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James D. Lockhart

James E. Duffy

TAX COURT RULES IN *NELSON* THAT S CORPORATION EXCLUDED COD INCOME DOES NOT INCREASE SHAREHOLDER STOCK BASIS†

James D. Lockhart and James E. Duffy††

I. INTRODUCTION

In a unanimous decision, the Tax Court in *Nelson v. Commissioner*[1] held that cancellation of indebtedness income realized at the S

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†† James D. Lockhart is a CPA with Lurie, Besikof, Lapidus & Co., LLP, in Minneapolis. James E. Duffy is a tax attorney with Briggs & Morgan in Minneapolis. Each author received his LL.M. in Taxation at New York University School of Law and were Attorney Advisors to the U.S. Tax Court. The authors are grateful for the contributions of Scott M. Hagel and Matthew R. Nyberg of Lurie, Besikof, Lapidus & Co., LLP.

1. 110 T.C. 114 (1998). Notice of appeal to the Court of Appeals for the Tenth Circuit was filed with the Tax Court on May 8, 1998.

corporation level does not pass-through to its shareholders and thereby increase the basis of their stock.[2] This ruling is a retreat from its earlier opinion in *Winn v. Commissioner*,[3] issued less than eight months before *Nelson*, in which the court held in favor of the taxpayer on the same issue.[4] While the decision in *Winn* was based on a single, narrow argument, it gave most commentators and practitioners comfort because it confirmed their interpretation of Section 108 of the Internal Revenue Code ("the Code") as applied in conjunction with the conduit rules of Subchapter S of the Internal Revenue Code "Subchapter S."[5]

One commentator has suggested that the *Nelson* holding was not unexpected because a contrary rule would result in a windfall for the taxpayer.[6] A reading of the *Nelson* opinion makes it clear that the court is troubled with the taxpayer's apparent windfall from a stock basis increase. While the court states that its holding is based upon the plain language of the statutes, it strains the statutory construction to reach what it believes to be the correct policy objective: no stock basis increase for which the taxpayer has borne no economic outlay due to excluded COD income.[7] The authors submit that the result in *Nelson* was unexpected based upon the plain meaning of the applicable statutes, their respective legislative histories, and interpretations of analogous areas of tax law.

II. BACKGROUND

The issue in *Nelson* is relatively straightforward: Are shareholders of an insolvent S corporation entitled to a stock basis increase equal to their allocable share of the corporation's realized COD income that is excluded from Section 61(a)'s gross income definition pursu-

2. *See id.* at 130.

3. 73 T.C.M. (CCH) 3167 (1997), *withdrawn and superceded,* 75 T.C.M. (CCH) 1840 (1998). Notice of appeal to the Court of Appeals for the Tenth Circuit was filed with the Tax Court on April 28, 1998.

4. *See id.*

5. Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder. The Internal Revenue Code is contained in Title 26 of the United States Code.

6. *See* Richard M. Lipton, *Tax Court Rejects S Corp. Basis Step-up for COD Income In* Nelson, 88 J. TAX'N 272, 277 (1998).

7. *See* Nelson v. Commissioner, 110 T.C. 114, 128 (1998). As used in this article, "COD" refers to cancellation of debt income or income from the discharge of indebtedness. *See generally* I.R.C. § 108 (1994).

ant to Section 108?[8] Many commentators have agreed that an affirmative answer to this question is provided by a straightforward interpretation of the pertinent statutes.[9]

A. *Statutory Framework*

The resolution of the issue rests upon the interaction of Subchapter S and Section 108.

1. *Subchapter S*

In determining a shareholder's tax liability, Section 1366(a)(1) provides, in pertinent part, that each taxpayer must take into account his allocable share of the corporation's "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."[10]

The character of any item included in the shareholder's income or loss is determined under Section 1366(b) as if the "item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation."[11] Under Section 1367(a)(1), "[t]he basis of each shareholder's stock in an S corporation shall be increased . . . by the items of income described in subparagraph (A) of Section 1366(a)(1)."[12]

Congress enacted Subchapter S to allow taxpayers to operate in corporate form without the imposition of a tax, which would nor-

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8. *See Nelson*, 110 T.C. at 116.

9. *See generally* JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS, ¶ 14.04[2] (3d ed. 1993 & Supp. 1998) (stating that a basis increase should result from excluded COD income if the Code is read literally); BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 6.10[2] (6th ed. 1994) (interpreting the Code to allow shareholders to increase their basis); Robert L. Cohen, *Exempt COD Income Creates S Corp. Basis Adjustment*, 24 TAX ADVISOR 788 (1993) (analyzing the statutory language of the Code and discussion the possible grounds for an IRS challenge on the increase of basis issue); AICPA, PRE-RELEASE COMMENTS REGARDING REGULATIONS ON DISCHARGE OF INDEBTEDNESS INCOME UNDER INTERNAL REVENUE CODE SECTION 1366, Apr. 15, 1995, at 1 (analyzing TAM 9423003 and criticizing the reasoning which was later adopted by the court in the *Nelson* decision); Bryan P. Collins & Mark A. Schneider, *TAM 9423003—The IRS Says Excluded COD Income Does Not Increase S Corporations Stock Basis*, 6 J. S.CORP. TAX'N 348 (1995) (analyzing TAM 9423003); Stephen R. Looney, *Recent Developments: Income From Discharge of Indebtedness Excluded From Gross Income Under Section 108 Does Not Increase S Corporation Shareholders' Basis*, 6 J. S.CORP. TAX'N 356 (1995) (criticizing TAM 9423003).

10. I.R.C. § 1366(a)(1)(A) (1994).

11. I.R.C. § 1366(b) (1994).

12. I.R.C. § 1366(a)(1) (1994).

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mally apply if the corporation liquidated and continued business as a partnership.[13] In light of this policy objective, the approach in Subchapter S was to treat income items as they are treated under the Subchapter K regime. Thus, Congress provided that an S corporation's taxable income will be computed under the same rules applicable to partnerships under Section 703.[14] As with partners in a partnership, each shareholder in an S corporation is to take into account his *pro rata* share of income and deduction items of the corporation.[15] The character of the items of income are to pass through to the S corporation shareholders in the same manner as the character of such items of a partnership passes through to partners. Further, both taxable and nontaxable income serve to increase a shareholder's basis in the S corporation stock in a manner analogous to that provided for in a partner's outside partnership basis.[16] Accordingly, the basis adjustment rules of Section 1367 were written to parallel the basis adjustment rules regarding partners under Section 705.[17]

With respect to suspended losses, Section 1366(d)(1) provides that the aggregate amount of losses taken into account by a shareholder under Section 1366(a) cannot exceed the sum of the shareholder's adjusted basis of the shareholder's S corporation stock and any indebtedness of the S corporation to the shareholder.[18] Any loss or deduction disallowed due to insufficient stock or debt basis is carried over indefinitely.[19] The carryover of losses and deductions are the sole tax attributes of the shareholder and cannot be transferred to any other, or subsequent, shareholder.[20]

With respect to carryovers of S corporations, Subchapter S is explicit. Section 1371(b)(2) states that "[n]o carryforward, and no carryback, shall arise at the corporate level for a taxable year for which a corporation is an S corporation."[21]

13. *See* S. REP. NO. 97-640, at 5 (1982).
14. *See id.* at 15.
15. *See id.* at 17.
16. *See id.* at 18.
17. *See id.* at 2, 17, 18.
18. *See* I.R.C. § 1366(d)(1) (1994).
19. *See* I.R.C. § 1366(d)(2) (1994).
20. *See* S. REP. NO. 97-640, at 3 (1982).
21. I.R.C. § 1371(b)(2) (1994).

