Tax issues

S Corporation Shareholders Benefit From Supreme Court Ruling

by Steven M. Friedman and Steven J. Szymanski

The U.S. Supreme Court recently ruled in favor of taxpayers in a potential windfall decision for shareholders of S corporations.

Many small companies, including real estate-related ventures, elect to be treated as S corporations with the Internal Revenue Service. An S corporation generally is not subject to taxes as an entity. Instead, shareholders are allocated a pro rata share of the corporation's income items, including loss, deduction, credit, or tax-exempt income. Shareholders report these items on their individual tax returns. The basis of each shareholder's stock in an S corporation is increased or decreased by the above items of income or loss.

In *David A. Gitlitz, et ux. et al. v. Commissioner* in January, the Supreme Court held that discharge of debt, even if it is excluded from the shareholder's income, is an item that increases the basis of S corporation stock to its shareholders. The Supreme Court also ruled that the increase in the S corporation shareholders' bases occurs before a reduction in the S corporation's tax attributes.

In effect, cancellation of debt income realized by an insolvent S corporation and excluded under Internal Revenue Code Section 108(a) will be treated as a tax-exempt income item that flows through to the S corporation's shareholders and will increase the shareholders' bases. Thus, the shareholder avoids income from cancellation of a debt, while increasing his basis in his S corporation stock, resulting in a potential loss upon the liquidation or sale of the S corporation.

Statutory Background IRC Section 61(a)(12) provides that when an obligation to repay borrowed funds is discharged, the amount of the discharge must be included in gross income. This is called cancellation of debt income, or COD income.

However, IRC Section 108(a) provides an exception to the general rule in that COD income can be excluded from gross income if the discharge occurs when the taxpayer is bankrupt or insolvent. If COD income is excluded using the insolvency exception, IRC Section 108(b) generally requires a reduction in the taxpayer's tax attributes, including net operating losses, various credits, and basis reductions that would be used to offset future taxable income.

The *Gitlitz* Case
In the Supreme Court case, David Gitlitz and Philip Winn each owned 50 percent of PDW&A, an S corporation. PDW&A was a partner in a real estate partnership that realized about $4 million in COD income in 1991. PDW&A's distributive share of COD income was $2 million (with $1 million each allocated to Gitlitz and Winn).

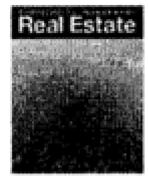
When the partnership realized the COD income, PDW&A was insolvent to the extent of $2.1 million, and the COD income was excluded from its tax liability. Because of PDW&A's insolvency, compared with the COD income of $2 million, Gitlitz and Winn excluded the full amount of COD income.

The Supreme Court case involves Gitlitz's next course of action. Instead of just excluding the COD income, Gitlitz treated the excluded COD income as an income item and increased his basis in his PDW&A stock by $1 million.

Additionally, Gitlitz claimed a loss of $1 million on his 1991 federal income-tax return due to prior S corporation losses for which he had no basis in his stock. Absent the basis increase, the deductibility of these losses would have been precluded for federal income tax purposes.

The IRS disallowed the losses that Gitlitz claimed on the premise that he lacked sufficient basis in his PDW&A stock and assessed a federal income tax and deficiency of $251,192 on Gitlitz's tax return.

The U.S. Tax Court and the U.S. Court of Appeals for the 10th Circuit affirmed the commissioner's decision by rejecting the taxpayer's position that the excluded COD income did not increase the shareholder's stock basis. The Supreme Court decided to take the case due to split decisions among the various circuits. It considered a number of issues.



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First, the court considered whether the IRC permits taxpayers to increase bases in their S corporation stock by the amount of an S corporation's COD income excluded from gross income. The IRS commissioner argued that the COD income of an insolvent S corporation is not an income item and thus, never passes through to shareholders.

Under IRC Sections 61 and 108, the Supreme Court rejected this argument, stating that excluded discharged debt is an income item that passes through to the shareholders and increases their bases in the stock of the S corporation.

Next, the court considered that if the IRC permits such an increase, it must be clear whether the increase occurs before or after taxpayers are required to reduce the S corporation's tax attributes.

This timing is vital. If the attribute reduction occurs before the COD income is passed through to its shareholders, the shareholders' losses that exceed basis are treated as the corporation's net operating loss and then are reduced by the amount of the discharged debt. Based on this case, the taxpayer would have no suspended losses in order to take the deduction.

If, however, the attribute reduction occurs *after* the COD income is passed through, the shareholders would be able to deduct their losses (up to the amount of the basis increase due to the COD income). Any suspended losses that remain will be treated as S corporation net operating losses and reduced accordingly.

The Supreme Court ruled that this sequence of events is expressly addressed in the statute and provides that the attribute reductions "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge."

Thus, the court ruled in favor of the taxpayers on this issue, stating, "Because their basis increase is equal to their losses, petitioners have no suspended losses remaining" and no net operating losses remaining.

New Considerations Based on the Supreme Court decision, COD income realized by an insolvent S corporation and excluded under IRC Section 108(a) will be treated as an income item that flows through to the S corporation's shareholders and increases the shareholders' basis.

Additionally, the Supreme Court ruled that the flow through of COD income occurs before the reduction of the S corporation's tax attributes under IRC Section 108(b).

It appears that such income should be reported the same way tax-exempt income is reported on Schedules K and K-1 of the S corporation's tax return. Taxpayers who have taken a position contrary to the Supreme Court's decision may have an opportunity for a refund for open years for those who file a refund claim based on the case. However, the Treasury Department may recommend legislation to close such a windfall; whether or not the legislation would be retroactive is uncertain. -

For further information, consult with a tax adviser.

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