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Timothy R. Koski

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S CORPORATION SHAREHOLDERS ALLOWED TAX WINDFALL:
SUPREME COURT RESOLVES CONTROVERSY REGARDING
THE IMPACT OF CANCELLATION OF INDEBTEDNESS
INCOME ON S CORPORATION SHAREHOLDERS

TIMOTHY R. KOSKI*

I. INTRODUCTION

In *Gitlitz v. Commissioner*,¹ the United States Supreme Court held that S corporation shareholders can increase their stock basis by cancellation of indebtedness (COD) income² excluded from the corporation's income under section 108(a) of the Internal Revenue Code.³ The Court also held that this basis increase occurs after the tax attribute reduction required by section 108(b).⁴ The Supreme Court's decision results in a windfall to S corporation shareholders by exempting them from tax on COD income while allowing them to increase their stock basis and deduct previously suspended losses.⁵

The issue addressed by the Supreme Court in *Gitlitz* is a difficult one. Courts addressing the issue have differed significantly in both the result reached and the analysis used.⁶ Commentators also disagree on

* J.D., 1985, University of North Dakota; LL.M. in Taxation, 1986, Southern Methodist University; Ph.D. in Accounting, 1998, University of Missouri-Columbia. Timothy R. Koski is a certified public accountant and an attorney specializing in taxation. He has several years experience as both a CPA and as an attorney. He currently teaches tax and accounting at the University of Southern Indiana.

1. 121 S. Ct. 701 (2001).

2. *Gitlitz*, 121 S. Ct. at 708. Cancellation of indebtedness income is also referred to as discharge of indebtedness income. As used herein, COD income means cancellation of indebtedness income or discharge of indebtedness income.

3. *Id.* Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended. See generally 1986 U.S.C.C.A.N. (current version at 26 U.S.C. (1994 & Supp. V 1999)).

4. *Gitlitz*, 121 S. Ct. at 709.

5. *Id.* at 708-09.

6. The Sixth, Seventh, and Tenth Circuits, along with the Tax Court, have used different reasoning to decide this issue in favor of the Service. See *Gaudiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000); *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000); *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999); *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd* 182 F.3d 1152 (10th Cir. 1999). The Third and Eleventh Circuits have decided this issue in favor of the taxpayer. See *United States v. Farley*, 202 F.3d 198 (3d Cir. 2000); *Pugh v. Commissioner*, 213 F.3d 1324 (11th Cir. 2000).

the proper resolution of the issue.⁷ The Sixth Circuit summarized the difficulty of the issue as follows:

As the conflicting decisions of the other courts that have analyzed this issue demonstrate, interpreting the Internal Revenue Code is about as easy as swimming through mud. The sections at issue, 108, 1366, and 1367, while seemingly clear on their faces, become muddy when they are applied in conjunction with each other.⁸

This article reviews the impact of COD income on S corporation shareholders. The main purpose of this article is to analyze the different statutory interpretations that courts have used to resolve the issue. The article also discusses the Supreme Court's recent decision in *Gitlitz*.

II. THE OPERATIVE STATUTES

A. S CORPORATION TAXATION

A corporation that makes an election under Subchapter S of the Internal Revenue Code is generally not subject to federal income tax.⁹ Instead, S corporation income (or loss) is passed through on a pro-rata basis and taken into account in determining the shareholder's tax.¹⁰ Section 1366(a)(1) provides that both nonseparately computed income (or loss) and separately stated items are taken into account in determining the shareholder's taxable income.¹¹ Separately stated items are "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."¹² Section 1366(b) provides that the character of S corporation items in a shareholder's hands is "determined as if [the] item[s] were realized directly from the source . . . realized by the

7. See generally Richard M. Lipton, *Tax Court Rejects S Corp. Basis Step-Up for COD Income in Nelson*, 88 J. TAX'N 272 (1998); Richard M. Lipton, *The Impact of Excluded COD Income on S Shareholders—The Tenth Circuit Gets Lost in Gitlitz*, 91 J. TAX'N 197 (1999); Richard M. Lipton, *Different Courts Adopt Different Approaches to the Impact of COD Income on S Corporations*, 92 J. TAX'N 207 (2000); James D. Lockhart & James E. Duffy, *Tax Court Rules in Nelson that S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis*, 25 WM. MITCHELL L. REV. 287 (1999); James F. Loebel, *Does the Excluded COD Income of an Insolvent S Corporation Increase the Basis of the Shareholders' Stock?*, 52 FLA. L. REV. 957 (2000).

8. *Gaudio*, 216 F.3d at 533.

9. I.R.C. § 1363(a) 1986 U.S.C.C.A.N. (current version at 26 U.S.C. § 1363(a) (1994)). Although an S corporation is a pass-through entity and not subject to federal income tax, it may be subject to (1) built-in gains tax under section 1374, (2) tax on excess net passive income under section 1375, and (3) LIFO (last-in, first-out) recapture tax under section 1363(d).

10. I.R.C. § 1366 1986 U.S.C.C.A.N. (current version at 26 U.S.C. § 1366 (1994 & Supp. V 1999)).

11. I.R.C. § 1366(a)(1). Nonseparately computed income or loss is defined as gross income minus allowable deductions, determined by excluding separately stated items as described in section 1366(a)(1)(A). See I.R.C. § 1366(a)(2).

