

Office of Chief Counsel
Internal Revenue Service
memorandum

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Third Party Communication: None
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UILC: 642.08-00

date: July 20, 2010

to: Associate Area Counsel, CC:SB:1:NEW:1
(Small Business/Self-Employed)

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

subject: Request for Chief Counsel Advice

This Chief Counsel Advice may not be used or cited as precedent.

LEGEND

Estate =

Decedent =

Administrator

Counsel

Date 1 =

Date 2 =

Date 3 =

Date 4

Date 5

a =

b =

Year 1 =

Year 2

Year 3

Year 4

ISSUE

Whether, under § 642(h)(1), the beneficiaries of the Estate, none of whom will receive any of the Estate's property pursuant to a Settlement Agreement with the United States arising from Decedent's unpaid income taxes, should succeed to approximately \$a of the Estate's unused capital loss carryovers.

More specifically, are these beneficiaries included within the phrase, "beneficiaries succeeding to the property of the estate" under 642(h)(1)?

CONCLUSION

The Estate's beneficiaries should not be entitled to any of the Estate's unused loss carryovers under § 642(h)(1).

FACTS

Decedent died on Date 1. Decedent's will provided that Decedent's spouse received the entire residuary estate in trust for life, with the residue divided equally among descendants of four named individuals at the spouse's death. At the time of death, Decedent had unpaid assessments arising from underpayments of income tax for the taxable years of Year 1 through Year 4 for joint returns filed with the spouse. The Administrator of the Estate entered into a Settlement Agreement dated Date 2 with the United States, which was approved by a state court of appropriate jurisdiction on Date 3. Decedent's spouse had died by the time of the Settlement Agreement, and the spouse's executor consented to the Agreement.

The Settlement Agreement provided that the Estate was to be deemed insolvent and that the United States was to receive all the proceeds of the Estate less outstanding administrative expenses. Accordingly, under the terms of the Settlement Agreement, none of the individual testamentary beneficiaries are entitled to receive any property.

Subsequent to the Settlement Agreement, on or about Date 4, the United States and Administrator, as Administrator of the Estate, entered into a stipulation and consent agreement, reducing to judgment in the amount of \$b plus interest in favor of the United States. This consent judgment represented the assessed federal income tax liabilities for Year 2 through Year 3.

The Estate anticipates reporting approximately a \$a capital loss carryover under § 1212 on its final income tax return for the taxable year ending Date 5.

The Estate has received a formal opinion from its tax counsel, Counsel, who concludes that the allocation of the Estate's unused carryover loss to the Estate's beneficiaries is not barred by the terms of the Settlement Agreement, by the fact that the Estate is insolvent, or by the outstanding \$b tax liability owed to the United States.

The Administrator of the Estate filed a summary motion with a state court seeking a judgment directing the Administrator to issue Schedules K-1 (Form 1041), Beneficiary's

Share of Income, Deductions, Credits, etc. to the Estate's residuary beneficiaries reporting their share of the estimated \$b unused capital losses. The Department of Justice, Tax Division, contacted CC:SBSE Area Counsel (1) regarding whether they should file a motion to remove this matter from state court and place it into federal court because a state court's judicial declaration would violate federal rights and (2) whether the underlying proposal to issue Schedules K-1 to the beneficiaries is correct. CC:SBSE requested our assistance to determine whether the beneficiaries are entitled to the Estate's unused capital losses under § 642(h)(1).

Law & Analysis:

Section 642(h)(1) states that if on the termination of an estate or trust, the estate or trust has a net operating loss carryover under § 172 or a capital loss carryover under § 1212 then such carryover or such excess 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) 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 any excess of deduction over gross income for which a deduction is allowed, under § 642(h).

Section 1.642(h)-3(b) provides that with reference to an intestate estate, the phrase "beneficiaries succeeding to the property of the estate or trust" means the heirs and next of kin to whom the estate is distributed, or if the estate is insolvent, to whom it would have been distributed if it had not been insolvent.

Section 1.642(h)-3(c) provides that in the case of a testate estate, the phrase "beneficiaries succeeding to the property of the estate or trust" means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary beneficiaries. However, the phrase does not include the recipient of a specific sum of money even though it is payable out of the residue, except to the extent that it is not payable in full. On the other hand, the phrase includes a beneficiary (including a trust) who is not strictly a residuary beneficiary but whose devise or bequest is determined by the value of the decedent's estate as reduced by the loss or deductions in question.

In the example to §1.642(h)-4, the decedent's will leaves \$100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only \$90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of \$5,000, and a capital loss carryover of \$15,000, to both of which § 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of \$10,000, and since the total of the excess of deductions and the loss carryover is \$20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

With respect to intestate estates, § 1.642(h)-3(b) specifically contemplates an insolvent estate. However, the regulation does not distinguish degrees of insolvency. In the present case, the Estate is testate. With respect to testate estates, § 1.642(h)-3(c) states that the phrase include, “a beneficiary of a fraction of a decedent’s net estate after payment of debts, expenses, etc.” This section does not distinguish a void net estate.

The Estate obtained a legal opinion letter stating that the Estate’s residuary beneficiaries would be included within the phrase “beneficiaries succeeding to the property of the estate” under § 642(h)(1). The opinion letter also stated that it was made in the absence of any authority (other than the regulation itself) addressing the application of that phrase in the context of no property passing to any beneficiary. Therefore, the opinion letter concludes that this opinion has not been tested in either a decided case or any published Internal Revenue Service ruling. In addition, the opinion includes the observation that § 1.642(h)-3 indicates that the Department of the Treasury contemplates that net operating loss carryovers survive the termination of an insolvent estate likewise has not been tested in either a decided case or any published Internal Revenue Service ruling.

Section §1.642(h)-3(a) states carryovers and excess deductions pass only to “beneficiaries succeeding to the property of the estate or trust” who are “those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed....” In the present case, the individual beneficiaries of the Estate should no longer be considered beneficiaries after the Estate entered into the Settlement Agreement to transfer all the proceeds of the Estate to the United States. This is a distinguishable situation from that set forth in the allocation example. Beneficiaries in that example received a loss carryover despite not receiving any property, but could have received property if the estate had sufficient funds. Here, as a legal matter, the individual beneficiaries could no longer receive anything. Any losses incurred by the Estate were to the detriment of the United States rather than the individual beneficiaries. Therefore, the Estate’s beneficiaries should not be entitled to any of the Estate’s unused loss carryovers under § 642(h)(1).

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Please call _____ of this office at (202) 622-3060 if you have any further questions.