Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **20253101F**
Release Date: 8/1/2025

CC:SB:8:LGN:1:JEB:
POSTF-104851-24

UILC: 172.00-00

date: May 23, 2024

to:
Internal Revenue Agent

Supervisory Internal Revenue Agent

from: Jordan E. Baumer
General Attorney
Office of Chief Counsel, Small Business/Self-Employed

subject:

Revenue Agent contacted Area Counsel to obtain Counsel advice and memorandum on a Form 1045 Application for Tentative Refund received from taxpayers (hereafter "Taxpayers"), which identified a net operating loss ("NOL") carryback of from Taxpayers' taxable year to Taxpayers' taxable year . This memorandum provides a coordinated Counsel response to Exam's request for Counsel review.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

BACKGROUND

Taxpayers are individuals married to each other and file joint returns for all relevant tax years. They use the calendar year as their tax year. On or about , Taxpayers filed a Form 1040 for tax year (" Tax Return"), attached as Exhibit A.[1] The Tax Return shows that Taxpayers sustained a net operating loss of in that year. Taxpayers submitted a Form 1045, Application for Tentative Refund (attached as Exhibit B), seeking to carry the NOL from to tax years .[2]

The primary loss source identified on the Form 1040, Schedule E, is , incorporated on , is an S corporation owned equally by Taxpayers and uses a fiscal year ending as its taxable year.

On filed for Chapter 11 bankruptcy relief in the Bankruptcy Court for the District of (hereafter "Bankruptcy Case"). The Court ordered that the case be jointly administered with related cases [3], and was identified as the lead case . In the jointly administered case, the Court entered an "Order Approving Liquidation Sale of the Debtors' Assets and Granting Related Relief" on , pursuant to which a related entity, , was the purchaser under a pre-confirmation § 363 sale. On , the jointly administered non-individual debtors filed a motion to convert the cases from Chapter 11 to Chapter 7 , and the Court entered an order of conversion on . Since conversion, the Chapter 7 trustee has actively administered the bankruptcy estate, .

1 The IRS IMFOLT transcript for Taxpayers reflects that an initial Form 1040 was received on . The IRS EUP system shows that the " Tax Return" was e-filed on . Attached as Exhibit E is a copy of the faxed letter Taxpayers provided to the IRS with a copy of the original return, the Tax Return (identified as Form 1040X in the letter), and Form 1045 stamped on .

2 The issue of whether taxpayers submitted a processible claim for refund is outside the scope of this memorandum and further Counsel review would be necessary if this matter is in question. In addition to the Form 1045 referenced herein, file includes 1040X returns for tax years [redacted], and [redacted], which the IRS received by fax on [redacted].

3

On or about , the Chapter 7 trustee filed a Form 1120-S, U.S. Income Tax Return for an S corporation, on behalf of [4] (attached as Exhibit C), for the tax year beginning , and ending . The Form 1120-S shows that the S corporation sustained an ordinary business loss of and an I.R.C. § 1231 loss of , which flowed through to Taxpayers as reflected on their Schedules K-1.

On the Tax Return, Taxpayers claimed deductions for nonpassive losses from for each Taxpayer).[5] The NOL sustained by Taxpayers in supposedly include the .

On the Form 1045, Taxpayers seek to carry back the NOL from back to through pursuant to the five-year NOL carryback provision of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136.[6] Taxpayers request a refund of in income taxes paid for tax years . This request for refund and is, therefore, . The Specialist assigned to the case requested that the Revenue Agent obtain Area Counsel guidance on two issues: 1) whether the taxpayers would receive a double benefit from carryback of NOLs plus a bankruptcy discharge; and 2) whether the ongoing bankruptcy proceeding impacts the release of funds to the taxpayer.

BRIEF ANSWER

1) There is no double benefit because Taxpayers **<u>may not</u>** claim the loss on their Form 1040 for taxable year . Pursuant to I.R.C. § 1366, the loss shown on the for the tax year ending , would flow through to Taxpayers' Form 1040 for taxable year rather than for taxable year .

2) The bankruptcy case does not affect Taxpayers' ability to claim passthrough loss from the entity.