12. I.R.C. § 1366(a)(1)(A). Common separately stated items include interest, dividends, capital gains and losses, charitable contributions, and the section 179 election to immediately expense the cost of tangible personal property placed in service.

corporation.”¹³ If an S corporation realizes a capital gain, for example, section 1366(b) ensures that the item will remain a capital gain after it passes through to shareholders.¹⁴

In order to prevent double taxation of amounts distributed by an S corporation to its shareholders, section 1367(a)(1) provides that a shareholder’s basis in his or her S corporation stock is increased by both nonseparately computed income and separately stated items.¹⁵ Likewise, a shareholder’s basis in his or her S corporation stock is decreased by nonseparately computed loss and separately stated items of loss and deduction.¹⁶

An S corporation shareholder cannot deduct S corporation losses to the extent that the losses exceed his or her adjusted basis in the S corporation stock plus debt that the S corporation owes the shareholder.¹⁷ Losses that cannot be deducted because of insufficient basis are suspended and carryover indefinitely until the shareholder’s basis in his or her stock and debt is large enough to permit the deduction.¹⁸

B. COD INCOME

COD income is included in gross income under section 61(a)(12).¹⁹ Section 108(a)(1), however, provides several exceptions to this general rule.²⁰ Under section 108(a)(1)(B), COD income is excluded from income if “the discharge occurs when the taxpayer is insolvent.”²¹ Insolvency is defined as the excess of liabilities over the fair market value of assets, determined immediately before the debt discharge.²²

13. I.R.C. § 1366(b).

14. *Id.*

15. I.R.C. § 1367(a)(1) 1986 U.S.C.C.A.N. (current version at 26 U.S.C. § 1367(a)(1) (1994)). The basis of a shareholder’s stock in an S corporation is also increased by the excess of depletion deductions over the basis of property subject to depletion. I.R.C. § 1367(a)(1)(C).

16. I.R.C. § 1367(a)(2). The basis of a shareholder’s stock in an S corporation is also decreased by distributions not included in the shareholder’s income under section 1368 and by corporate items that are nondeductible and not chargeable to capital. I.R.C. § 1367(a)(2)(D). In addition, a shareholder’s stock basis is decreased by the shareholder’s deduction for depletion of oil and gas property held by the S corporation to the extent that it “does not exceed the proportionate share of the adjusted basis of such property allocated to [the] shareholder under section 613A(c)(11)(B).” I.R.C. § 1367(a)(2)(E).

17. I.R.C. § 1366(d)(1).

18. I.R.C. § 1366(d)(2).

19. I.R.C. § 61(a)(12) 1986 U.S.C.C.A.N. (current version at 26 U.S.C. § 61(a)(12) (1994)).

20. I.R.C. § 108(a)(1) 1986 U.S.C.C.A.N. (current version at 26 U.S.C. § 108(a)(1) (1994 & Supp. V 1999)). The exceptions to the general rule of income exclusion are if the “(A) discharge occurs in a title 11 [bankruptcy] case, (B) the discharge occurs when the taxpayer is insolvent, (C) the indebtedness discharged is qualified farm indebtedness, [and] (D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.” *Id.*

21. I.R.C. § 108(a)(1)(B).

22. I.R.C. § 108(d)(3).

Taxpayers pay a price for section 108's exclusion from income.²³ Section 108(b) provides that taxpayers must reduce certain tax attributes, items that could yield future tax benefits, by the amount of income excluded under section 108(a).²⁴ Tax attributes are reduced by excluded COD income in the following order: (1) net operating loss (NOL), (2) general business credit, (3) minimum tax credit, (4) capital loss carryover, (5) the basis of property of the taxpayer, (6) passive activity loss and credit carryovers, and (7) foreign tax credit carryovers.²⁵ In the case of an S corporation, section 108(d)(7)(B) provides that the attribute reduction rule is applied at the corporate level.²⁶ S corporation losses disallowed because a shareholder has a zero basis in his stock are treated as NOLs subject to reduction.²⁷

C. THE RELATIONSHIP BETWEEN S CORPORATION TAXATION AND COD INCOME

The issue addressed in *Gitlitz* arises when COD income of an S corporation is excluded from income under section 108 and the shareholder has suspended losses under section 1366(d)(1).²⁸ Two basic issues arise.²⁹ The first issue is whether COD income excluded from income under section 108(a) is an "item of income" under section 1366(a)(1), resulting in an increase in an S corporation shareholder's basis under section 1367(a)(1).³⁰ If the shareholder's basis is increased by excluded COD income, the second issue, whether the increase occurs before or after the corporate level tax attribute reduction required under section 108(d)(7)(B), becomes important.³¹ Because suspended losses are treated as NOLs subject to reduction under section 108(b), they are not available to increase the basis of the shareholder's stock and to allow deduction of suspended losses if attribute reduction occurs before the section 1367(a)(1) basis increase.³²

III. ANALYSIS OF THE ISSUE

Courts have struggled with the issue of whether S corporation shareholders can increase their stock basis by excluded COD income and

23. *United States v. Farley*, 202 F.3d 198, 203 (3d Cir. 2000).

24. I.R.C. § 108(b)(2).

25. *Id.*

26. I.R.C. § 108(d)(7)(B).

27. *Id.*

28. *Gitlitz v. Commissioner*, 121 S. Ct. 701, 704 (2001).

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.* at 708-09.

thereby deduct suspended losses.³³ This section of the article discusses the different analyses used by courts before the Supreme Court's decision in *Gitlitz*.

A. THE TAX COURT POSITION

The Tax Court first dealt with this issue in *Winn v. Commissioner*.³⁴ Winn and Gitlitz, the taxpayers, were different shareholders in the same S corporation.³⁵ They were shareholders in PDW&A, Inc., an S corporation that was a partner in Parker Properties Joint Venture.³⁶ The partnership realized COD income in 1991.³⁷ PDW&A was insolvent when it realized its share of the partnership's COD income.³⁸ Both Winn and Gitlitz increased the basis of their PDW&A stock by their pro-rata share of the COD income.³⁹ As a result, they each claimed significant losses that, without the basis increase, would have been suspended under section 1366(d)(1).⁴⁰

Although the Service raised several arguments in support of various motions, it abandoned these arguments at trial.⁴¹ At trial, the Service contended that COD is not an "item of income" under section 1366(a)(1).⁴² This was the only issue dealt with by the court.⁴³ The Service conceded that if excluded COD income was an item of income under section 1366(a) it would flow through to the shareholders and increase their basis, allowing them to deduct previously suspended losses.⁴⁴

33. *Winn v. Commissioner*, 73 T.C.M. (CCH) 3167 (1997), *withdrawn and replaced*, 75 T.C.M. (CCH) 1840 (1998); *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd* 182 F.3d 1152 (10th Cir. 1999); *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999); *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000); *Gaudiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000); *United States v. Farley*, 202 F.3d 198 (3d Cir. 2000); *Pugh v. Commissioner*, 213 F.3d 1324 (11th Cir. 2000).