2. Section 108

The Internal Revenue Code explicitly defines gross income to include COD income.[22] Sections 101 through 135 of Subtitle A provide for various exemptions from gross income. Under Section 108(a), gross income does not include any amount that would be includable in gross income by reason of the discharge of indebtedness of the taxpayer if: (1) the discharge occurs in a title 11 case; (2) the discharge occurs when the taxpayer is insolvent; (3) the indebtedness discharged is qualified farm indebtedness; or (4) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.[23] In the case of insolvency, the amount excluded cannot exceed the amount by which the taxpayer is insolvent.[24] Under Section 108(d)(3), the term "insolvent" means the "excess of liabilities over the fair market value of assets."[25] Section 108 also provides that "the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge."[26]

Any amount excluded by reason of insolvency, title 11, or qualified farm indebtedness, is to be applied to reduce the tax attributes of the taxpayer as provided by Section 108(b).[27] Any attribute reduction is not to be made, however, until the determination of the taxpayer's tax liability for the year of discharge.[28] The effect of this provision is to not reduce any attributes until the beginning of the following tax year. In the not uncommon event that a corporation sells its assets or ceases existence in the year of discharge, Section 108 is silent with respect to attribute reduction.

Section 108(b)(2) provides that the first attribute to be reduced, and the one at issue in *Nelson*, is Net Operating Losses ("NOL"). Any NOL incurred in the year of discharge and any NOL carryover to such year is reduced first.[29] However, the taxpayer may elect to re-

22. *See* I.R.C. § 61(a)(12) (1994). Section 61(a) provides that "gross income means all income from whatever source derived, including . . . [i]ncome from discharge of indebtedness." *Id.*

23. *See* I.R.C. § 108(a) (1994).

24. *See* I.R.C. § 108(e) (1994).

25. I.R.C. § 108(d)(3) (1994).

26. *Id.*

27. *See* I.R.C. § 108(b) (1994).

28. *See* I.R.C. § 108(b)(4)(A) (1994).

29. *See* I.R.C. §108(b)(2)(A) (1994). The other tax attributes are reduced in the following order: (1) the general business credit; (2) the minimum tax credit; (3)

duce the basis of depreciable property before reducing any other tax attribute, including NOLs.[30]

With respect to S corporations, Section 108(d)(7) contains special rules. Section 108(d)(7)(A) provides that insolvency and title 11 determinations[31] and attribution reduction[32] are applied at the corporate level.[33] Section 108(d)(7)(B) provides that for purposes of NOL attribute reduction, any suspended loss or deduction that is disallowed in the year of discharge under Section 1366(d)(1) will be treated as an NOL for that taxable year.[34]

B. TAMS

The Service first addressed whether COD income excluded from gross income under Section 108(a) passes through to shareholders under Section 1366(a) as tax-exempt income for which S corporation shareholders may increase their stock basis under Section 1367 in Technical Advice Memorandum ("TAM") 9423003.[35] In the TAM, the taxpayer was the sole shareholder of an S corporation that became insolvent and defaulted on its bank loans.[36] In restructuring the S corporation's debt, a portion of the debt was discharged.[37] The amount of the discharge was not in excess of the amount by which the S corporation was insolvent.[38]

The Service ruled that the shareholder was not entitled to a basis increase for two reasons. First, the COD income that is excluded from gross income under Section 108 does not pass through to S corporation shareholders as a separately stated item of tax-exempt income.[39] Second, discharge of indebtedness is tax-deferred income not tax-exempt income.[40] According to the Service, Section 108(d)(7)(A) "operates as an exception to the general pass through scheme applicable to S corporations and S corporation shareholders

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capital loss carryovers; (4) basis; (5) passive activity loss and credit carryovers; and (6) foreign tax credit carryovers. *See* I.R.C. § 108(b)(2)(B)–(G) (1994).

30. *See* I.R.C. §108(b)(5) (1994).
31. *See* I.R.C. §108(a) (1994).
32. *See* I.R.C. §108(b) (1994).
33. *See* I.R.C. §108(d)(7)(A) (1994).
34. *See* I.R.C. §108(d)(7)(B) (1994).
35. *See* Tech. Adv. Mem. 9423003 (June 10, 1994).
36. *See id.*
37. *See id.*
38. *See id.*
39. *See id.*
40. *See id.*

under subchapter S."[41] Therefore, the Service concluded that to the extent of insolvency, there is no COD income passed through to the shareholder because the exclusion from income and the reduction in tax attributes apply at the corporate level.[42]

The taxpayer argued that because the reduction in tax attributes under Section 108(b) is not made until after the determination of the tax for the taxable year of discharge, all of the S corporation's items of separately stated income pass through to the shareholders in the year of discharge, increasing the shareholders basis in their stock prior to application of the ordering rules in Section 108(b)(2).[43] The Service rejected this argument on the grounds that the mechanics of Section 108(b) operate at the corporate level and because amounts excluded under Section 108(a)(1) are not tax-exempt income.[44]

In support of its position that the amounts excluded under Section 108(a) are not tax-exempt income, the Service cited the legislative history to the Bankruptcy Tax Act of 1980[45] which provides that no amount is to be included in income by reason of debt discharge; instead, the amount of discharged debt excluded from gross income is applied to reduce certain tax attributes.[46] Once a taxpayer reduces its tax attributes as required by Section 108(b)(1), any remaining debt discharge amount is disregarded; that is, such amount does not result in income or have other tax consequences.[47]

The Service also cited language in the legislative history that states that the rules of the statute are intended to carry out the congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.[48] The Service concluded that debt discharge income excluded under Section 108(a) is not tax-exempt, but tax deferred, and therefore, is not a separately stated item of tax-exempt income within the meaning of the parenthetical language of Section 1366(a)(1)(A).[49] The Service reached the same conclusion using the

41. *Id.*; *see* I.R.C. § 108(d)(7)(A) (1994).
42. *See* Tech. Adv. Mem. 9423003 (June 10, 1994).
43. *See id.*; *see also supra* note 30 and accompanying text.
44. *See* Tech. Adv. Mem. 9423003 (June 10, 1994).
45. Pub. L. No. 96-589, 94 Stat. 3389.
46. *See id.* (citing S. REP. NO. 96-1035, at 11 (1980), *reprinted in* 1980-2 C.B. 620, 625).
47. *See id.*
48. *See id.* (citing S. REP. NO. 96-1035, at 2 (1980), *reprinted in* 1980-2 C.B. 620, 620-21).
49. *See id.*

same rationale applied in TAMs 9541001 and 9541006.[50]