4 The Form 1120-S reflects an , date of incorporation with an S election that same day. (letter attached as Exhibit F (BMF Account Summary attached as Exhibit D), BMF Account Summary (see Exhibit G).

5 It is Counsel's understanding that Taxpayers' basis limitation resulted in the reduced loss amount, as reflected on Taxpayers' Schedule of Loss Limitations for tax year attached as **Exhibit H**.

6 It appears that Taxpayers had losses for tax years and and therefore could not carry the NOL to those years.

DISCUSSION

I. *There is no double benefit because taxpayers cannot claim the passthrough loss from on their Form 1040 for taxable year .*

Section 1366 of the Internal Revenue Code establishes the treatment of passthrough items (such as income or losses) to a shareholder of an S corporation. Passthrough items are taken into account "for the shareholder's taxable year in which the taxable year of the S corporation ends." I.R.C. § 1366(a)(1). Treasury Regulation § 1.1366-1(a) provides, "The shareholder takes these items into account in determining the shareholder's taxable income and tax liability for the shareholders' taxable year **with or within which the taxable year of the corporation ends.**" (emphasis added).

The application of I.R.C. § 1366(a)(1) with a fiscal year S corporation and calendar year shareholder may result in a shareholder's deferral of taxable income from the S corporation. The shareholder would not realize the passthrough income or loss until the fiscal year-end of the S corporation matches the calendar year of the shareholder. The authors of Federal Income Taxation of S Corporations note the implications of § 1366(a)(1), "If a shareholder and a corporation use different taxable years, the shareholder generally reports corporate income or loss on a somewhat deferred basis. Normally, such deferral is favorable in the case of income but unfavorable in the case of losses." James S. Eustice, et al., Federal Income Taxation of S Corporations § 7.07, 1-2 (2024). The section continues with an example:

> X, an S corporation, uses a fiscal year ending on September 30. A, the sole shareholder of X, uses a calendar year. X incurs a loss evenly throughout its taxable year starting October 1, 2014. A deducts that loss on A 's tax return for 2015. Thus, A 's deduction of the part of the loss incurred in October, November, and December 2014 is deferred until 2015.

Id.

. Beginning in and continuing to at least (the most recent tax period listed on the IRS BMF Account Summary for , the substitute-successor as discussed above – attached as **Exhibit D**), elected to use a fiscal tax year of . For Taxpayers' tax year on their 1040 return, the passthrough items from would flow through from the S corporation's fiscal year ending in . For Taxpayers' tax year on their 1040 return, passthrough items from would flow through from the S corporation's fiscal year ending in . On their Form 1040 for taxable year , Taxpayers erroneously included passthrough losses from the for fiscal year ending , and those losses may not be added to Taxpayers' NOL for .

II. *The bankruptcy case does not affect Taxpayers' ability to claim a passthrough NOL from .*

The has requested Counsel guidance on whether Taxpayers would doubly benefit from an entity's passthrough losses to the Taxpayer and the discharge of the entity's debts in an bankruptcy proceeding. Bankruptcy Code § 727(a)(1) expressly directs that "[t]he court shall grant the debtor a discharge, unless (1) the debtor is not an individual." National Labor Relations Bd. V. Better Bldg. Supply Corp., 837 F.2d 377, 378 (9th Cir. 1988) ("Partnerships and corporations may not discharge their debts in a liquidation proceeding under Chapter 7 of the Code."); In re Lang, 398 B.R. 1, 4 (Bankr. N.D. Iowa 2008) (emphasizing that corporations may not receive a discharge under chapter 7 of the Bankruptcy Code because "[t]he limited purpose of a corporate Chapter 7 case is the fair and orderly liquidation of corporate assets"). In Chapter 7 bankruptcy cases, only individuals may receive a discharge of debts.

filed for Chapter 11 bankruptcy relief in . This Chapter 11 case was converted, pre-confirmation, to one under Chapter 7 on .

As a non-individual debtor, the S corporation is not entitled to a Chapter 7 bankruptcy discharge. It should also be noted that the individual Taxpayers will similarly not be granted any bankruptcy discharge to the extent such individuals have not filed a bankruptcy petition (and Counsel is not aware of any such petition having been filed by either of the individual Taxpayers).