34. 73 T.C.M. (CCH) 3167 (1997), *withdrawn and replaced*, 75 T.C.M. (CCH) 1840 (1998).

35. *Winn*, 73 T.C.M. (CCH) at 3167.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.* PDW&A's share of the partnership's COD income was \$2,021,296. *Id.* PDW&A was insolvent by \$2,181,748 when it realized the COD income. *Id.* Both Winn and Gitlitz increased their stock basis by \$1,010,648. *Id.*

40. *Id.* Winn did not claim any losses in 1991 because he believed that the passive activity loss rules prevented him from doing so. *Id.* He claimed \$1,010,648 of losses from PDW&A on his 1992 return. *Id.* Gitlitz claimed \$1,010,648 of losses from PDW&A on his 1991 return. *Id.*

41. *Id.* at 3168.

42. *Id.*

43. *Id.*

44. *Id.* The Service did not make this concession in later cases. As discussed herein, if excluded COD income is held to be an item of income under section 1366(a)(1), several courts believe that the timing of tax attribute reduction must still be addressed in determining whether S corporation shareholders can deduct previously suspended losses. See discussion *infra* Parts III.B-E.

In a memorandum decision, the Tax Court held that COD is an "item of income" under section 1366(a)(1).⁴⁵ According to the court, COD is an item of income for purposes of determining a shareholder's basis in S corporation stock because of its inclusion in section 61's definition of gross income.⁴⁶ Because section 61(a)(12) specifically requires that COD be included in gross income, it is an "item of income."⁴⁷ The court saw no reason to treat COD differently from other items included in gross income under section 61 and excluded from income under other sections of the Code.⁴⁸

Winn was withdrawn less than a year after it was issued and superseded by *Nelson v. Commissioner*.⁴⁹ In *Nelson*, the Tax Court held that S corporation shareholders may not increase their stock basis by excluded COD income.⁵⁰ The taxpayer in *Nelson* was the sole shareholder in Metro Auto, Inc. (MAI), an S corporation that realized COD income.⁵¹ The COD income exceeded MAI's losses.⁵² MAI was insolvent prior and subsequent to realizing the COD income.⁵³ *Nelson* increased his stock basis by the excluded COD income.⁵⁴ He later disposed of his MAI stock and claimed a long-term capital loss.⁵⁵ The Service disallowed a portion of the loss, claiming *Nelson's* stock basis did not include the excluded COD income.⁵⁶

In a reviewed opinion, the Tax Court unanimously held that S corporation shareholders may not increase their stock basis by excluded COD income.⁵⁷ The taxpayer in *Nelson* argued that COD income is a separately-stated item of income (tax-exempt) under section 1366(a)(1)(A) that passes through to shareholders and increases

45. *Winn*, 73 T.C.M. (CCH) at 3169.

46. *Id.*

47. *Id.*

48. *Id.* The Tax Court cited sections 61(a)(4) and 103 (relating to interest) and sections 61(a)(1) and 101 (relating to insurance) as examples of items of income realized under section 61 and excluded elsewhere. *Id.*

49. 110 T.C. 114 (1998), *aff'd* 182 F.3d 1152 (10th Cir. 1999); *see also* *Winn v. Commissioner*, 73 T.C.M. (CCH) 3167 (1997), *withdrawn and replaced*, 75 T.C.M. (CCH) 1840 (1998).

50. *Nelson*, 110 T.C. at 130. The Tax Court has reaffirmed the position taken in *Nelson* several times thereafter. *E.g.*, *Bettisworth v. Commissioner*, 79 T.C.M. (CCH) 1424 (2000); *Goodman v. Commissioner*, 79 T.C.M. (CCH) 1398 (2000); *Mullen v. Commissioner*, T.C.M. (CCH) 1389 (2000).

51. *Nelson*, 110 T.C. at 115.

52. *Id.*

53. *Id.* at 116.

54. *Id.*

55. *Id.*

56. *Id.* COD income exceeded MAI's losses by \$1,375,790. *Id.* This was the portion of the loss disallowed by the Service. *Id.*

57. *Id.* at 130. There were two concurring opinions in *Nelson*. However, all nineteen Tax Court judges agreed that S corporation shareholders may not increase their stock basis by excluded COD income. Judge Beghe's and Judge Foley's concurring opinions discussed the issue of whether it is necessary to decide whether excluded COD income is tax-exempt income under section 1366(a)(1)(A). *Id.*

stock basis under section 1367(a)(1).⁵⁸ Under this analysis, section 108(b)(4)(A) governs the interaction between section 108(d)(7) and the tax attribute reduction required by section 108(b)(2).⁵⁹ Because section 108(b)(4)(A) provides that tax attribute reduction is made “after the determination of the tax . . . for the taxable year of the discharge,” the suspended losses flow through to the shareholder before tax attribute reduction.⁶⁰ Under this interpretation of section 108, the only purpose of section 108(d)(7)(A) is to create uniformity between S corporation shareholders.⁶¹ A pro-rata amount of COD income is excluded from the income of each shareholder to the extent that the S corporation is insolvent. The solvency status of the shareholders is not relevant.⁶²