C. Winn v. Commissioner

In a decision that many practitioners were expecting, the Tax Court in *Winn v. Commissioner*,[51] held that the taxpayers were entitled to increase their respective adjusted bases in the S corporation stock by their allocable share of COD income.[52] In *Winn*, the taxpayers (Winn and Gitlitz) were shareholders in PDW&A, Inc., an S corporation. PDW&A was a partner in Parker Properties.[53] Parker realized $4,154,891 of COD income in 1991.[54] PDW&A's allocable share of the COD income was $2,021,296.[55] At the time Parker realized the COD income, PDW&A was insolvent to the extent of $2,181,748.[56]

Each taxpayer's allocable share of PDW&A's COD income was $1,010,648.[57] Both Winn and Gitlitz increased their stock basis in PDW&A by that amount.[58] Gitlitz claimed losses from PDW&A totaling $1,010,648 on his 1991 federal income tax return.[59] Absent the basis increase, the deductibility of these losses would have been suspended under Section 1366(d).[60] Winn, however, did not claim a loss on his 1991 federal income tax return because he believed that the passive activity loss limitations prevented recognition of the deduction.[61] It was not until 1992 that Winn claimed the PDW&A losses

50. In TAM 9541001, the Service ruled that because the reduction of tax attributed occurs at the corporate level, excluded COD income is neither allocated nor passed through to S corporation shareholders. *See* Tech. Adv. Mem. 9541001 (Oct. 13, 1995). In TAM 9541006, the taxpayer was the sole shareholder of an S corporation that realized COD income when a related S corporation acquired debt of the first S corporation from an unrelated party for less than the face amount. *See* Tech. Adv. Mem. 9541006 (Oct. 13, 1995). The first S corporation was insolvent at the time the related S corporation acquired the debt. *See id.* The Service first ruled that the acquisition of the debt was treated under Section 108(e)(4)(A) as though the notes had been acquired by the S corporation itself. *See id.* As such, the S corporation realized income from discharge of indebtedness. *See id.*

51. 73 T.C.M. (CCH) 3167 (1997), *withdrawn and superceded*, 75 T.C.M. (CCH) 1840 (1998).

52. *See id.* at 3169.

53. *See id.* at 3167.

54. *See id.*

55. *See id.*

56. *See id.*

57. *See id.* at 3167-68.

58. *See id.*

59. *See id.* at 3168.

60. *See id.*

61. *See id.* at 3167-68.

carried over from 1991 on federal income tax return.[62]

The Service argued that:

> [i]f the court were to hold that excluded COD . . . is an item of income under Code Section 1366, then you would have to find that it flows through to the taxpayers and they increase their basis. Respondent's position is that it's not an item of income and never flows through.[63]

The court rejected the Service's argument that Sections 61 (a)(12) and 108 should operate differently than Sections 61(a)(4) and 103 (relating to interest) and Sections 61 (a)(10) and 101 (relating to insurance).[64] The court aptly stated:

> Section 61 requires that certain amounts be included in income, i.e., items of income. Specifically, Section 61(a)(12) requires that income from discharge of indebtedness be included in gross income. Absent any exclusionary provision, items of income are included in gross income .... Sections 101 through 135 exclude specific items of income from gross income. Discharge of indebtedness income to the extent of insolvency is one of the items of income so excluded.[65]

Accordingly, the Tax Court held that, by its inclusion in the definition of gross income under Section 61(a)(12), COD is an "item of income" for purposes of Sections 1367(a)(1) and 1366(a)(1) in determining a shareholder's basis in S corporation stock.[66]

III. *NELSON V. COMMISSIONER*

In *Nelson*, the taxpayer was the sole shareholder of Metro Auto, Inc. (MAI), an S corporation, which in 1991 realized COD income of $2,030,568 as a result of the disposition of its assets and a related agreement with its creditors.[67] The COD income of $2,030,568 ex-

62. *See id.* at 3168.
63. *Id.*
64. *See id.* at 3169.
65. *Id.*
66. *See id.*
67. *See* Nelson v. Commissioner, 110 T.C. 114, 115 (1998).

ceeded MAI's losses by $1,375,790 in 1991.[68] At the time of the discharge of indebtedness, MAI was insolvent and excluded the entire amount of the discharge from gross income.[69] The taxpayer increased the basis in his MAI stock by $1,375,790, disposed of the stock, and deducted a long-term capital loss that included the increase in basis.[70] The theory of the taxpayer's argument was that the COD income realized by MAI, but excluded under Section 108, is *tax-exempt* income for purposes of Sections 1366(a) and 1367(a).[71] As tax-exempt income, it passes through to the S corporation shareholders via Section 1366(a)(1)(A) as a separately stated item of income and, consequently, provides a corresponding stock basis increase via Section 1367(a).[72]

While the Service agreed that it was proper to exclude the COD income, it did not agree that the shareholder's stock basis should be increased by that amount.[73] Consequently, the Service disallowed $1,375,790 of the stock loss on the ground that the taxpayer lacked sufficient basis in the MAI stock.[74] As in the TAMs, the Service argued that pursuant to Section 108(d)(7)(A), COD income excluded under Section 108 does not pass through to the S corporation shareholder.[75] Because that Section explicitly provides that the income exclusion and attribute reduction rules apply solely at the S corporation level, the Service argued that the COD income realized by the entity is not permitted to pass through to the shareholder.[76]

No question of fact was presented in the case. Both parties agreed that in 1991 MAI realized COD income and that it was insolvent.[77] The parties further agreed that such income was excludable under Section 108.[78] The only question in dispute was whether the Code permitted the taxpayer to increase the basis of his MAI stock by the amount of the COD income.[79]

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68. *See id.*
69. *See id.*
70. *See id.*
71. *See id.* at 119.
72. *See id.*
73. *See id.*
74. *See id.* at 116.
75. *See id.* at 119; *see also* Tech. Adv. Mem. 9541006 (Oct. 13, 1995); Tech. Adv. Mem. 9541001 (Oct. 13, 1995); Tech. Adv. Mem. 9423003 (June 10, 1994).
76. *See Nelson*, 110 T.C. at 119.
77. *See id.* at 115.
78. *See id.*
79. *See id.*

A. The Majority Opinion

The Tax Court, in a reviewed opinion authored by Judge Hamblen, held that COD income, which is not includable in gross income under Section 108(a), does not pass through to a shareholder of an S corporation and therefore does not increase the shareholder's basis in his stock.[80] The Tax Court's decision was based on three rationales: first, under the plain meaning of 108(d)(7), excluded COD income does not pass through to the shareholder of an S corporation; second, excluded COD income is not tax-exempt income that operates to increase stock basis under Sections 1366 and 1367; and third, allowing excluded COD income to increase the stock basis would result in a windfall to the shareholder.[81]

1. Plain Meaning

The court resolved the statutory issue by focusing on the plain meaning of Section 108(d)(7)(A). The taxpayer argued that 108(d)(7)(A) requires that an S corporation be determined solvent or insolvent prior to the shareholder level determination of the shareholder's income tax liability and reduction of suspended losses, if any.[82] In agreeing with the Service's interpretation of that Section, the court found that the literal language of the statute mandates a corporate, as opposed to a shareholder, level application.[83] The court explained that such a result was mandated because the specific language of 108(d)(7)(A) overrides the more general provisions of Subchapter S, and, in particular the pass-through rules of Sections 1366 and 1367.[84]

The majority's analysis that Section 108(d)(7)(A) provides an explicit exception to the pass-through rules of Sections 1366 and 1367 goes beyond the wording of the statute. Such a construction is not necessitated by the legislative history. Prior to 1984, Section 108 provided that an insolvency determination was to be made at the shareholder level in the same manner that is utilized with respect to partnerships and partners.[85] Congress amended the statute in 1984 to provide that the insolvency exception be applied at the corporate

80. *See id.* at 130.
81. *See id.* at 121, 124, 130.
82. *See id.* at 120.
83. *See id.* at 121.
84. *See id.* at 121-22.
85. *See* I.R.C. § 108 (1984).

level so that all shareholders would be treated in the same manner.[86] This means that unlike partners who may receive disparate treatment depending upon each partner's financial condition, i.e., solvent, insolvent, or in a title 11 proceeding, all shareholders are to be afforded the same treatment regardless of their financial condition because the exclusion of the COD income depends upon the financial status of the S corporation.

