



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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TL-N-3559-01

MEMORANDUM FOR AREA COUNSEL (SBSE), AREA 1, MANHATTAN

FROM: Lawrence H. Schattner, Chief, Branch 2
(Collection, Bankruptcy and Summonses)

SUBJECT:

By way of e-mail, and attached facsimile dated August 15, 2001, your office requested advice regarding the above referenced case. The taxpayer is seeking to carry forward a net operating loss ("NOL") from the taxable year in which his Chapter 7 bankruptcy petition was filed. This NOL was the result of losses incurred by taxpayer's Subchapter S corporations for the period from the beginning of the corporations' tax year until the date the petition was filed. We conclude that the taxpayer is not entitled to these losses. This document is not to be cited as precedent.

LEGEND

Amount A
Amount B
Amount C
Creditor
Date A
Date B
Date C
Date D
Date E
Year A
Year B
Year C
Year D
Year E
Year F

ISSUES

(1) Whether the individual taxpayer or the bankruptcy estate accrued the flow-through losses of Subchapter S corporations for the period from the beginning of the corporate tax year until the day the taxpayer's Chapter 7 bankruptcy petition was filed?

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(2) Was the taxpayer entitled to use such losses after the termination of the bankruptcy case?

CONCLUSIONS

(1) The bankruptcy estate, not the individual taxpayer, accrued the flow-through losses of the Subchapter S corporations for the tax year in which the bankruptcy petition was filed, including the period from the beginning of the year until the day the taxpayer's petition was filed.

(2) The taxpayer was not entitled to use such losses after the termination of the bankruptcy case to the extent those losses were reduced by the cancellation of indebtedness income excluded from the taxpayer's income in the year in which the bankruptcy discharge was granted, and to the extent that the basis in the stock of the Subchapter S corporations was reduced by virtue of the bankruptcy case.

FACTS

Taxpayer formed two Subchapter S corporations in Year A, one of which was funded with a Amount A loan from Creditor. Taxpayer filed a Chapter 7 bankruptcy petition on Date A, and the taxpayer's shares of the S corporations became property of the bankruptcy estate. Taxpayer did not elect to bifurcate the Year B tax year into short, prepetition and postpetition, years pursuant to I.R.C. section 1398(d)(2). The case was converted to a Chapter 11 case in Date B.

Each of the corporations incurred substantial losses in Year B, totaling over Amount B. On his Year B return the taxpayer claimed flow-through losses from the corporations of approximately Amount C. This amount represents the portion of the S corporations' losses attributable to the period from Date C, to the Chapter 7 petition date. On taxpayer's Year C through Year D returns taxpayer carried forward the Year B loss, effectively shielding himself from income taxes in those years.

During the bankruptcy proceeding the taxpayer brought an adversary proceeding against the Service with regard to prepetition and postpetition taxes, and the Year B NOL issue was briefed to the bankruptcy court. However, the adversary proceeding was resolved through a settlement that did not resolve the Year B NOL issue. Taxpayer received a discharge in the bankruptcy case on Date D, discharging the Amount A debt to Creditor. The bankruptcy case was closed on Date E.

The Service recently sent the taxpayer a statutory notice of deficiency for years Year E, Year F and Year D (the assessment statute has expired for earlier years), asserting that the taxpayer was not entitled to the NOL carry-forward from Year B.

ANALYSIS

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I.R.C. section 1398 applies to any case under Chapter 7 or Chapter 11 of the Bankruptcy Code in which the debtor is an individual. Section 1398(e)(1) provides that the gross income of the bankruptcy estate shall include the gross income of the debtor to which the estate is entitled under the Bankruptcy Code. Section 1398(e)(1) adds that the preceding sentence shall not apply to any amount received or accrued by the debtor before the commencement of the bankruptcy case.