The Tax Court interpreted section 108(d)(7)(A) broadly and held that both the insolvency determination and the COD income exclusion under section 108(a) apply at the corporate level.⁶³ The court stated that it was applying the plain meaning of the statute and that the specific provision of section 108(d)(7)(A) overrides the general provisions of Subchapter S, including sections 1366(a) and 1367(a).⁶⁴ Because section 108(d)(7)(A) precludes income recognition at the shareholder level, the income does not pass through to shareholders under section 1366(a)(1)(A) and therefore cannot increase the shareholder’s stock basis under section 1367(a)(1)(A).⁶⁵ The excluded COD income, in effect, “disappears” at the corporate level.⁶⁶ There is nothing to pass through to the shareholders.⁶⁷

The Tax Court noted that section 108(d)(6) provides that COD income exclusion is applied at the partner level in the case of a partnership.⁶⁸ Thus, partnership COD income may impact partners differently, depending on their financial position. In contrast, section 108(d)(7)(A) provides that COD income exclusion is applied at the corporate level in the case of S corporations.⁶⁹ The court believed that Congress intended to preclude separate treatment for S corporation

58. *Id.* at 119.

59. *Id.* at 123-24.

60. *Id.* at 123.

61. *Id.* at 123-24.

62. See generally *Nelson*, 110 T.C. 114.

63. *Id.* at 124.

64. *Id.* at 124-25.

65. *Id.*

66. Richard M. Lipton, *Tax Court Rejects S Corp. Basis Step-Up for COD Income in Nelson*, 88 J. TAX’N 272, 274 (1998).

67. *Nelson v. Commissioner*, 110 T.C. 114, 119 (1998).

68. *Id.* at 122.

69. I.R.C. § 108(d)(7)(A) 1986 U.S.C.A.N. (current version at 26 U.S.C. § 108 (d)(7)(A) (1994 & Supp. V 1999)).

shareholders.⁷⁰ According to the court, “if Congress had intended a step-up in basis to accompany the recognition of excluded COD income at the shareholder level, it would have provided for statutory language reaching that result.”⁷¹

The Tax Court majority rejected the taxpayer’s argument that COD income is “tax-exempt” income within the meaning of sections 1366(a)(1)(A) and 1367(a)(1)(A) and therefore statutorily required to pass through to the shareholders pursuant to section 1366(a)(1)(A).⁷² The Service has continually taken the position that excluded COD income is tax-deferred income (as opposed to tax-exempt income) that does not pass through to S corporation shareholders and increase their stock basis.⁷³ The Service first announced this position in Technical Advice Memorandum (TAM) 94-23-003⁷⁴ and has reiterated it several times thereafter.⁷⁵ In fact, Treasury Regulation 1.1366-1(a)(2)(viii) provides that excluded COD income is not tax-exempt income.⁷⁶

According to the Tax Court, section 108 is not designed to provide a permanent exemption from tax.⁷⁷ COD income is tax-deferred, not tax-exempt.⁷⁸ Tax deferral is accomplished through the reduction in tax attributes required by section 108(b).⁷⁹ Because section 108 is not designed to be a permanent exemption from tax, the Tax Court majority rejected the “argument that excluded COD income is ‘tax-exempt’ [income] pursuant to section 1366(a)(1)(A) and, thus, is statutorily required to pass through to the S corporation shareholders.”⁸⁰

Judge Beghe and Judge Foley issued concurring opinions stressing the fact that characterization of COD income as tax-exempt is not relevant.⁸¹ According to Judge Beghe, the only relevant inquiry is whether excluded COD income is a pass-through item at all.⁸² Because section 108(d)(7)(A) provides that it doesn’t pass through to the shareholders,

70. *Nelson*, 110 T.C. at 122-23.

71. *Id.*

72. *Id.* at 125.

73. Tech. Adv. Mem. 94-23-003 (Feb. 28, 1994).

74. *Id.*

75. See generally Tech. Adv. Mem. 95-42-001 (July 10, 1995); Tech. Adv. Mem. 95-41-006 (July 5, 1995).

76. Treas. Reg. § 1.1366-1(a)(2)(viii) (2000). Treas. Reg. § 1.1366-1(a)(2)(viii) is effective for S corporation taxable years beginning after August 18, 1998. Because it was not effective in the tax years at issue, none of the cases reviewed herein addressed the validity of the regulation. *Id.*

77. *Nelson v. Commissioner*, 110 T.C. 114, 125 (1998).

78. *Id.*

79. *Id.* at 127-28.

80. *Id.* at 125.

81. *Id.* at 130, 137. Judge Halpern agreed with Judge Beghe’s concurring opinion. Four other judges agreed with Judge Foley’s concurring opinion. *Id.*

82. *Id.* at 131 (Beghe, J., concurring).

the question of whether it is tax-exempt isn't relevant.⁸³ Judge Foley also saw no reason to distinguish between tax-deferred and tax-exempt income.⁸⁴ According to Judge Foley, "after the application of section 108(b) and the resulting reduction of tax attributes . . . there are no 'items of income,' tax-exempt or otherwise, to which section 1366(a) may apply."⁸⁵

The majority opinion concluded by expressing concern over the windfall that granting a basis increase would create.⁸⁶ The court did not believe a taxpayer should be allowed a basis increase where he has neither suffered an economic cost nor made an economic outlay.⁸⁷ In the court's opinion, such a windfall was against section 108's statutory approach of subjecting excluded COD income to tax in the future, via section 108(b)'s tax attribute reduction.⁸⁸

B. THE TENTH CIRCUIT POSITION

In *Gitlitz*, the Tenth Circuit reached the same result as the Tax Court in *Nelson*, but for an entirely different reason.⁸⁹ According to the Tenth Circuit, all items of income, including excluded COD income, are attributed initially to the corporation.⁹⁰ Tax attribute reduction, however, occurs before pass-through to the shareholders.⁹¹ Suspended losses are treated as NOLs subject to attribute reduction.⁹² Thus, they are reduced by excluded COD income.⁹³ Because this occurs at the corporate level, the suspended losses are not available for use at the shareholder level.⁹⁴

The Tenth Circuit first set forth its standard of review.⁹⁵ According to the Tenth Circuit, the Supreme Court's holding that the Code should not be interpreted to allow taxpayers the equivalent of a double deduction, absent a clear declaration of intent by Congress, applies to windfalls as well as deductions.⁹⁶ The court made it clear that it would adopt the taxpayer's position only if the position was unequivocally sup-

83. *Id.* at 134.

