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subject: Electing Small Business Trust Net Operating Loss Carryovers

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

ISSUE

May the S portion of an electing small business trust (ESBT) carry to another taxable year a net operating loss (NOL) attributable to a loss passed through to the ESBT by an S corporation of which it is a shareholder?

CONCLUSION

The S portion of the ESBT may carry to another taxable year the NOL passed through from the S corporation.

FACTS

Although we understand that actual cases involving this issue have arisen in the examination process, we have not requested or received taxpayer-specific information. The facts presented are purely hypothetical, intended to clearly present the issue.

In its X taxable year, an S corporation incurred an NOL that it passed through to its sole shareholder, an ESBT. The ESBT had sufficient basis in its stock to fully claim the loss. However, it did not have sufficient income in its S portion to cover the loss, thus creating

an NOL at the trust level. The ESBT carried the NOL to its Y taxable year to use against the income of the S portion.

LAW

Section 172(a) of the Internal Revenue Code provides the allowance of a deduction for an NOL.

Section 172(b) provides rules regarding the taxable years to which a NOL may be carried.

Section 172(c) provides that the term "net operating loss" means the excess of the deductions allowed for Federal income tax purposes over the gross income, computed with modifications specified in § 172(d).

Section 641(c)(1) generally provides that for purposes of chapter 1, (A) the portion of any electing small business trust which consists of stock in one or more S corporations shall be treated as a separate trust, and (B) the amount of tax imposed on such separate trust shall be determined with the modifications of § 641(c)(2).

Section 641(c)(2) provides that for purposes of § 641(c)(1), the modifications are the following: (A) except as provided in § 1(h), the amount of tax imposed by § 1(e) shall be determined by using the highest rate of tax set forth in § 1(e); (B) the exemption amount under § 55(d) shall be zero; and (C) the only items of income, loss, deduction, or credit to be taken into account are the following: **(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; (iii) to the extent provided in regulations, state or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii), and (iv) any interest expense paid or accrued on indebtedness incurred to acquire stock in an S corporation. **No deduction or credit shall be allowed for any amount not described in this paragraph**, and no item described in this paragraph shall be apportioned to any beneficiary. [Emphases added]

Section 1.641(c)-1(a) of the Income Tax Regulations generally provides that an electing small business trust within the meaning of § 1361(e) is treated as two separate trusts for purposes of chapter 1. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust (the S portion). 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).[1] Section 1.641(c)-1(d)(2)(i) provides in general that the S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to § 1366 and the regulations thereunder. **Rules**

[1] For purposes of this memorandum, we ignore the possibility that an ESBT might also have a “grantor portion,” consisting of that portion of the trust treated as owned by the grantor or another person under the rules of subpart E of part 1 of subchapter J.

otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. Section 1.641(c)-1(j) provides in part that upon the termination or revocation of an ESBT election, if the S portion has a NOL under § 172, a capital loss carryover under § 1212, or deductions in excess of gross income, then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under § 642(h), to the trust, or to the beneficiaries succeeding to the trust property of the trust if the entire trust terminates. [Emp. added]

Section 642(d) provides that the benefit of the deduction for NOLs provided by § 172 shall be allowed to estates and trusts under regulations prescribed by the Secretary. Section 1.642(d)-1 provides the NOL deduction allowed by § 172 is available to estates and trusts generally, with two specific exceptions not relevant to this memorandum.

Section 642(h)(1) provides that if on the termination of an estate or trust, the estate or trust has a NOL carryover under § 172 or a capital loss carryover under § 1212, then such carryover 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 1361(a)(1) provides generally that for purposes of title 26, the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year. Section 1361(b)(1) lists the definitional requirements to be a "small business corporation," of which the relevant one is § 1361(b)(1)(B), that the corporation not have as a shareholder a person (other than an estate, 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)(v) provides that an electing small business trust may be a shareholder for purposes of § 1361(b)(1)(B). Section 1361(e)(1)(A) generally defines an electing small business trust as meaning any trust, except as provided in § 1361(e)(1)(B), if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) and organization described in § 170(c)(2), (3), (4), or (5), or 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 1366(a)(1) provides generally that in determining the tax under chapter 1 of an S corporation shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and nonseparately computed income or loss (as defined in § 1366(a)(2)).

Section 1366(d)(1) generally provides that the aggregate amount of losses and deductions taken into account by a shareholder under § 1366(a) for any taxable year shall not exceed the sum of (A) the adjusted basis of the shareholder's stock in the S corporation and (B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder. Section 1366(d)(2)(A) provides in general that except as provided in § 1366(d)(2)(B) (relating to certain spousal transfers), any loss or deduction which is disallowed for any taxable year by reason of § 1366(d)(1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

ANALYSIS

S corporation shareholders generally take into account in their current taxable year the items their pro rata share of the S corporation's income, loss, deduction, or credit allocated to them under § 1366(a)(1). But the ability to use the losses flowing through in the current year may be limited for various reasons, including when the shareholder's current year income is less than the amount of the losses, the basis limitation of § 1366(d)(1) applies, or other provisions of law such as the "at-risk" rules under § 465 or the passive loss rules under § 469, and such suspended losses will be deductible in other taxable years only as specifically authorized by the relevant provision.

In the case of an individual S corporation shareholder who is allocated a loss from the corporation, if the amount of the loss exceeds the shareholder's gross income for the taxable year, the shareholder may sustain an NOL, which the shareholder may carry to another taxable year pursuant to § 172(b) and claim an NOL deduction under § 172(a). However, if such a loss is allocated to the S portion of an ESBT shareholder and creates a trust-level NOL, the special rules of § 641(c)(2)(C) are implicated, complicating the question of whether such NOL may be carried over to another taxable year of the trust and taken into account by the S portion in that year.