Nothing in Section 108(d)(7)(A) mentions or even contemplates that the pass-through rules of Subchapter S will be impacted by operation of this statute. Section 108(d)(7)(A) merely provides that the determination of insolvency and attribute reduction occurs at the corporate level. Further, there is nothing in the legislative history that indicates the 1984 amendment to Section 108 operates as an exception to pass-through treatment for Subchapter S.[87] The legislative history does not indicate any purpose of the revised statute other than to ensure that all shareholders are accorded the same tax treatment.[88]

The court interpreted Section 108(d)(7)(B) to mean that losses suspended under Section 1366(d) are "deemed" to be NOLs.[89] In particular, the court stated that "the suspended losses are *carried* to the corporate level pursuant to Section 108(d)(7)(A), and *converted* to net operating losses pursuant to Section 108(d)(7)(B)."[90] In the court's view, the fact that suspended losses are determined on the shareholder level pursuant to Section 1366(d), without more, does not denote that the conversion and subsequent reduction are performed on the same level.[91] Consequently, the court concluded that Section 108(d)(7)(B) does not require that excluded COD income be included in the shareholder's calculation of income tax liability and suspended losses of Section 1366(d),[92] and that Section 108(d)(7)(A) does not require that such income pass through to the shareholders.[93]

It is unclear how the plain meaning of "treated as" can be interpreted as "converted to." Such an interpretation is contrary to the

86. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 99 Stat. 494. *See also* H.R. REP. NO. 98-432, at 334 (1983).
87. *See id.*
88. *See id.*
89. *See Nelson*, 110 T.C. at 120-21.
90. *Id.* at 124 (emphasis added).
91. *See id.*
92. *See id.*
93. *See id.*

legislative history of Section 1366 and the language of Section 1371(b)(2).[94] The legislative history to Section 1366 makes it clear that the loss carryforward is that of the shareholder.[95] There is no indication in any subsequent statute or its legislative history that this intention had been changed. Moreover, Section 1371(b)(2) states that no carryforward shall arise at the S corporation level.[96] The court's conclusion that a shareholder's suspended losses are no longer his own and that the S corporation can use them as a loss carryforward is in direct conflict with the Subchapter S authority discussed previously.[97]

The court stated that neither Sections 108(d)(7)(A) nor 108(d)(7)(B) require that excluded COD income at the S corporation level pass through to the shareholder.[98] By reading these Sections in the way that most commentators and the authors submit is the correct interpretation, Section 108(d)(7) does not operate to convert shareholder suspended losses into S corporation NOLs.[99] Rather, Section 108(d)(7) requires that the insolvency determination and the reduction of S corporation attributes, not including the suspended losses of the shareholders, occur at the corporate level.[100] Suspended losses are the S corporation equivalent of a C corporation's NOL carryover. By treating suspended losses as an NOL carryover, Section 108(d)(7)(B) provides the mechanism by which the shareholder attribute (suspended losses) will be subject to the existing corporate attribute reduction regime under 108(b)(2)(A). The statutory requirement that the insolvency determination and other attribute reduction occur at the entity level, has no bearing on the pass-through nature of the COD income. We must look to Sections 1366 and 1367 for the appropriate shareholder level treatment, as Congress clearly intended.

Further, the court's analysis does not consider the shareholder level effect. As previously noted, the losses are losses of the shareholder, not attributes of the S corporation. The more consistent interpretation of the statutes would be that Section 108(d)(7) works in tandem with the Subchapter S rules, not in opposition or as an ex-

94. *See* H.R. REP. NO. 98-432, at 334 (1983); *see also* I.R.C. § 1371(b)(2) (1994).
95. *See* H.R. REP. NO. 98-432, at 334.
96. *See* I.R.C. § 1371(b)(2) (1994).
97. *See supra* notes 10-20 and accompanying text.
98. *See Nelson*, 110 T.C. at 123.
99. *See supra* note 9.
100. *See* I.R.C. §108(d)(7) (1994).

ception to the pass-through regime.[101]

The court in *Nelson* then considered the statute in the overall scheme of the Code.[102] In this regard, the court found that Section 1366(b) undermined the taxpayer's argument.[103] Under that Section, the character of any item included under Section 1366(b) is determined as if such item were realized "directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation."[104] Based on this language, the court found that Section 1366(a)(1)(A), in conjunction with 108(d)(7)(A), precludes excluded COD income from recognition at the shareholder level.[105] Because excludable COD income does not pass from the S corporation to its shareholders under 1366(a)(1)(A), the court concluded such income cannot increase their stock basis under Section 1367(a)(1)(A).[106]

The statutory scheme and legislative history of both Section 108 and Subchapter S do not support the majority's interpretation of the interaction of those provisions. The legislative history of Section 1366 states that an S corporation's income will be computed under the same rules presently applicable to partnerships and, as with partners of a partnership, each shareholder will take into account his *pro rata* share of income and loss items in a manner that parallels the partnership rules of Section 702.[107] Section 702(b) provides that the character of any item of income or loss "shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."[108] This language is parallel to the language in Section 1366(b).[109] Under Section 108, insolvent partners are permitted to increase the outside basis of their partnership interest by the amount of excluded COD income.[110] Given the call for identical treatment of

101. As a practical matter, shareholders, and not the S corporation, maintain basis and suspended loss records. Hence, it is not only statutorily consistent to report excluded COD income to the shareholders, but it is necessary in order for the losses to be reduced, if necessary, under Section 108(b).

102. *See Nelson*, 110 T.C. at 121.

103. *See id.* at 121.

104. I.R.C. § 1366(b) (1994).

105. *See Nelson*, 110 T.C. at 122.

106. *See id.*

107. *See* S. REP. NO. 97-640, at 17 (1982).

108. I.R.C. § 702(b) (1994).

109. *Compare* I.R.C. § 702(b) (1994) *with* I.R.C. § 1366(b)(1994) (indicating that income is determined at the partner or shareholder level).

110. *See* S. REP. NO. 95-1035, at 22 n.28 (1980).

partnerships and S corporations in the legislative history and the parallel statutes, there is no rationale for disparate tax treatment between partners and S corporation shareholders with respect to excluded COD income under Section 108. The court's interpretation is also in conflict with the conduit nature of S corporations.