84. *Id.* at 137 (Foley, J., concurring).

85. *Id.* at 136.

86. *Id.* at 123.

87. *Id.* at 129-30.

88. *Id.* at 130.

89. *Gitlitz v. Commissioner*, 182 F.3d 1143, 1151 (10th Cir. 1999).

90. *Id.* at 1143.

91. *Id.*

92. *See* I.R.C. § 108(d)(7)(B) 1986 U.S.C.C.A.N. (current version at 26 U.S.C. § 108(d)(7)(B) (1994 & Supp. V 1999)).

93. *See* I.R.C. § 108(b)(2).

94. *Gitlitz*, 182 F.3d at 1148-49.

95. *Id.* at 1145.

96. *Id.* at 1147-48 (paraphrasing the holding in *United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969)).

ported by statutory text.⁹⁷ While acknowledging that the position was not without merit, the court did not believe Congress intended to confer a windfall upon taxpayers with excluded COD income and suspended S corporation losses.⁹⁸

The Tenth Circuit held that all items are initially attributed to the S corporation under section 1366(a)(1).⁹⁹ Because an S corporation is not a taxpaying entity, however, the items must pass through to the shareholders.¹⁰⁰ The critical question, according to the Tenth Circuit, is when attribute reduction occurs.¹⁰¹ If attribute reduction occurs after pass-through to the shareholders, COD income increases a shareholder's basis under section 1367(a)(1).¹⁰² If attribute reduction occurs prior to pass-through, on the other hand, excluded COD income is absorbed before it passes to shareholders and is not available to increase their basis.¹⁰³

The court held that attribute reduction occurs before items pass through to shareholders.¹⁰⁴ Because losses suspended under section 1366(d)(1) are treated as NOLs for purposes of section 108(b)(2)(A), they are reduced by excluded COD income.¹⁰⁵ A shareholder's pro-rata share of the NOL passes through only to the extent it is not absorbed by the shareholder's pro-rata share of excluded COD income.¹⁰⁶

The Tenth Circuit struggled with the impact of section 108(b)(4)(A) on the timing of attribute reduction.¹⁰⁷ As previously mentioned, section 108(b)(4)(A) provides that attribute reduction "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge."¹⁰⁸ While acknowledging there are different opinions on this issue, the court saw section 108(b)(4)(A)'s role as simply computing certain tax applications before reducing tax attributes.¹⁰⁹ The limit on deducting contributions to charity, for example, would be calculated before attribute reduction.¹¹⁰ The Tenth Circuit did not read section

97. *Id.* at 1148.

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.* at 1149.

102. *Id.* at 1147.

103. *Id.* at 1148.

104. *Id.* at 1149.

105. *Id.* at 1148.

106. *Id.* at 1148-49.

107. *Id.* at 1149.

108. I.R.C. § 108(b)(4)(A) 1986 U.S.C.C.A.N. (current version at 26 U.S.C. § 108(b)(4)(A) (1994 & Supp. V 1999)).

109. *Gitlitz v. Commissioner*, 182 F.3d 1143, 1150 (10th Cir. 1999).

110. *Id.* Other examples of tax applications cited by the court were establishing income ceilings for section 108(b)(2) deductions/credits and evaluating applications of possible alternative minimum tax. *Id.*

108(b)(4)(A) as mandating attribute reduction “*in the tax year following the year of the discharge.*”¹¹¹

The court confined its holding to excluded COD income.¹¹² The court made it clear that the exceptions treating excluded COD income at the corporate level under section 108(d)(7)(A) and section 108(b)'s tax attribute reduction do not apply to other forms of tax-exempt income.¹¹³ According to the Tenth Circuit, the critical distinction between COD income and other types of excluded income, such as interest on municipal bonds, is the initial economic outlay.¹¹⁴ Unlike purchasers of municipal bonds, S corporation shareholders with excluded COD income have made no economic outlay.¹¹⁵

C. THE SEVENTH CIRCUIT POSITION

In *Witzel v. Commissioner*¹¹⁶ the Seventh Circuit decided the issue differently than the Tax Court and the Tenth Circuit. In an opinion by Judge Posner, the Seventh Circuit first held that tax attribute reduction occurs at the corporate level before income is passed through to shareholders.¹¹⁷ As a result, excluded COD income reduces S corporation losses suspended under section 1366(d)(1).¹¹⁸ Thus, the taxpayer in *Witzel* did not receive the immediate windfall of both excluding COD income and deducting previously suspended S corporation losses.¹¹⁹ This portion of *Witzel* is consistent with the Tax Court's decision in *Nelson* and the Tenth Circuit's decision in *Gitlitz*.¹²⁰

According to Judge Posner, however, the shareholder's stock basis is increased by excluded COD income.¹²¹ Judge Posner stated that section 1366 is explicit in passing through tax-exempt income to shareholders, and excluded COD income is tax-exempt in the fullest sense.¹²² Therefore, the court concluded that excluded COD income increases the shareholder's basis under section 1367, even though the shareholder isn't able to deduct existing suspended losses because of section 108(d)(7)(A).¹²³ Although shareholders are not able to deduct existing

111. *Id.*

112. *Id.* at 1151.

