Chesapeake Outdoor Enterprises, Inc. v. Commissioner, T. C. Memo. 1998-175

The Tax Court has jurisdiction over the characterization of cancellation of debt (COD) income in S corporations, and such income excluded under section 108(a) is not a separately stated item of tax-exempt income for shareholders.

Summary

Chesapeake Outdoor Enterprises, Inc. , an insolvent S corporation, excluded $995,000 of cancellation of debt (COD) income under section 108(a) in its 1992 tax year. The court determined it had jurisdiction to consider the characterization of this income as a subchapter S item, despite the Commissioner's concession on a related shareholder basis issue. The court followed Nelson v. Commissioner, holding that excluded COD income does not pass through to shareholders as tax-exempt income under section 1366(a)(1)(A), thus not increasing shareholder basis.

Facts

Chesapeake Outdoor Enterprises, Inc. , an S corporation, was insolvent during its tax year ending March 19, 1992. It realized $995,000 in COD income from restructuring its debts with Chase Manhattan Bank and Tec Media, Inc. Chesapeake excluded this income from its gross income under section 108(a) and reported it as tax-exempt income on its S corporation tax return. The Commissioner issued a Final S Corporation Administrative Adjustment (FSAA) proposing adjustments to the characterization of this income and to shareholders' stock basis.

Procedural History

The Commissioner issued an FSAA on July 15, 1996, proposing adjustments to Chesapeake's 1992 tax year. Chesapeake timely filed a petition for readjustment on October 9, 1996. The parties stipulated to the disallowance of deductions for accrued interest expenses. The Commissioner conceded that the proposed adjustment to shareholder basis was inappropriate at the corporate level.

Issue(s)

1. Whether the Tax Court has jurisdiction to hear this case regarding the characterization of COD income as a subchapter S item.
2. Whether COD income excluded from an S corporation's gross income under section 108(a) qualifies as a separately stated item of tax-exempt income for purposes of section 1366(a)(1)(A).

Holding

1. Yes, because the characterization of COD income is a subchapter S item subject to the unified audit and litigation procedures, and the FSAA's reference to the

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characterization of COD income confers jurisdiction.
2. No, because following Nelson v. Commissioner, excluded COD income does not pass through to shareholders as a separately stated item of tax-exempt income under section 1366(a)(1)(A).

Court's Reasoning

The court applied the unified audit and litigation procedures for S corporations, finding that the characterization of COD income is a subchapter S item under section 6245 and the temporary regulations. The FSAA's remarks explicitly addressed the characterization of COD income, conferring jurisdiction. The court followed its decision in Nelson v. Commissioner, reasoning that COD income excluded under section 108(a) is not permanently tax-exempt and thus does not qualify as tax-exempt income that passes through to shareholders under section 1366(a)(1)(A). The court emphasized the policy that excluded COD income should not increase shareholder basis without a corresponding tax event.

Practical Implications

This decision clarifies that the Tax Court has jurisdiction over the characterization of COD income in S corporations, even if other adjustments are conceded. Practitioners must carefully report excluded COD income on S corporation returns, as it will not increase shareholder basis. This ruling aligns with the IRS's position on the tax treatment of excluded COD income and may influence how S corporations structure debt restructurings to avoid unintended tax consequences for shareholders. Subsequent cases involving the tax treatment of COD income in S corporations will likely rely on this precedent.

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