Uncertainty in this area has been created in part by commentators' speculation as to the meaning of CCA 200734019 (issued 8/24/07). In the CCA, Trust was a residuary testamentary trust created pursuant to the will of A, who died on Date 1. On Date 2, Trust was funded with assets including stock of X, an S corporation, which A had held directly during life. During the administration of A's estate (between Dates 1 and 2), A's estate did not have sufficient income to absorb losses attributable to the X stock, giving rise to an NOL. The NOL carryover remained unused at the termination of the estate and funding of Trust on Date 2, and Trust succeeded to it under § 642(h)(1). Pursuant to § 1361(c)(2)(A)(iii), Trust qualified as an S corporation shareholder for the 2-year period beginning on Date 2. To remain as an eligible shareholder following that period, Trust elected to be an ESBT effective Date 3.

The CCA concludes 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, the flush

language specifically denying a deduction or credit for any amount not included in the statutory list. Because the NOLs that Trust succeeded to under § 642(h)(1) are not listed, the S portion was precluded from taking deductions attributable to them. However, the NOLs would be available as a deduction to the non-S portion. The CCA notes that the taxpayer had argued that the NOL should be allocated to the S portion of Trust because it is attributable to losses sustained by the S corporation whose stock is held in that portion. The CCA rejects this taxpayer argument based on the "plain language" of § 641(c)(2)(C).

A standard treatise, S Corporations Federal Taxation (May 2020 updated version), Blau, Richard D., Lemons, Bruce N., and Rohman, Thomas P., (hereinafter, "Blau") suggests at § 19:35 a possible government interpretation of the CCA that would forbid the S portion of an ESBT from using NOL carryovers in any situation:

> As an additional example, consider that while losses that pass through the S corporation to the ESBT under § 1366 are specifically required to be taken into account in the S portion of the trust, the S portion of the trust may have insufficient income to absorb these losses in a particular year. In that case, the S portion of the trust would carry such loses back forward [sic], presumably, under § 172 to a prior or future year. But, when the losses are carried forward to the future year, the losses arise, not under § 1366, but, rather, under § 172. The Service might argue that since losses under § 172 are not 'items required to be taken into account under § 1366' as provided in § 641(c)(2)(C), these types of carry forward losses can only be taken into account with respect to the non-S portion of the trust, perhaps resulting in the inability to use the losses against future income of the S corporation passed through to the S portion of the trust. One can argue that such an approach would not be appropriate.

The footnotes to the quoted text cite to the CCA and suggest that its holding could have been reached on other grounds: "One way of dealing with this issue would have been for the Service to simply have noted that since the losses had arisen before the trust was an ESBT, the losses were necessarily part of the non-S portion of the trust." They then suggest multiple reasons in opposition to a reading of the CCA as disallowing any NOL carryovers to the S portion of an ESBT, which we paraphrase as follows:

1. There is no policy ground for disallowing losses carried forward or back under a section other than § 1366. The statute and regulation only require that they "originate" under § 1366. Section 1.641(c)-1(d)(2)(i) states that rules otherwise applicable to trusts apply in determining the extent to which a loss or deduction may be taken into account by the S portion; under those rules, a trust would normally be able to carry over a § 1366 loss under § 172.

2. Disallowing losses that flowed through under § 1366 in a prior or subsequent year leads to an unreasonable result. If an ESBT owned stock in two S corporations, it

would clearly be able to offset flow-through gain from one with a flow-through loss from the other, yet a narrow reading of the CCA would disallow the use of losses from one corporation against gain from that same corporation if they occurred in different years, which the treatise describes as “simply mak[ing] no sense.”

3. As previously noted, the CCA conclusion could have been reached on the alternative ground that the losses were part of the non-S portion because they arose before the trust was an ESBT that had an S portion.[2]

4. Losses suspended under § 1366(d) because of insufficient current year basis would be treated more favorably than other losses for no apparent reason. The statute explicitly allows these losses to carry forward, whereas losses based on insufficient current year income would be permanently lost.

5. Section 1.641(c)-1(j) does not imply any limit on the use of NOL carryovers by the S portion of an ESBT during its existence, but merely addresses the use of unused NOLs upon the termination of the S portion.

We agree with the commentators that the holding of the CCA does not require the disallowance of all NOL carryovers by the S portion of an ESBT. The ESBT described in the CCA received the NOL carryovers from another taxpayer, the estate, under the special rule of § 642(h)(1) allowing these items to be carried over to a successor rather than lost at the estate’s termination. The ESBT never had a § 1366 item related to these losses. We believe that if a loss flowing through to the S portion of an ESBT under § 1366 cannot be used in the current taxable year because of the lack of offsetting income, it is nonetheless an item “taken into account” by reason of § 1366 in the prior or subsequent year in which it is deductible under § 172. To hold otherwise is to defeat the language of both § 1.641(c)-1(d)(2)(i) that the rules “otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account,” and of § 1.642(d)-1 providing that the § 172 NOL deduction should be “generally” available other than for listed exceptions. We do not feel compelled to interpret § 641(c)(2)(C) in a manner that anomalously disadvantages certain § 1366 flow-through losses relative to others or ESBTs relative to other S corporation shareholders.

Please call (202) 317-6852 if you have any further questions.

[2] This point is not convincing. We would have reached the same answer in the CCA, as in this document, if the testamentary trust and the ESBT had existed concurrently.