113. *Id.* The court assumed that COD income is tax-exempt income. *Id.* at 1151 n.7. They did not directly address the issue. *Id.* at 1151.

114. *Id.*

115. *Id.*

116. 200 F.3d 496 (7th Cir. 2000).

117. *Witzel*, 200 F.3d at 498.

118. *Id.* at 497.

119. *See generally Witzel*, 200 F.3d at 496-98.

120. *See discussion supra* Parts III.A-B.

121. *Witzel*, 200 F.3d at 496-98.

122. *Id.* at 498.

123. *Id.*

suspended losses, the basis increase proposed by the Seventh Circuit may enable them to deduct suspended losses in the future or decrease capital gain realized upon the sale of their stock.¹²⁴

D. THE SIXTH CIRCUIT POSITION

In *Gaudiano v. Commissioner*¹²⁵ the Sixth Circuit followed the reasoning of the Tenth and Seventh Circuits in connection with the ordering of attribute reduction. The Sixth Circuit thought that attribute reduction must occur at the corporate level before pass-through to shareholders.¹²⁶ The court expressed concern that if attribute reduction is made after COD income passes through to shareholders there will be no attribute reduction at the corporate level.¹²⁷ The court did not think that section 108(b)(4)(A) precluded the reduction of tax attributes in the year of discharge:

Specifically, section 108(b)(4)(B) provides that reductions of net operating loss for the taxable year of discharge and any net operating loss carryover and any capital loss carryover shall be made "first in the loss for the taxable year of discharge." Thus, the corporation must determine its net operating losses and suspended operating losses for the year of discharge and reduce those attributes by the amount of COD income realized. If the losses exceed the COD income, then the extra losses pass through to the shareholders.¹²⁸

The Sixth Circuit disagreed with the Tax Court and Tenth Circuit's findings that COD income is not income under section 1366(a)(1) and therefore does not pass through to shareholders and increase their stock basis.¹²⁹ Agreeing with Judge Posner's opinion in *Witzel*, the court reasoned that COD is income under section 1366(a)(1)(A) because: (1) COD income is not always tax-deferred, it may be truly tax-exempt if no

124. *Id.* The Seventh Circuit stated:

We offer this view tentatively, in part because the Tenth Circuit has held the contrary and we are reluctant to precipitate an intercircuit conflict, in part because Mr. Witzel may never again have suspended losses, making the issue rather moot as to him unless he someday sells his stock and his capital-gains tax liability is affected by his basis (higher in our view than the Tax Court's), and in part because a recently promulgated Treasury Regulation (not applicable to this case, however, because it applies only to tax years beginning on or after August 18, 1998) adopts the Tax Court's interpretation of section 1366 that we are criticizing.

Id.

125. 216 F.3d 524 (6th Cir. 2000).

126. *Gaudiano*, 216 F. 3d. at 534.

127. *Id.*

128. *Id.*

129. *Id.* This was also the Tax Court's position in *Nelson*.

suspended losses are available to offset the income, and (2) section 1366(a) is not limited to tax-exempt income.¹³⁰

The Sixth Circuit went on to hold that because COD income is income under section 1366(a)(1)(A) it increases stock basis under section 1367(a)(1)(A).¹³¹ Unlike the Seventh Circuit, however, the Sixth Circuit thought that only COD income remaining after current and suspended losses are reduced at the corporate level would flow through to the shareholders and increase their stock basis.¹³²

E. THE THIRD CIRCUIT POSITION

In *United States v. Farley*,¹³³ the Third Circuit held that S corporation shareholders could increase their stock basis by excluded COD income and thereby deduct suspended losses.¹³⁴ The taxpayers in *Farley* were shareholders in two separate S corporations.¹³⁵ They obtained income tax refunds as a result of increasing the basis in their S corporation stock by excluded COD income and thereby deducting previously suspended losses.¹³⁶ After initially issuing refunds, the Service disallowed the basis increase and brought suit in district court to recover the refunds.¹³⁷

Like the Tenth, Seventh, and Sixth Circuits, the Third Circuit believed that the ultimate disposition of this issue hinges on the interaction of sections 108(d)(7)(A) and 108(b)(4)(A).¹³⁸ However, it disagreed with the other circuits on the timing of pass-through.¹³⁹ The Third Circuit held that attribute reduction occurs after the COD income is passed through to shareholders.¹⁴⁰

According to the Third Circuit, the "statutory language is unambiguous, and the operation of the statutory language is straightforward."¹⁴¹ Section 108(b)(4)(A) "clearly indicates that tax attributes are reduced on the first day of the tax year *following* the year of the discharge of indebtedness."¹⁴² Thus, tax attribute reduction takes place after income has passed through to S corporation shareholders and

130. *Id.*

131. *Id.*

132. *Id.* at 537.

133. 202 F.3d 198 (3d Cir. 2000).

134. *Farley*, 202 F.3d at 206.

135. *Id.* at 199.

136. *Id.* The taxpayers in *Farley* obtained the refunds in late 1995 and early 1996 after filing amended returns for 1989, 1990, 1992, and 1993. *Id.*

137. *Id.*

138. *Id.* at 205.

139. *Id.* at 205-06.

140. *Id.* at 206.

141. *Id.*

142. *Id.* at 205.

increased their stock basis.¹⁴³ Income pass-through is a necessary prerequisite to “[the determination of] the tax imposed by this chapter for the taxable year of the discharge” as required by section 108(b)(4)(A).¹⁴⁴

While the Third Circuit went on to discuss the Service’s contentions at length, it did not find any of the Service’s arguments controlling.¹⁴⁵ The clear and unambiguous language of the Code requires that S corporation income pass through to shareholders and increase their stock basis before tax attribute reduction.¹⁴⁶ In *Farley*, the Third Circuit became the first court of appeals to rule in favor of the taxpayer and allow S corporation shareholders the windfall of excluding COD from income while increasing their stock basis and deducting previously suspended losses.

