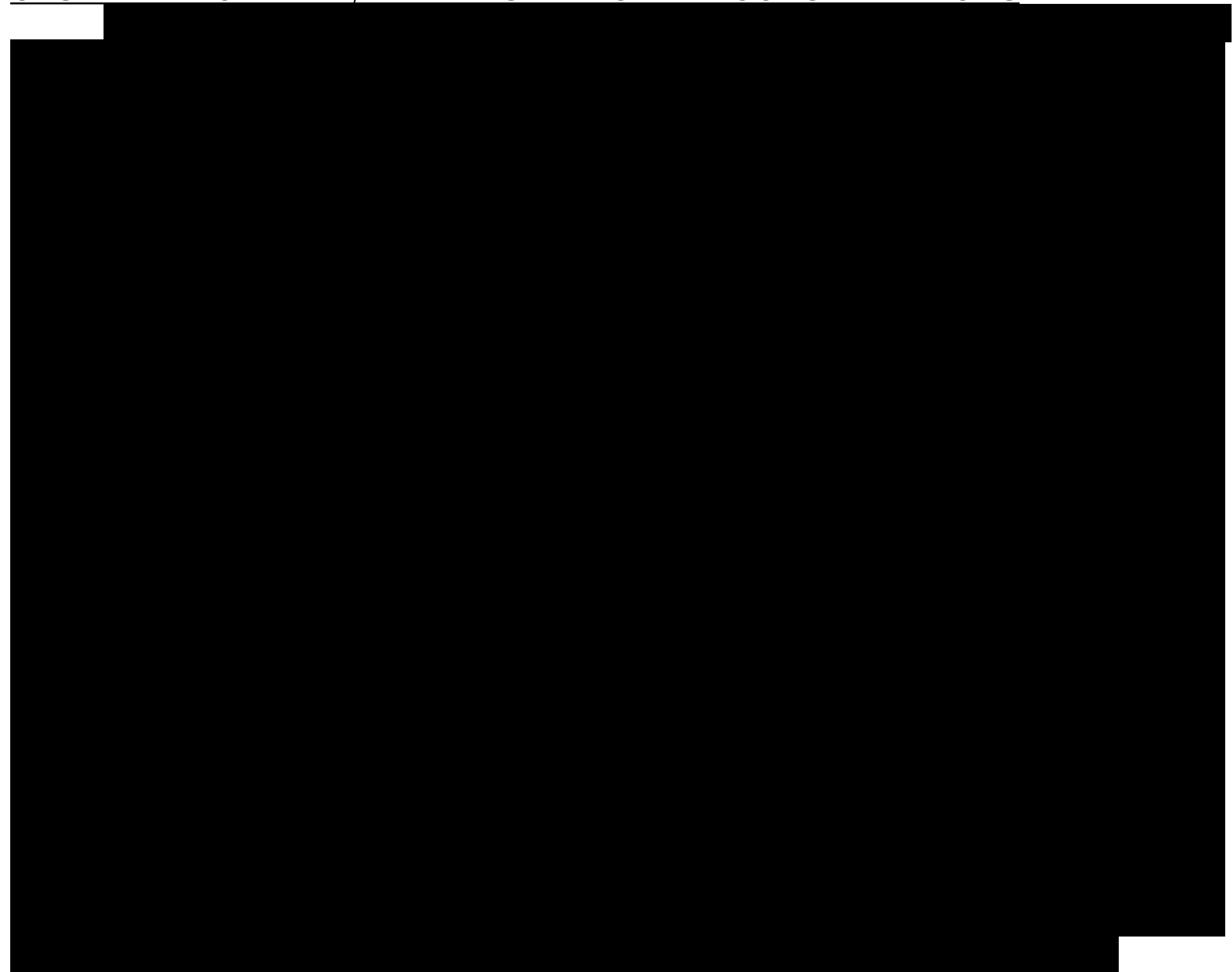
In Poorbaugh v. Commissioner, 423 F.2d 157 (3d Cir. 1969), rev'g No. 67-72 (W.D. Pa. 1968), an individual operating a cash-basis sole proprietorship died before making a payment for cost of goods sold. The payment was made after death and the widow attempted to deduct the amount on the joint return filed for the year of death. The court held that the amount could not be deducted on the joint return for purposes of determining the decedent's cost of goods sold. Rather, the payment could only be taken into account by the decedent's estate. The court noted that:

> In the District Court the appellee contended that it was permissible to file a joint return treating income and expenses as if the decedent had lived through December 31, 1962. The [District] Court, however properly concluded:
>
> "[A] short year is still required, even though that short year may be included within the joint return. The authority for this is found in section 6013(a). ... The requirement of the taxable year of each, the court holds, embraces the concept found in section 443, and a short return for the decedent is the only permissible return."

Here, had the bankruptcy terminated before H's death, W could have used the NOLs that H would have succeeded to under I.R.C. § 1398(i) when she filed a joint return for Year 5. However, H died before the estate was terminated and his tax

year ended on Date 2. Because H was not entitled to the NOL carryover before he died, W cannot use it on the joint return.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



Please call if you have any further questions.

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