



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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LM:NR:DAL:1

FROM: ASSOCIATE CHIEF COUNSEL
CC:PSI

SUBJECT: PASSIVE LOSS RULES

This Field Service Advice responds to your memorandum dated August 1, 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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LEGEND

Decedent
Trust
S Corporation
District Court
Date 1
Date 2
Date 3

ISSUES

1. Whether Decedent's interest in a passive activity was transferred by reason of his death pursuant to Internal Revenue Code § 469(g)(2).
2. Whether certain S Corporation stock is includible in Decedent's estate.

CONCLUSIONS

1. Based upon the information provided, Decedent's interest in the passive activity transferred by reason of his death under section 469(g)(2).
2. Based upon the information provided, the S Corporation stock is not includible in Decedent's estate.

FACTS

The facts submitted are as follows. Decedent was the sole current income beneficiary of Trust. Trust was established by Decedent's parents on Date 1. Trust held stock in S Corporation. Decedent filed an election under section 1361(d) to treat Trust as a Qualified Subchapter S Trust (hereinafter "QSST").

Trust's terms, as modified on Date 2 by a judgment of District Court, provide that if Decedent lives to age forty, Trust is to terminate and its corpus distributed to Decedent. However, if Decedent dies before attaining age forty, Trust is to terminate and is to be distributed to Decedent's living lineal descendants. If Decedent has no living lineal descendants, Trust is to be distributed to the living lineal descendants of Decedent's parents. Decedent died on Date 3 before attaining age forty. Trust was distributed to the living lineal descendants of Decedent's parents.

During his life, Decedent was unable to deduct certain losses accrued by S Corporation because of the passive activity loss limitations under section 469. Carryover passive activity losses of approximately \$1.5 million were claimed on Decedent's final federal income tax return form 1040. Net operating losses were carried back on the income tax returns for three prior years and refunds were made

to Decedent. These refunds were included in Decedent's form 706.

LAW AND ANALYSIS

Issue 1

Under section 1361(c)(2)(A)(i), a trust treated as a wholly owned grantor trust may be a shareholder of an S corporation. If a beneficiary of QSST makes an election under section 1361(d)(2), the QSST is treated as if it were a grantor trust that is described in section 1361(c)(2)(A)(i), and the income beneficiary of the QSST is treated as the owner of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. Section 1361(d)(1). When an individual is treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the individual treated as the owner, those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income or credits against the tax of an individual. Section 671.

You have informed us that the QSST election in this case was proper and that, at all times, Trust met the requirements provided in section 1361(d)(3). As a result of the valid QSST election, Decedent was treated as the owner of the S Corporation stock held by the QSST.

The passive activity loss rules, enacted by Congress as part of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, generally prohibit certain taxpayers from using losses from passive activities to offset income from nonpassive activities. Disallowed losses are suspended and carried forward to reduce passive activity income generated in future years. Section 469(b). Because of the passive activity loss limitations under section 469, Decedent was unable to deduct the passive losses generated by S Corporation during his life.

Section 469(g)(2) provides special rules for interests in passive activities that are transferred by reason of the death of a taxpayer. When a taxpayer transfers his interest in a passive activity by reason of his death, the suspended passive activity losses allocated to his interest in the activity are deductible on his last income tax return to the extent such losses are greater than the excess (if any) of the basis of such property in the hands of the transferee, over the adjusted basis of such property immediately before the taxpayer's death. The suspended losses are treated as losses not from a passive activity and therefore may offset nonpassive income. Section 469(g)(2)(A). The amount of the passive activity loss that equals the step-up in basis by reason of decedent's death is not allowed as a deduction to anyone in any taxable year. Section 469(g)(2)(B). See also St. Charles Investment Co. v. Commissioner, 110 T.C. 46 (1998).

When Decedent died, his interest in the activity transferred. Accordingly, under section 469(g)(2), the carryover passive losses allocated to Decedent's interest are deductible on Decedent's last income tax return to the extent such losses are greater than the excess (if any) of the basis of such property in the hands of the transferee, over the adjusted basis of such property immediately before Decedent's death.

Issue 2

Decedent was the sole current income beneficiary of Trust established by his parents. When Decedent died, Trust was distributed to the living lineal descendants of Decedent's parents. Given these facts, the S Corporation stock held by the QSST is not includible in Decedent's estate under any estate tax provisions of the Internal Revenue Code.

Please call if you have any further questions.

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