F. THE ELEVENTH CIRCUIT POSITION

In *Pugh v. Commissioner*¹⁴⁷ the Eleventh Circuit joined the Third Circuit in holding that an S corporation’s COD income passes through to its shareholders under Section 1366(a)(1) and increases their basis.¹⁴⁸ The taxpayer in *Pugh* was a shareholder in an insolvent S corporation that realized COD income.¹⁴⁹ Unlike the taxpayers in *Nelson*, *Gilitz*, *Witzel*, and *Farley*, however, the taxpayer in *Pugh* had no suspended losses under section 1366(d).¹⁵⁰ The taxpayer’s stock became worthless, and he increased his stock basis by the excluded COD income when calculating his capital loss.¹⁵¹ The Service contended that excluded COD income could not be used to increase stock basis.¹⁵²

The Eleventh Circuit held that excluded COD income is tax-exempt income required to pass through to S corporation shareholders under

143. *Id.* at 206.

144. *Id.*

145. See generally *Loebel*, *supra* note 7, for a complete discussion of this portion of the *Farley* opinion.

146. *United States v. Farley*, 202 F.3d 198, 209-10 (3d Cir. 2000). The Third Circuit was well aware of the fact that the windfall allowed to S corporation shareholders may not have been what Congress intended. The court stated:

We are aware that the result reached today in interpreting the relevant statutory language may not have been the result intended by Congress. However, we are not free to disregard the clear and unambiguous language of the controlling statutes. It is the function of this court to interpret the statutory language as written. If policy considerations suggest that the Code should be amended, Congress can do so. We may not.

Id. at 212 n.10.

147. 213 F.3d 1324 (11th Cir. 2000).

148. *Pugh*, 213 F.3d at 1326.

149. *Id.* at 1325.

150. *Id.* at 1328-29.

151. *Id.* at 1327.

152. *Id.* at 1327-28.

section 1366(a)(1)(A).¹⁵³ According to the Eleventh Circuit, nothing in the Code distinguishes excluded COD income from other tax-exempt items, such as tax-exempt bond interest and life insurance proceeds.¹⁵⁴ While acknowledging the merit of the Service's argument that a basis increase should not be allowed when the taxpayer has made no economic outlay, the court went on to hold that because excluded COD income passes through to shareholders under section 1366(a)(1)(A), it must increase basis under section 1367(a)(1)(A).¹⁵⁵ This result is required even when the shareholder has no suspended losses to offset the COD income.¹⁵⁶ The taxpayer in *Pugh* was able to claim a larger capital loss because of this basis increase.¹⁵⁷

Because the taxpayer had no tax attributes to reduce, the court did not rule on whether tax attribute reduction occurs before or after income passes through to shareholders.¹⁵⁸ Thus, prior to the Supreme Court's decision in *Gitlitz*, the Third Circuit was the only circuit court of appeals to rule in favor of the taxpayer on the timing of attribution reduction issue.¹⁵⁹

IV. THE SUPREME COURT DECISION

The Supreme Court granted certiorari in *Gitlitz* and resolved the conflict among the circuits.¹⁶⁰ In an opinion by Justice Thomas, the Supreme Court ruled in favor of the taxpayer.¹⁶¹ The Supreme Court first held that excluded COD is an "item of income" that passes through to shareholders under section 1366 and increases their stock basis under section 1367.¹⁶² The Court used the plain meaning of the statute to reach its conclusion.¹⁶³ According to the Court, section 108(a) provides that COD income is excluded from income when a taxpayer is insolvent.¹⁶⁴ This exclusion "does not imply that the amount ceases to be an item of income."¹⁶⁵ The Court found nothing in the statute treating

153. *Id.* at 1330-31.

154. *Id.* at 1331.

155. *Id.*

156. *Id.* at 1330.

157. *Id.*

158. See generally *Pugh*, 213 F.3d 1324.

159. In *Hogue v. United States*, the United States District Court for the District of Oregon also concluded that COD income is tax-exempt income that passes through to shareholders under section 1366(a), and that under section 108(b)(4)(A), attributes were reduced on the first day of the following year. 85 A.F.T.R.2d (RIA) 426 (D.Or. 2000), available at 2000 U.S. Dist. LEXIS 601, at *6-*7.

160. *Gitlitz v. Commissioner*, 121 S. Ct. 701 (2001).

161. *Id.* at 709-10.

162. *Id.* at 708.

163. *Id.* at 707.

164. *Id.*

165. *Id.* at 706.

excluded COD income differently than the other exclusions set forth in sections 101 through 136.¹⁶⁶

Addressing the Service's argument that excluded COD income is not tax-exempt income under section 1366(a)(1)(A), the Court noted that section 1366 applies to "items of income."¹⁶⁷ The fact that the statute expressly includes tax-exempt income does not mean that it excludes tax-deferred income.¹⁶⁸ Section 1366 is "worded broadly enough to include any item of income, even tax-deferred income, that 'could affect the liability for tax of any shareholder.'"¹⁶⁹

The Court went on to address the timing of attribute reduction.¹⁷⁰ The Court held that this question was expressly addressed in the statute.¹⁷¹ Section 108(b)(4)(A) provides that the required attribute reduction "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge."¹⁷² According to the Court, "In order to determine the 'tax imposed,' an S corporation shareholder must adjust his basis in his corporate stock and pass through all items of income and loss Consequently, the attribute reduction must be made *after* the basis adjustment and pass-through."¹⁷³

In a footnote, the Court addressed the argument that section 108(d)(7)(A) mandates that COD income be determined and applied to reduce tax attributes at the corporate level and therefore cannot pass through to shareholders.¹⁷⁴ According to the Court, section 108(d)(7)(A) doesn't state or imply that debt discharge provisions apply only at the corporate level.¹⁷⁵ Section 108(d)(7)(A) does not suspend the operation of the pass-through rules of Subchapter S.¹⁷⁶

The Supreme Court briefly dealt with the concern expressed in *Gaudio* that if COD income is passed through to shareholders before attribute reduction, there can never be any COD remaining at the corporate level by which to reduce tax attributes.¹⁷⁷ The Court stated the statute did not impose the restriction that tax attributes can be reduced only if COD itself remains at the corporate level; it only requires that tax

166. *Id.*

167. *Id.* at 704.