The court found further support for its position in Section 108(d)(6).[111] Under that Section, in the case of a partnership, the insolvency determination is to be applied at the partner, as opposed to the partnership, level.[112] According to the majority, this Section permits the inference that the treatment of excluded COD income was intended to be decoupled with respect to S corporations and partnerships.[113] In support of this proposition, the court cited the 1984 legislative history to Section 108(d)(7)(A) which articulates Congress' intent that all S corporation shareholders be treated in the same manner by providing that the exclusion of income and attribute reduction be applied at the corporate level.[114]

As previously stated, the legislative history to Section 108 requires that excluded COD income increase an insolvent partner's outside partnership basis.[115] The legislative history to Sections 1366 and 1367 is clear that the manner in which shareholders account for the corporation's items of income and loss and the manner in which shareholders adjust the basis of their stock are to be identical to the manner in which partners account for partnership items and adjust their outside partnership interests.[116] While Section 108 provides that the insolvency determination will be made at different levels (i.e., the partnership or S corporation levels), there is nothing in the statute or legislative history that requires, once the insolvency determination has been made, partners and S corporation shareholders to account for the items in a different manner. It is consistent with the parallel rules of Subchapters K and S to afford partners and S corporation shareholders the same tax treatment with respect to COD income ex-

111. *See* Nelson v. Commissioner, 110 T.C. 114, 122 (1998).
112. *See* I.R.C. § 108(d)(6) (1994).
113. *See Nelson*, 110 T.C. at 122.
114. *See id.* (citing H.R. REP. NO. 98-432, at 1019 (1983)).
115. *See supra* note 86 and accompanying discussion.
116. *See* S. REP. NO. 97-640, at 6, 15, 18 (1982). The legislative history states that "[T]he bill adopts a partnership approach which treats all items . . . generally like they are treated under the partnership provisions." *Id.* at 6. (referring to items of income and loss that pass through to the corporation's shareholders). With respect to Section 1367, the legislative history states that the rules providing for increases in a shareholder's basis "will be analogous to those provided for partnerships under section 705." *Id.* at 18.

cluded under Section 108.

The court in *Nelson* stated that if Congress had intended a basis step-up for excluded COD income, it would have included a statutory provision for such a result.[117] Most commentators thought Congress had so provided in Sections 1366 and 1367.[118] Contrary to the Tax Court's conclusion, Sections 108(b), 108(d)(7), 1366, and 1367 should be interpreted so that they work in tandem. This means that excluded COD income under Section 108 would pass through to the shareholders under Sections 1366 and 1367. Consequently, the shareholder would receive a stock basis step-up and a corresponding reduction in his suspended losses. Any attribute reduction in suspended losses at the shareholder level would need to be reported to the S corporation to determine to what extent, if any, corporate level attributes must be reduced. An analysis of the remainder of the court's decision, we believe, further supports such an interpretation.

2. Tax-exempt Income

The court rejected the taxpayer's argument that excluded COD income was tax-exempt for purposes of Section 1366(a)(1)(A) and therefore, under the language of the statute, was required to pass through to the S corporation shareholders.[119] The taxpayer attempted to analogize excluded COD income to insurance proceeds in excess of premiums paid under Section 101(a) not being subject to tax; to state and local bond interest under Section 103(a) not being subject to tax; and to income arising from the recovery of any amount deducted in prior years to the extent that such income did not produce a tax benefit under Section 111(a) not being subject to tax.[120] The court accepted the Service's position that excluded COD income is merely deferred, not permanently exempt.[121]

While there is no definition of tax-exempt income in Section 1366(a)(1)(A), there was no suggestion by the Tax Court in *Nelson* that the income excluded under the other Code Sections cited by the taxpayer is not tax-exempt. The taxpayer's argument is supported by the general statutory regime. As stated in *Winn*: "Absent any exclusionary provision, items of income are included in gross income. Sections 101 through 135 exclude specific items of income from gross

117. *See Nelson*, 110 T.C. at 122-23.
118. *See supra* note 9.
119. *See Nelson*, 110 T.C. at 122.
120. *See id.* at 124.
121. *See id.* at 125.

income."[122] Income excluded under Section 108 is one of those items excluded.[123]

The court, in a somewhat cryptic portion of its opinion, sought to distinguish the taxpayer's "attempt to correlate the exclusion from gross income pursuant to Section 108 with an item of income that is 'tax-exempt' pursuant to Section 1366(a)(1)(A), e.g., Section 103(a)" by contrasting the term "exclusion" with the language in Section 103(a) that "expressly delineates that gross income does not *include* income derived from interest paid on any State or local bond."[124] The court's basis for making this comparison is not clear. Section 108(a) contains language identical to Section 103(a) (i.e., gross income does not *include* any amount by reason of the discharge of indebtedness).[125] Where the term "excluded" is used in other subsections of Section 108, it is used to refer back to an amount that "gross income does not include" under Section 108(a).[126] Accordingly, there is no statutory basis for distinguishing between income that is exempt under Section 101 or Section 103 and income that is exempt under Section 108.

The court and one commentator believe that the basis increase is not warranted because the shareholder/taxpayer has not borne the economic cost or outlay for the tax benefit of the basis increase.[127] While as a matter of general tax policy, a taxpayer is entitled to basis for his investment of after tax dollars, there are numerous exceptions to that rule, including the ability to increase basis for amounts borrowed and receipt of other types of tax-exempt income by S corporation shareholders and partners in partnerships.

> *Example.* *A*, an S corporation, owned by *A* and *B*, paid the insurance premiums on a key-man life insurance policy on employee *E* with a death benefit of $1 million. At the time of *E*'s death, the insurance premiums paid totaled $10,000. The full amount of the insurance proceeds is not included in gross income and the shareholders receive a corresponding stock basis

122. Winn v. Commissioner, 73 T.C.M. (CCH) 3167, 3169 (1997), *withdrawn and superceded*, 75 T.C.M. (CCH) 1840 (1998).

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

124. *Nelson*, 110 T.C. at 125 (emphasis added). The court referred to the Webster's dictionary definitions of exclusion and exclude in support of its finding that those terms do not necessarily contemplate exclusion on a permanent basis. *See id.*

125. *Compare* I.R.C. § 103(a) (1994) *with* I.R.C. § 108(a) (1994).

126. I.R.C. § 108 (1994).

127. *See Nelson*, 110 T.C. at 118; *see* Lipton, *supra* note 6, at 278.

increase by the same amount.

In the Example neither *A* nor *B* has directly incurred an economic outlay of the after-tax costs of the insurance proceeds. The point is that both Section 101 and 108, in conjunction with Sections 1366 and 1367, can produce an increase in S corporation stock basis without a commensurate after-tax investment by the shareholders. Accordingly, in light of the identical statutory language of Sections 101 and 108, it is unclear why the absence of an economic outlay results in excluded COD income being treated differently from excluded insurance proceeds.