The taxpayer argues that he, and not the bankruptcy estate, is entitled to the losses from the S corporations for the portion of petition year prior to the commencement of the bankruptcy case because those losses accrued on a daily basis pursuant to I.R.C. sections 1366 and 1377, and are therefore allocated to the taxpayer under section 1398(e). Section 1366(a) provides that in determining the tax of a shareholder of an S corporation for the shareholder's taxable year in which the tax year of an S corporation ends, there shall be taken into account the shareholder's pro rata share of the corporation's items of income loss, deduction, or credit the separate treatment of which could affect the liability for of any shareholder, and nonseparately computed income or loss. Section 1366(c) provides that in any case where it is necessary to determine the gross income of a shareholder, such gross income shall include the shareholder's pro rata share of the gross income of the corporation. Section 1377(a) provides that each shareholder's pro rata share of any item for any taxable year shall be the sum of the amount determined with respect to the shareholder by assigning an equal portion of such item to each day of the taxable year, and then by dividing that portion pro rata among the shares outstanding on such day.

We conclude that the flow-through losses of the Subchapter S corporations for the entire corporate tax year in which the petition was filed belong to the bankruptcy estate. Pursuant to Bankruptcy Code section 541(a), the taxpayer's shares in the S corporations passed to the bankruptcy estate when the bankruptcy case was commenced. Pursuant to section 1398(f), the transfer of the taxpayer's stock in the S corporations to the bankruptcy estate is not treated as a disposition for purposes of any provision of the Code, and the bankruptcy estate is treated as the taxpayer would be treated with respect to the stock. Accordingly, section 1377 (and 26 C.F.R. section 1.1377-1(a)(2)(ii)), which provides the rule for determining a shareholder's pro rata share of any item of the S corporation when there has been a disposition of the shares during the corporate tax year, does not apply to this case. Pursuant to section 1366(a) the losses of the S corporations accrued to the shareholders on the last day of the corporate tax year, and therefore belong to the bankruptcy estate.¹ This conclusion is consistent with the holdings of the Tax Court that when a partner commences a bankruptcy case before the last day of the partner's tax year and the bankruptcy estate holds the partnership interest on the

¹ Also note that pursuant to section 1398(g) the taxpayer's basis in the Subchapter S corporations passed to the bankruptcy estate. Section 1366(d) provides that the aggregate amount of losses and deductions taken into account by a shareholder shall not exceed the sum of the adjusted basis in the shareholder's stock.

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last day of that year, then that partner's share of income, gain, loss, deduction, or credit of the partnership is treated as earned by the bankruptcy estate. Gulley v. Commissioner, T.C. Memo 2000-190, and Katz v. Commissioner, 116 T.C. 5 (2001). Any losses which pass through to the bankruptcy estate will reduce the estate's bases in the shares under section 1367.

The taxpayer also may not use the Year B losses for periods following the termination of the bankruptcy case because these losses were reduced by the amount of cancellation of indebtedness income excluded from the taxpayer's gross income by virtue of the bankruptcy case. Pursuant to I.R.C. section 108(a), the taxpayer's cancellation of indebtedness income was excluded from his gross income in the year of the bankruptcy discharge. Pursuant to section 108(b)(1), certain tax attributes are reduced by the amount of the excluded cancellation of indebtedness income in the order provided for in section 108(b)(2). Under section 108(b)(2), reductions apply first to NOLs for the taxable year of the discharge and any NOL carryover to that year, and then to other tax attributes, including taxpayer's basis in property, unless the taxpayer makes an election under section 108(b)(5) to reduce basis first. Pursuant to section 108(d)(8), the bankruptcy estate is treated as the taxpayer in section 1398 cases for purposes of section 108(b)(1) reductions in tax attributes. Thus, absent an election under section 108(b)(5), the NOL carried forward from the petition year shall be reduced by the amount of the cancellation of indebtedness income excluded from the taxpayer's gross income, after determination of the tax for the taxable year of the discharge. The excess of the cancellation of indebtedness over the NOL would then be applied to reduce other tax attributes listed in section 108(b), including the basis of the bankruptcy estate in the Subchapter S corporation stock. Pursuant to sections 1398(i), the taxpayer succeeds to the assets and tax attributes of the bankruptcy estate upon the termination of the bankruptcy case. If the reduction in attributes resulted in a complete reduction of the NOLs, the bankruptcy estate had no NOL carryforward when the case was terminated and none would pass to the taxpayer when the bankruptcy was closed. The taxpayer also succeeded to the reduced basis in the Subchapter S corporations stock.

If you have any questions please call the attorney assigned this matter at 202-622-3620.

Attachments (2)