168. *Id.* at 708.

169. *Id.*

170. *Id.* at 708-10.

171. *Id.*

172. I.R.C. § 108(b)(4)(A) 1986 U.S.C.C.A.N. (current version at 26 U.S.C. § 108(b)(4)(A) (1994 & Supp. V 1999)).

173. *Gitlitz v. Commissioner*, 121 S. Ct. 701, 709 (2001).

174. *Id.* at 707 n.6.

175. *Id.*

176. *Id.*

177. *Id.*

attributes be reduced by the amount excluded from gross income.¹⁷⁸ As noted by the court:

The very purpose of Subchapter S is to tax at the shareholder level, not the corporate level. Income is determined at the S corporation level, see section 1363(b), not in order to tax the corporation, see section 1363(a) (exempting an S corporation from income tax), but solely to pass through to the S corporation's shareholders the corporation's income. Thus, the controlling provision states that, in determining a shareholder's liability, "there shall be taken into account the shareholder's pro rata share of the corporation's . . . items of income (including tax-exempt income) . . ." section 1366(a)(1). Nothing in section 108(d)(7)(A) suspends the operation of these ordinary pass-through rules.¹⁷⁹

Because tax attributes can be reduced even though excluded COD income passes through to shareholders and increases their stock basis, situations may arise where shareholders recognize increased income in later years.¹⁸⁰ If, for example, the basis of property were reduced under section 108(b)(2)(E), the shareholders would recognize increased income as a result of lower depreciation deductions or increased gain upon sale of the property.

The Supreme Court addressed the taxpayer windfall argument very briefly, stating as follows: "[b]ecause the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern."¹⁸¹

Justice Breyer dissented.¹⁸² In Justice Breyer's opinion, an ambiguous statute such as section 108(d)(7)(A) should be read as closing, not maintaining, tax loopholes.¹⁸³ Justice Breyer did not contend that section 108(d)(7)(A) had to be read as requiring that both COD income exclusion and tax attribute reduction occur at the corporate level, leaving nothing to flow through to S corporation shareholders.¹⁸⁴ Where the "practical equivalent of a double deduction" would occur, however, he

178. *Id.*

179. *Id.* at 707 n.6.

180. *Id.* at 708. There was no indication as to whether the taxpayer in *Giltitz* had any other tax attributes to reduce. *Id.*

181. *Id.* at 710.

182. *Id.* (Breyer, J., dissenting).

183. *Id.* at 710-11.

184. *Id.* at 711.

thought that, absent a clear indication by Congress, this reading of the statute was the best alternative.¹⁸⁵

V. ANALYSIS OF THE SUPREME COURT DECISION

The Supreme Court's holding that COD income is an item of income under section 1366(a)(1)(A) is a correct interpretation of the statute. Under the plain language of section 1366(a)(1)(A), an item's status as tax-exempt is irrelevant. Section 1366(a)(1)(A) applies to all "items of income (including tax-exempt income)."¹⁸⁶

The Supreme Court correctly ruled that the inclusion of tax-exempt income in section 1366(a)(1)(A) does not mean that tax-deferred income (if that is what excluded COD income is) is excluded from the statute. Although there has been much debate about the character of excluded COD income, the fact of the matter is, its character is irrelevant to the issue. Section 1366 applies to all items of income and COD income is clearly an item of income. Judge Beghe summed up the issue nicely in his concurring opinion in *Nelson*: "The only relevant inquiry under section 1366 is not whether COD excluded from gross income of an insolvent S corporation is 'tax-exempt income,' but whether it's a passthrough item at all."¹⁸⁷

The timing of tax attribute reduction was the more difficult issue addressed by the Supreme Court. Although much has been written on the issue and courts have addressed the issue at great length, the Supreme Court handled the issue in three short paragraphs.¹⁸⁸ According to the Supreme Court, the plain text of section 108(b)(4)(A) directs that attribute reduction be made after the pass-through of excluded COD income and basis increase.¹⁸⁹ According to the Tax Court, on the other hand, the plain meaning of section 108(d)(7)(A) precludes income recognition at the shareholder level.¹⁹⁰ Perhaps the Sixth Circuit was the most correct when it stated that these statutes "become muddied when they are applied in conjunction with each other."¹⁹¹

Whatever position one has on the proper reading of the relevant statutes, the issue has been decided. It is now up to Congress to address

185. *Id.* at 712 (quoting *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934)).

186. I.R.C. § 1366(a)(1) 1986 U.S.C.C.A.N. (current version at 26 U.S.C. § 1366(a)(1) (1994 & Supp. V 1999)).

187. *Nelson v. Commissioner*, 110 T.C. 114, 134 (1998) (Beghe, J., concurring), *aff'd* 182 F.3d 1152 (10th Cir. 1999).

188. *Gitlitz v. Commissioner*, 121 S. Ct. 701, 708-09 (2001).

189. *Id.*

190. *Nelson*, 110 T.C. at 121-22.

191. *Gaudiano v. Commissioner*, 216 F.3d 524, 533 (6th Cir. 2000).

the matter if it believes that S corporation shareholders should not be allowed the windfall of excluding COD income while increasing their stock basis and deducting previously suspended losses.

* * *