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Supreme Court Addresses Discharge of Debt Income for S Corporation in "Gitlitz"

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The Supreme Court has held that income of an insolvent S corporation from the discharge of indebtedness—income that is excluded from the shareholders' gross income under Internal Revenue Code ("Code") section 108—nonetheless increases the bases of the shareholders in their stock. *Gitlitz v. Commissioner*, No. 99-1295, 531 U.S. ___ (Jan. 9, 2001). Consequently, S corporation losses that have not been allowed to shareholders, by reason of a provision that "suspends" the deductibility of S corporation pass-through losses in excess of a shareholder's basis in his stock, may become available to shareholders by reason of a nontaxable discharge of debt.

The Supreme Court decision addresses an issue that had resulted in numerous conflicting decisions in the lower courts, and strongly suggests that a Treasury regulation that was issued in 1999 (effective for taxable years commencing on or after August 18, 1998), and takes a position denying deductibility of the suspended pass-through loss, is invalid. The Court's opinion, approved by all but one of the Justices (Justice Breyer dissenting), includes language addressing the broader question of whether a literal reading of Code provisions should be used, even where the result is arguably inconsistent with Congressional intent and may result in a windfall for certain taxpayers.

Facts of 'Gitlitz'

David Gitlitz and Philip Winn each owned 50% of the stock of P. D. W. & A., Inc. ("PDWA"), an S corporation. In 1991, a partnership in which PDWA owned an interest realized discharge of indebtedness ("DOI") income of which approximately $2 million was allocated to PDWA.

The pro rata share, for each of Gitlitz and Winn, of PDWA's losses for 1991 and prior years was slightly more than $1 million in the aggregate. The pre-1991 losses, however, had been suspended (and could not be used by the shareholders) by reason of the shareholders' lack of sufficient basis in their shares.

DOI income is excluded from a taxpayer's gross income if, and to the extent that the taxpayer is insolvent. Even though the items of income and deduction of an S corporation pass through to its shareholders, the insolvency of an S corporation is determined at the corporate level for purposes of this exclusion.

It was undisputed that PDWA was insolvent by more than the DOI amount. Accordingly, under Code section 108, the discharge of debt did not result in any gross income to the shareholders.

The tax return of each of the shareholders for 1991 reflected an increase to his stock basis for the DOI amount allocated to him, under the reasoning that this amount, although excluded from gross income, was nonetheless an "item of income" that, under Code sections 1366 and 1367, increased his basis in his shares and allowed him to deduct the previously suspended losses. With that adjustment, each shareholder was able to make full use of his pro rata share of the corporation's suspended and current losses.

Where DOI income is excluded from gross income by reason of the exclusion for insolvent taxpayers under Code section 108, the Code requires reduction of the taxpayer's tax attributes by the amount excluded from income. The first attribute subject to reduction, in general, is net operating losses. Suspended losses of an S corporation that have not been allowed to be taken into account by shareholders by reason of the basis limitation are treated as net operating losses for this purpose.

Tax attribute reductions are made "after the determination of the tax imposed by [chapter 1 of the Code] for the taxable year of the discharge" (Code Search7RH108(b)(4)(A)). Relying on this ordering rule, the shareholders did not take any tax attribute reduction into account in 1991.

The Commissioner disallowed the losses claimed by the shareholders in 1991 attributable to PDWA, on the premise that the DOI income that was excluded from gross income under section 108 did not increase the shareholders' bases in their shares. Upon petition

for review of the resulting assessments, the Tax Court initially held, in a memorandum decision, that the DOI amounts were items of income that could support increases in stock bases, such that the PDWA losses were allowable to the shareholders.

Thereafter, however, the full Tax Court issued a decision in the case of another taxpayer (*Nelson v. Commissioner,* 110 T.C. 114 (1998)), that addressed the same issue and held for the Commissioner, under the rationale that, because of the statutory rule that the provisions of section 108 are generally applied at the corporate level and operate to prevent the corporation from realizing income, the DOI income excluded under section 108 could not flow through to shareholders and increase their stock bases. In connection with that decision, the Tax Court granted the Commissioner's motion for reconsideration of the prior decision for Messrs. *Gitlitz* and Winn, and held for the Commissioner in this case as well.

Court of Appeals Ruling

The Court of Appeals for the Tenth Circuit affirmed the Tax Court's decision in *Gitlitz,* but on different grounds. The Court of Appeals concluded that the ordering rule should be read to first reduce the suspended losses in the year of discharge at the corporate level. The resulting reduction in current and suspended losses "fully absorb[ed]" the excluded DOI income, such that there was no remaining income to pass through to shareholders or to affect their stock bases, and no remaining suspended losses to be triggered.

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