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

Discharge of indebtedness income excluded from gross income by an insolvent S corporation does not pass through to shareholders and thus does not increase their stock basis.

Summary

Mel T. Nelson, the sole shareholder of an insolvent S corporation, sought to increase his basis in the corporation's stock by the amount of the corporation's discharge of indebtedness (COD) income. The Tax Court held that such COD income, excluded from gross income under section 108(a), does not pass through to the shareholder under section 1366(a)(1)(A), and thus cannot increase the shareholder's basis in the stock under section 1367(a)(1)(A). The decision hinged on section 108(d)(7)(A), which mandates that the COD income exclusion be applied at the corporate level for S corporations, preventing it from flowing through to shareholders.

Facts

Mel T. Nelson was the sole shareholder of Metro Auto, Inc. (MAI), an S corporation. In 1991, MAI disposed of all its assets and realized COD income of $2,030,568. MAI was insolvent at the time of the discharge and excluded this income from its gross income. Nelson attempted to increase his stock basis in MAI by $1,375,790, the amount by which the COD income exceeded MAI's losses. After disposing of his MAI stock, Nelson claimed a long-term capital loss of $2,403,996 on his 1991 tax return, which the Commissioner disallowed to the extent of the basis increase Nelson claimed due to the COD income.

Procedural History

The case was submitted fully stipulated to the U. S. Tax Court. The Tax Court's decision was reviewed by the full court, with the majority opinion holding that the COD income exclusion does not pass through to the shareholder, resulting in no basis increase.

Issue(s)

1. Whether discharge of indebtedness income excluded from gross income by an insolvent S corporation under section 108(a) passes through to the shareholder under section 1366(a)(1)(A)?

2. Whether such excluded COD income increases the shareholder's basis in the S corporation's stock under section 1367(a)(1)(A)?

Holding

1. No, because section 108(d)(7)(A) mandates that the COD income exclusion be

applied at the corporate level, preventing it from passing through to the shareholder.

2. No, because since the COD income does not pass through to the shareholder, it cannot increase the shareholder's basis in the S corporation's stock under section 1367(a)(1)(A).

Court's Reasoning

The court relied on the plain language of section 108(d)(7)(A), which specifies that the COD income exclusion and subsequent tax attribute reductions are applied at the corporate level for S corporations. This prevents the COD income from passing through to shareholders under the general passthrough rules of section 1366(a)(1)(A). The court rejected the taxpayer's argument that excluded COD income is "tax-exempt" and should pass through as an item of income, clarifying that COD income under section 108 is "deferred income" rather than permanently exempt. The legislative history of section 108 supports the notion that COD income should eventually result in ordinary income and that exemptions from taxation must be clearly stated. The court also noted that allowing a basis increase without an economic outlay by the shareholder would result in an unwarranted benefit.

Practical Implications

This decision impacts how S corporation shareholders handle COD income in cases of corporate insolvency. It clarifies that such income does not increase shareholder basis, affecting the ability of shareholders to claim losses or deductions based on that income. Practitioners should advise clients not to include excluded COD income in their basis calculations for S corporation stock. The ruling also highlights the importance of considering the at-risk rules under section 465, which could further limit the use of losses even if a basis increase were allowed. Subsequent cases have followed this ruling, emphasizing the application of COD income exclusions at the corporate level for S corporations.