Moreover, the losses do not constitute property of the bankruptcy estate. Rather, it is Counsel's understanding that is not subject to Federal income taxation under applicable law and that any losses incurred by the entity are deemed to flow through to Taxpayers who own all of the outstanding stock of See I.R.C. §§ 1363, 1366. As shareholders of , Taxpayers, not the S corporation, have the right to receive tax benefits for the losses sustained by the S corporation. As such, the losses as they are taken into account in figuring Taxpayers' NOL for and any Federal income tax refunds that ultimately result from the carryback of the NOL constitute rights and property of the individual Taxpayers under applicable federal tax law and do not constitute property of the bankruptcy estate in this case under Bankruptcy Code § 541. *See Segal v. Rochelle*, 382 U.S. 375 (1966) (in a case involving NOLs resulting from losses of a debtor S Corporation that ultimately resulted in tax refunds being owed to the S Corporation's individual owners, the Court reviewed the statutory predecessor to § 541 and ultimately determined that the NOLs constituted property of the bankruptcy estates <u>for the individual owners of the S-Corp</u>, who had each also filed bankruptcy petitions); *see also In re Majestic Star Casino, LLC, 716 F.3d 736 (3d Cir. 2013) (recognizing in part - and citing to In re Forman Enters, Inc.,* 281 B.R. 600, 612 (Bankr. W.D. Pa. 2002) - that "when an S-corp files for bankruptcy, its estate cannot contain any NOLs because '[u]nder the provisions of the [I.R.C.] . . . , the NOL and the right to use it automatically passed through by operation of law to [the] . . . S corporation shareholders."); and

Mourad v. Commissioner, 121 T.C. 1 (2003) (holding that an S corporation's bankruptcy petition does not terminate its status as an S corporation).

Because will not be granted a discharge in Chapter 7 proceeding and because the S corporation loss does not constitute property of the bankruptcy estate, Counsel sees no concerns or issues here regarding any potential "double benefit" to Taxpayers or to stemming from the bankruptcy case. However, in accordance with I.R.C. § 1366 and as discussed above, passthrough losses from the 1120-S for fiscal year ending , may not be added to Taxpayers' NOL for .

CONCLUSION

Counsel recommends that the passthrough loss be disregarded for purposes of Taxpayers' Form 1040 for tax year and that any NOL carryback from to and subsequent years omit losses from fiscal tax year ending . While the bankruptcy proceedings of do not affect the release of a requested refund to Taxpayers, section 1366(a)(1) of the Internal Revenue Code does affect Taxpayers' refund request. Taxpayers <u>cannot</u> claim the passthrough loss from on their Form 1040 for taxable year and therefore cannot carry back the NOL passthrough amount to their taxable year.

In comparing the entities listed on Taxpayers' Form 1040 for tax year , Schedule E , with the list of jointly administered entities identified on the Bankruptcy Court docket, , Counsel observes that only appears on both documents. With respect to any losses that flow through to Taxpayers from other debtor-entities jointly administered under the lead bankruptcy case identified above ( ), Counsel advises that additional review may be necessary to confirm that the bankruptcy case does not affect the NOL amount. However, as to any losses that properly flow through to Taxpayers in accordance with § 1366(a) (meaning that Taxpayers claim the passthrough items in the correct tax year and not in), bankruptcy matter will not result in a discharge of debts or prohibit the release of funds to Taxpayers.

Sincerely,

Jordan E. Baumer
General Attorney

(Small Business/Self-Employed)

Enclosures:

Exhibit A: Tax Return,
Exhibit B: Form 1045 Application for Tentative Refund,

Exhibit C: Form 1120-S for fiscal year ending

Exhibit D: BMF Account Summary for
Exhibit E: Faxed letter from , with Form 1040 Returns and Form 1045
Exhibit F: Letter explaining EIN differences
Exhibit G: BMF Account Summary for
Exhibit H: Schedule of Loss Limitations for tax year

Additional Enclosures:

-