Instead of trying to explain why income exempt under Section 108 should be accorded different treatment than other items specifically excluded from gross income in Sections 101 through 135, the court focused on the permanency of the exclusion.[128] The majority stated that the legislative history of Section 108 "manifests an intention to 'insure that the debt discharge amount eventually will result in ordinary income.'"[129] The court then noted that the Supreme Court in *United States v. Centennial Savings Bank*[130] observed that the effect of Section 108 is not to exempt such income from taxation, but rather to defer the payment of the tax by reducing the taxpayer's annual depreciation deductions or by increasing the size of taxable gains upon the disposition of the property.[131]

The Tax Court's citation to *Centennial Savings* is dicta.[132] In that case, the Supreme Court was faced with the issue of whether penalties collected by a bank from customers due to the customer's premature withdrawal of certificates of deposit constituted COD income that the bank could exclude "as qualified business indebtedness" by reducing the basis of its depreciable assets.[133] A determination of whether Section 108 constitutes a deferral or an exemption with respect to excluded COD income was unnecessary to the resolution of the issue before the Court and the Court undertook no critical analysis of that question.[134]

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128. *See Nelson*, 110 T.C. at 121.

129. *Id.* at 125 (quoting S. REP. NO. 96-1035, at 11 (1980), *reprinted in* 1980-2 C.B. 620, 625).

130. 499 U.S. 573 (1991).

131. *See Nelson*, 110 T.C. at 125 (citing *Centennial Savings*, 499 U.S. at 580).

132. *See Centennial Savings*, 499 U.S. at 580.

133. *Id.* at 579.

134. Section 108(c), prior to the Tax Reform Act of 1986, required the amount excluded from gross income as qualified business indebtedness to be applied to re-

The legislative history of Section 108 only partially supports the Tax Court's conclusion in *Nelson* that excluded COD income is tax deferred rather than tax-exempt. As the court points out, the legislative history of the Bankruptcy Tax Act of 1980[135] states that the Act is intended to carry out the congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.[136] However, as the Tax Court also acknowledges, the legislative history was intended to accommodate both bankruptcy policy and tax policy.[137] Arguably, to the extent that the amount of excluded COD income exceeds the available tax attributes to be reduced, tax policy takes second place to the bankruptcy policy of preserving a fresh start for the debtor/taxpayer. If the primary policy to be served in such circumstances is the tax policy of ensuring that none of the excluded COD income escapes eventual taxation, a mechanism could have been provided to ensure this result. No such mechanism is provided.

Accordingly, to the extent the COD income exceeds the tax attributes to be reduced, it is "necessarily tax-exempt on a permanent basis."[138] This consequence is clearly contemplated by the legislative history quoted by the Tax Court that "any further remaining debt discharge . . . does not result in income or have other tax consequences."[139] Therefore, COD income that is not included in taxpayer income is not entirely tax deferred or tax-exempt. The treatment of the tax-exempt portion as tax deferred is no more appropriate than the converse treatment. The answer is that excluded COD income was intended to be, and is, tax-exempt *to the extent* it exceeds tax attributes available for reduction.

3. Taxpayer's Windfall

In the course of its analysis of the relatively sparse legislative history, the majority revealed what appears to have really been troubling it. According to the court, if the taxpayer is allowed a basis increase

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duce basis of depreciable property and limited the amount excludable from income to the aggregate adjusted basis of depreciable property held by the taxpayer at the beginning of the taxable year following the taxable year of discharge. *See* I.R.C. § 108(c) (1982).

135. Pub. L. No. 96-589, 94 Stat. 3389.

136. *See* S. REP. NO. 96-1035, at 11 (1980), *reprinted in* 1980-2 C.B. 620, 625.

137. *See Nelson*, 110 T.C. at 135.

138. *Id.*

139. *Id.* at 127 (citing S. REP. NO. 96-1035, at 2 (1980), *reprinted in* 1980-2 C.B. 620, 620-21).

on account of the excluded COD income, an economic windfall would be bestowed.[140] The court reached this conclusion because it perceived that the creditors, and not the taxpayer, incurred an economic outlay.[141] As discussed above, as a matter of statutory construction, the economic outlay consideration does not appear to distinguish Section 108 in this context from Sections 101 or 103.[142] Moreover, to the extent application of the relevant statutes results in what the court perceives to be an unwarranted windfall, principles of judicial restraint dictate that the statute be applied as written unless such application would create an absurd result, which the Tax Court did not allege.[143]

The taxpayer cited *CSI Hydrostatic Testers, Inc. v. Commissioner*,[144] as analogous and dispositive authority.[145] In that case, CSI Hydrostatic owned 80 percent of the stock of Sea Level International with which it filed consolidated returns.[146] In 1987, Sea Level adopted a plan of liquidation in bankruptcy pursuant to which it was discharged from $4,321,245 of debt outstanding after its liquidation.[147] Sea Level excluded from its taxable income the discharged debt pursuant to Section 108(a) and included the COD income in its earnings and profits for its final taxable year pursuant to Section 312(1).[148] Pursuant to Treasury Regulations Section 1.1502-32(b)(1), CSI made a positive adjustment to its investment basis in its Sea Level stock equal to undistributed E&P.[149] As a result of CSI's positive basis adjustment, CSI

140. *See Nelson*, 110 T.C. at 128.
141. *See id.*
142. *See supra* Part III.B.
143. "[It is a] well-established principle that, where the language at issue is ambiguous, it is necessary to examine the underlying statutory framework and legislative history to understand its correct meaning." Exxon Corp. v. Commissioner, 102 T.C. 721, 727 (1994). On other hand it also has been stated that:

> [C]ourts are forbidden to tamper with the plain meaning of the words employed unless they are clearly ambiguous or nonsensical. The concomitant rule of interpretation is that courts may not re-write unartfully but unambiguously drafted legislation in order to accomplish results perceived by the court to be the goals of such flawed legislation.

Id. at 727-28 (citations omitted).
144. 103 T.C. 398 (1994), *aff'd per curiam*, 62 F.3d 136 (5th Cir. 1995).
145. *See Nelson*, 110 T.C. at 125-26.
146. *See CSI Hydrostatic*, 103 T.C. at 400.
147. *See id.* at 401.
148. *See id.*
149. *See id.* at 402.

eliminated the balance of an excess loss account in its Sea Level stock that would have been created and would have been required to be included in CSI's income under Treasury Regulations Section 1.1502-19, but for the inclusion of Sea Level's COD income in Sea Level's E&P for the purpose of the investment basis adjustment rules of Section 1.1502-32.[150]

The Service took the position that CSI was not entitled to a positive adjustment to its investment basis, arguing that unless the balance in a parent corporation's excess loss account ("ELA") is included in the parent corporation's income when the subsidiary becomes insolvent, the consolidated group will have received tax benefits it will never have to pay for, which is contrary to the purpose of Section 1.1502-19.[151] The Tax Court in *CSI Hydrostatic Testers* noted that effective for taxable years following the year in issue, Congress amended Section 1503(e)(1) to provide that, solely for the purpose of determining gain or loss on a disposition of a subsidiary's stock and the amount of any inclusion in income of an ELA, the positive investment adjustment to the stock's basis under the Consolidated Return Regulations would not include E&P from COD income excluded from the subsidiary's taxable income under Section 108 to the extent tax attributes other than basis are not reduced.[152]

In *Nelson,* the Tax Court correctly stated that *CSI Hydrostatic Test-*

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150. *See id.* at 402-03.

