TaxWire Special

By Robert A. Briskin

Supreme Court Reverses Tenth Circuit in *Gitlitz*

The taxpayer was victorious in the recent U.S. Supreme Court case *D.A. Gitlitz.*[1] The Court held that S corporation shareholders may deduct corporate level tax losses by increasing their stock basis by the amount of corporate cancellation of debt (COD) income, even though this COD income was not included in either the corporation's or the shareholders' gross income.[2]

S corporation shareholders can only utilize tax losses to the extent of their basis in the corporation's stock and debt. Tax losses that cannot be used by the corporation's shareholders are "suspended" and carried forward to the shareholders' succeeding taxable years in which the shareholders have basis. Thus, by *Gitlitz* allowing shareholders to increase their stock basis for S corporation level COD income, these suspended tax losses are now passed through to shareholders to use on their personal income tax returns. The Supreme Court rejected the IRS's argument that COD income of an insolvent S corporation is not an "item of income" that should pass through to the shareholders. Rather, the Supreme Court concluded that the COD income first increases the shareholders' stock basis to release to the shareholders these suspended losses for the shareholders to then use on their individual income tax returns. The Supreme Court rejected the lower court's concern that the pass-through of COD income to increase shareholders' stock basis might produce a "double windfall" for shareholders. Instead the Court held that the Internal Revenue Code's "plain text permits the taxpayers" to receive such tax benefits.

The tax benefits of the Supreme Court's *Gitlitz* decision are illustrated by the following example:

Assume that an S corporation accumulates losses of $5.1 million between 1995 and 1998 before becoming insolvent. The corporation's sole shareholder invested only $100,000 in 1995 to purchase his stock, with the corporation's remaining $5 million coming from a bank. The bank agrees to write off the full amount of the debt in 1999 because the corporation is insolvent. The shareholder has not guaranteed any of the corporation's debt. The shareholder used his $100,000 investment to deduct losses on his personal income tax returns between 1995 and 1998-the amount of the shareholder's basis in his stock. However, based upon *Gitlitz* the $5 million of canceled indebtedness in 1999 causes the shareholder's stock basis in 1999 to increase to $5 million, yet the corporation does not have to include the $5 million in its 1999 income because of the Code Sec. 108 exception for insolvent corporations. The result is that in 1999 $5 million of tax losses pass through to the shareholder. The shareholder can files amended 1999 individual income tax return to use these losses on his 1999 federal income tax return, and receive tax refunds. Also, the shareholder can carry back unused tax losses on his personal federal return. Additionally, the shareholder can offset his taxable income on his personal income tax returns in future years with the unused tax losses. Neither the shareholder nor the corporation recognizes the $5 million of COD income, because the corporation was insolvent when the corporation's creditors forgave the $5 million debt in 1999.

In the above illustration, the shareholder invests only $100,000, yet receives $5,100,000 in tax losses. Because of this "too good to be true" tax result for taxpayers, Congress may consider amending the Subchapter S and COD Internal Revenue Code provisions in the future. In the meantime, taxpayers should be using these *Gitlitz* tax losses by filing amended personal income tax returns.[3]

ENDNOTES

1 D.A. *Gitlitz*, SCt, 2001-1 USTC ¶50,147, 531 US — (2001). Rev'g CA-10, 99-2 USTC ¶50,645. This was an eight to one decision. The majority opinion was authored by Justice Thomas, with Justice Breyer dissenting.

2 For a detailed discussion of the tax issues and the conflicting court decisions leading up to *Gitlitz*, see Robert A. Briskin, *New Court of Appeals Decision Allows S Corporation Stock Basis Increase For Excluded COD Income*, TAXES, May 2000, at 38.

3 The Treasury Regulations for tax years beginning on or after August 18, 1998 deny the pass-through of excluded COD income to increase S corporation shareholders' stock basis, thereby preventing shareholders from using suspended losses. See Reg. §1.1366-1(a)(2)(viii) (Dec. 22, 1999). Even though the Supreme Court in *Gitlitz* did not specifically invalidate these regulations, the Court held that "tax-deferred" income could be interpreted to be included under Code Sec. 1366. Thus, the validity of these regulations now appears questionable.

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