Syllabus

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Timber & Lumber Co.*, 200 U. S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

GITLITZ ET AL. *v.* COMMISSIONER OF INTERNAL REVENUE

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

No. 99–1295. Argued October 2, 2000– Decided January 9, 2001

Shareholders of a corporation taxed under Subchapter S of the Internal Revenue Code may elect a "pass-through" taxation system, under which the corporation's profits pass through directly to its shareholders on a pro rata basis and are reported on the shareholders' individual tax returns. 26 U. S. C. §1366(a)(1)(A). To prevent double taxation of distributed income, shareholders may increase their corporate bases by certain items of income. §1367(a)(1)(A). Corporate losses and deductions are passed through in a similar manner, §1366(a)(1)(A), and the shareholders' bases in the S corporation's stock and debt are decreased accordingly, §§1367(a)(2)(B), 1367(b)(2)(A). However, to the extent that such losses and deductions exceed a shareholder's basis in the S corporation's stock and debt, the excess is "suspended" until that basis becomes large enough to permit the deduction. §§1366(d)(1)–(2). In 1991, an insolvent S corporation in which petitioners David Gitlitz and Philip Winn were shareholders excluded its entire discharge of indebtedness amount from gross income. On their tax returns, petitioners used their pro rata share of the discharge amount to increase their bases in the corporation's stock on the theory that it was an "item of income" subject to pass-through. They used their increased bases to deduct corporate losses and deductions, including suspended ones from previous years. With the upward basis adjustments, they were each able to deduct the full amount of their pro rata share of the corporation's losses. The Commissioner determined that they could not use the corporation's discharge of indebtedness to increase their bases in the stock and denied their loss deductions. The Tax Court ultimately agreed. In affirming, the Tenth Circuit assumed that excluded discharge of

indebtedness is an item of income subject to pass-through, but held that the discharge amount first had to be used to reduce certain tax attributes of the S corporation under §108(b) and that only the leftover amount could be used to increase basis. Because the tax attribute to be reduced here (the corporation's net operating loss) equaled the discharged debt amount, that entire amount was absorbed by the reduction at the corporate level and nothing remained to be passed through to the shareholders.

Held:

1. The statute's plain language establishes that excluded discharged debt is an "item of income," which passes through to shareholders and increases their bases in an S corporation's stock. Section 61(a)(12) states that discharge of indebtedness is included in gross income. And §108(a) provides only that the discharge ceases to be included in gross income when the S corporation is insolvent, not that it ceases to be an *item of income,* as the Commissioner contends. Not all items of income are included in gross income, see §1366(a)(1), so an item's mere exclusion from gross income does not imply that the amount ceases to be an item of income. Moreover, §§101 through 136 employ the same construction to exclude various items from gross income, but not even the Commissioner encourages a reading that would exempt all such items from pass-through. Instead the Commissioner asserts that discharge of indebtedness is unique because it requires no economic outlay on the taxpayer's part, but can identify no statutory language that makes this distinction relevant. On the contrary, the statute makes clear that §108(a)'s exclusion does not alter the character of discharge of indebtedness as an item of income. Specifically, §108(e) presumes that such discharge is always "income," and that the only question for §108 purposes is whether it is includible in gross income. The Commissioner's contentions that, notwithstanding the statute's plain language, excluded discharge of indebtedness is not income and, specifically, that it is not "tax-exempt income" under §1366(a)(1)(A) do not alter the conclusion reached here. Pp. 5–9.

2. Pass-through is performed before the reduction of an S corporation's tax attributes under §108(b). The sequencing question presented here is important. If attribute reduction is performed *before* the discharge of indebtedness is passed through to the shareholders, the shareholders' losses that exceed basis are treated as the corporation's net operating loss and are then reduced by the amount of the discharged debt; in this case no suspended losses would remain that would permit petitioners to take deductions. However, if it is performed *after* the discharged debt income is passed through, then the shareholders would be able to deduct their losses (up to the amount

of the increase in basis caused by the discharged debt). Any suspended losses remaining then will be treated as the S corporation's net operating loss and reduced by the discharged debt amount. Section 108(b)(4)(A) expressly addresses the sequencing question, directing that the attribute reductions "shall be made *after* the determination of the *tax imposed* . . . for the taxable year of the discharge." (Emphases added.) In order to determine the "tax imposed," a shareholder must adjust his basis in S corporation stock and pass through all items of income and loss. Consequently the attribute reduction must be made *after* the basis adjustment and pass-through. Petitioners must pass through the discharged debt, increase corporate bases, and then deduct their losses, all before any attribute reduction could occur. Because their basis increase is equal to their losses, they have no suspended losses remaining and thus have no net operating losses to reduce. The primary arguments made in Courts of Appeals against this reading of the sequencing provision are rejected. Pp. 9–13.

182 F. 3d 1143, reversed.

THOMAS, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and STEVENS, O'CONNOR, SCALIA, KENNEDY, SOUTER, and GINSBURG, JJ., joined. BREYER, J., filed a dissenting opinion.