151. *See id.* at 405-07 (quoting Wyman-Gordon Co. v. Commissioner, 89 T.C. 207, 222-23 (1989)). The court stated:

> The significance of the addition of section 312(l) to the Code cannot be understood without considering important amendments to section 108 that also were made by the Bankruptcy Tax Act of 1980. That section was significantly rewritten to provide, among other things, that a taxpayer who under new section 312(l) excludes discharge of indebtedness income from taxable income due to insolvency and does not elect to reduce basis in its depreciable assets under section 1017, *must reduce certain other tax attributes.* The first tax attribute to be reduced under section 108 is the debtor's net operating losses. Thus, under amended sections 108 and 312(l), if these provisions were applicable to petitioners in 1978 . . . [the second-tier subsidiary] would be entitled to exclude the . . . discharge of indebtedness from its taxable income, and it would be entitled to increase is earnings and profits (and thereby reduce is excess loss account) by the amount of the discharge of indebtedness income.

Id. at 406-07.

152. *See id.* at 415.

ers was decided within the context of the Consolidated Return Regulations as applicable to C corporations and that it contained no express support for the proposition that COD income must pass through to the shareholders of an S corporation.[153] However, the Tax Court's approach in deciding *CSI Hydrostatic Testers* arguably undercuts any reliance in *Nelson* on the windfall that results from the increase in shareholder basis for excluded COD income. The windfall in *Nelson* is no greater than the tax benefit that CSI received and did not have to pay for. Yet, in *CSI Hydrostatic Testers*, the court apparently felt constrained to apply the statute and regulations as written despite the perceived windfall to the taxpayer. The court stated that because the Consolidated Return Regulations carry the force and effect of law, it would not invalidate them unless clearly contrary to the intent of Congress.[154] In contrast, the Tax Court in *Nelson*, even in light of the relatively sparse legislative history bearing on the issue, appeared more inclined to construe the statutory language to prevent the taxpayer from obtaining an unwarranted benefit.

The court's last rationale for its holding was that in the partnership context and prior to the enactment of Section 108 in its current form, an increase in basis is allowable when COD income is actually recognized, and no basis increase is warranted when application of the insolvency exception prevents such recognition.[155] In this connection, the court cited *Babin v. Commissioner*[156] and *Gershkowitz v. Commissioner*.[157] Because those cases have no factual or legal relevance to *Nelson*, it is unclear why they were cited.

Not only has *Babin* been criticized,[158] but the Service has stated that it does not apply to partnership transactions occurring after 1980.[159] Thus, in the Service's view, a taxpayer may increase the basis of his partnership interest for COD income excluded under the insolvency exemption of Section 108(a)(1)(B).

In *Gershkowitz*, the Tax Court allowed the taxpayer/partner to increase the outside basis of his partnership interest because he was sol-

153. *See* Nelson v. Commissioner, 110 T.C. 114, 126 (1998).
154. *See CSI Hydrostatic*, 103 T.C. at 406-07.
155. *See Nelson*, 110 T.C. at 131.
156. 23 F.3d 1032 (6th Cir. 1994).
157. 88 T.C. 984 (1987).
158. *See* Richard M. Lipton, *Insolvent Partner Taxed on Partnership's COD Income Despite Code Provision*, 81 J. TAX'N 248, 252 (1994); Richard M. Lipton, *IRS Challenges S Corporation Basis Increase for COD Income*, 81 J. TAX'N 340, 344 (1994).
159. *See* Tech. Adv. Mem. 9739002 (May 19, 1997); *see also* Shop Talk, *IRS Renounces its Victory in* Babin, 87 J. TAX'N 318, 318 (1997).

vent and, consequently recognized COD income.[160] Moreover, the Tax Court stated in *Gershkowitz* that it did not have to consider whether an insolvent partner would be permitted to increase basis for excluded COD income.[161]

B. Concurring Opinions

While the result in *Nelson* was unanimous, seven judges did not entirely agree with the majority's reasoning. Judge Beghe wrote a concurring opinion, with which Judge Halpern joined. Judge Foley also wrote a concurring opinion joined by four judges.

1. Judge Beghe's Concurrence

Judge Beghe articulated five reasons why a taxpayer should be denied a basis step-up in the S corporation stock as a result of excluded COD income.[162] With one exception, his arguments are addressed and dismissed by our analysis of the majority opinion[163] and our discussion of Judge Foley's concurrence below.[164]

Judge Beghe's argument remaining to be addressed is his argument based on Section 465. Because the intent of Section 465 is to preclude current deductions arising from basis step-ups that have not been paid for, he contends that Section 465 should not allow an S corporation shareholder a basis increase for an adjustment that was not paid for, as represented by the excluded COD income.[165]

In our view, the reference to Section 465 does not support Judge Beghe's position. The issue before the court in *Nelson* was whether the taxpayer was entitled to a basis increase. We submit that Section 465 does not apply in the determination of a taxpayer's basis. It operates to preclude a taxpayer from deducting losses until his at-risk amount is increased. This concurrence only makes a passing reference to Section 465 and does not expand on the mechanics of its application in these circumstances, which is arguably appropriate since it does not go to the specific issue before the court.

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160. *See Gershkowitz*, 88 T.C. at 1009.
161. *See id.* at 1010.
162. *See* Nelson v. Commissioner, 110 T.C. 114, 130-35 (1998) (Beghe, J., concurring).
163. *See supra* Parts III.A.1–2.
164. *See infra* Part III.B.2.
165. *See Nelson*, 110 T.C. at 135.

2. *Judge Foley's Concurrence*

Judge Foley wrote separately to state his opinion that there is no need to distinguish between tax-exempt and tax-deferred income, since, based upon his reading of the legislative history of the Bankruptcy Tax Act of 1980,[166] there are no items of income to increase stock basis under Section 1367 after application of the attribute reduction rules of Section 108(b).[167] There is nothing in the statutory language that supports this interpretation.

Judge Foley's argument is unpersuasive for three reasons. First, it is internally inconsistent with the legislative history, which expressly recognizes that insolvent partners will increase basis for the full amount of the excluded COD income, whether or not it results in attribute reduction.[168] Second, the relevant statutory provisions provide for the existence of COD income and that such income is not taxable to the extent of insolvency. Nothing in Sections 61 or 108 provide that the existence or exclusion of COD income is dependent upon the presence or absence of tax attributes available for reduction. Third, it is not until after the basis increase and not until the beginning of the following tax year that tax attributes are reduced. Because the stock basis increase occurs in the tax year before the attribute reduction, Judge Foley's interpretation of the application and effect of those rules is not supported by the statutes.

IV. POST-*NELSON* OPPORTUNITIES

Despite the Tax Court's decision in *Nelson*, does an opportunity remain for taxpayers to increase the basis of their S corporation stock by the amount of any entity-level excluded COD income?

Since issuing *Nelson*, the Tax Court, in memorandum opinions, has applied the *Nelson* holding in disallowing taxpayers a stock basis increase for COD income excluded at the S corporation level under Section 108. In *Chesapeake Outdoor Enter. Inc., v. Commissioner*,[169] the issues were (1) whether the court had jurisdiction, and (2) whether COD income excluded by reason of Section 108 qualified as a separately stated item of tax-exempt income for purposes of Section

166. Pub. L. No. 96-589, 94 Stat. 3389. *See also* S. REP. NO. 96-1035, at 1 (1980), *reprinted in* 1980-2 C.B. 620, 620.
167. *See Nelson*, 110 T.C. at 135 (Foley, J., concurring).
168. *See* S. REP. NO. 96-1035, at 20 (1980), *reprinted in* 1980-2 C.B. 620, 631.
169. 75 T.C.M. (CCH) 2279 (1998).

1366(a)(1)(A).[170] After it found that it had jurisdiction, the court stated that it had already determined in *Nelson* that excluded COD income does not pass through to S corporation shareholders as an item of income under Section 1366(a)(1)(A) and that there was no need to repeat its detailed exegesis on the issue contained therein.[171] The court stated in *Chesapeake* that the taxpayer's arguments were not worth addressing and were dismissed as unconvincing.[172]

A similar approach was applied in *Friedman v. Commissioner*,[173] which involved (1) whether the taxpayers' S corporation realized COD income under Section 108, and (2) whether the taxpayers were entitled to increase their basis in their S corporation stock by the amount of the COD income.[174] With respect to the first issue, the court concluded that the S corporation did not realize COD income for the tax year in issue.[175] In dismissing the second issue, the court, citing *Nelson*, stated that even if the entity had realized COD income, the shareholders would not be entitled to increase their stock basis to the extent it was excluded from gross income by reason of Section 108.[176] Notwithstanding the Tax Court's adherence to its ruling in *Nelson*, commentary interpreting the Code with respect to this issue is in direct conflict with that decision.[177]

Taxpayers taking the reporting position that excluded COD income will increase stock basis should consider the potential for penalties in light of *Nelson*. The negligence penalty is imposed when a taxpayer fails to make a reasonable attempt to comply with the Code.[178] The Tax Court's negligence formulation is typically stated as the failure to do what a prudent person would do in the circumstances.[179] However, the penalty is not imposed when the law concerning the correct treatment of a deduction at the time the deduction was taken is not settled.[180] Thus, taxpayers who make a reasoned analysis and reach a different conclusion than the Tax Court did in *Nelson*, particularly in light of the substantial amount of commentary that is at

170. *See id.* at 2279.
171. *See id.* at 2282.
172. *See id.*
173. 75 T.C.M. (CCH) 2383 (1998).
174. *See id.* at 2383.
175. *See id.*
176. *See id.* at 2383.
177. *See* Lipton, *supra* note 6, at 277-78.
178. *See* I.R.C. § 6662 (c) (1994).
179. *See* Neely v. Commissioner, 85 T.C. 934, 947 (1985).
180. *See* Hummer v. Commissioner, 56 T.C.M. (CCH) 657, 661-62 (1988).

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odds with its decision in that case, should arguably not be subject to negligence penalties.

Practitioners should obviously advise any taxpayer for whom disallowance of the basis increase would result in a substantial understatement of tax liability to consider disclosure to avoid any penalties arising from such understatement. The twenty percent substantial understatement penalty applies to the excess of the amount required to be shown on the return over the amount of tax that is shown on the return.[181] The penalty does not apply to the amount of the understatement attributable to (1) an item for which at the time of reporting there was substantial authority for the taxpayer's treatment; or (2) which the relevant facts affecting the items tax treatment are adequately disclosed in the return or a statement attached to the return.[182] The "substantial authority" standard is an objective one involving an analysis of the law and application of the law to the relevant facts. The standard is less stringent than the "more likely than not" standard (i.e., greater than fifty percent likelihood of being upheld), but more stringent than the reasonable basis standard (which, if satisfied, will prevent imposition of the negligence penalty under Section 6662(b)).[183]

Under the Regulations, there is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial "in relation to the weight of authorities supporting contrary positions."[184] There may be substantial authority for more than one position with respect to the same item. Authorities that may be taken into account include applicable provisions of the Internal Revenue Code; proposed, final, and temporary regulations; court decisions; congressional intent as reflected in committee reports; and joint explanatory statements of managers included in conference committee reports.[185] However, conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals are not authority.[186]

It might be argued that the applicable provisions of the Code and the relevant legislative history constitute authority for increasing shareholder basis by the distributive share of excluded COD income.

181. *See* I.R.C. § 6662(d)(2)(A) (1994).
182. *See* I.R.C. § 6662(d)(2)(B) (1994).
183. *See* H.R. CONF. REP. NO. 97-760, at 575 (1982), *reprinted in* 1982-2 C.B. 600, 650.
184. Treas. Reg. § 1.6661-3(b)(1) (1998).
185. *See* H.R. REP. NO. 101-247, at 1387-88 (1989).
186. *See* Treas. Reg. § 1.6661-3(b)(2) (1998).

However, the Tax Court opinions addressing this matter raise the distinct likelihood that a court might decide there is not substantial authority for such a reporting position.[187] Thus, it is advisable for taxpayers to disclose their position to avoid the substantial understatement penalty.

Disclosure for this purpose is considered adequate only where the position has a reasonable basis and is disclosed in the manner provided in the regulations.[188] Unless the Commissioner has by Revenue Procedure approved disclosure of an item on the taxpayer's return for this purpose, disclosure will be adequate only if made on Form 8275. Not surprisingly, the Service has not included this particular item in the list of those for which no disclosure in addition to that on the return is required.[189]

V. CONCLUSION

Under the foregoing analysis, COD income excluded under Section 108 is an item of income that an S corporation shareholder must take into account under Section 1366(a)(1)(A). COD income is to be treated as if it were realized directly from the source, which puts S corporation shareholders on par with insolvent partners. But partners who receive COD income (unlike S corporation shareholders, under the ruling in *Nelson*) are entitled to an increase in their outside basis. In *Nelson*, the court's interpretation that Section 108(d)(7)(A) was intended to decouple the treatment of S corporations and partnerships is satisfied if the statutes discussed herein are construed as the authors advocate so that the exclusion of COD income for shareholders is determined by insolvency at the corporate level. This contrasts with excludability of COD income for partners, which is determined by their individual solvency or insolvency.

Even if the presence of a windfall is conceded, as the Tax Court in *CSI Hydrostatic Testers* concluded in its discussion of the prior Consolidated Return Regulations, principles of judicial restraint mandate that the statutes be applied as written and that a strained statutory construction should not be undertaken to remedy a perceived inadequacy of the legislation. That task should be left to Congress. Until

187. *See* Freidman v. Commissioner, 75 T.C.M. (CCH) 2383 (1998); Chesapeake v. Commissioner, 75 T.C.M. (CCH) 2279 (1998); Nelson v. Commissioner, 110 T.C. 114 (1998).

188. *See* Treas. Reg. § 1.6662-3(a)(1) (1998).

189. *See* Rev. Proc. 97-56, 1997-52 I.R.B. 18.

such time, taxpayers should be entitled to increase their stock basis by their allocable share of excluded S corporation COD income.

However, since the Tax Court has spoken on the issue, taxpayers must look to an appeals court, a district court, or the Claims Court for a different conclusion.[190] Until such time, to avoid penalties taxpayers should disclose a position contrary to *Nelson*.

190. *See* Prop. Reg. § 1.1366 (Aug. 18, 1998) (disallowing a basis increase).