

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
 ) No. 98A-0661  
Blaine B. and Bobbi J. Quick )  
 )

Representing the Parties:

For Appellants: Kirk H. Riley, Attorney  
For Franchise Tax Board: Kimberly Mitchell Bott, Counsel

Counsel For Board of Equalization: Selvi Stanislaus, Tax Counsel

O P I N I O N

This appeal is made pursuant to section 19045 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Blaine B. and Bobbi J. Quick against proposed assessments of additional personal income tax in the amounts of \$66,296 and \$105,204, for the years 1993 and 1994, respectively.<sup>1</sup>

Both parties agree to the material facts in this appeal. They separate, however, on a question of law. The issue which must be resolved is this: may appellants increase their basis in S corporation stock for cancellation of debt (COD) income that was excluded from gross income at the corporate level under Internal Revenue Code<sup>2</sup> section 108(a) and did not pass through as income to appellants? We conclude that appellants may not.

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<sup>1</sup> An oral hearing on this matter was held on February 5, 1999. At the hearing, respondent agreed to abate the total tax liability for 1993 and reduce the additional tax liability for 1994 to \$41,024. We adopt those concessions as part of this opinion.

<sup>2</sup> Unless otherwise specified, all section references hereinafter are to sections of the Internal Revenue Code as in effect for the years in issue.

By way of background, appellants owned stock in Residential Developers Fund (RDF), a California corporation. RDF was incorporated on October 22, 1987, and elected to be taxed as an S corporation for federal and state tax purposes. RDF fell into financial difficulty, with the result that it filed for relief under Chapter 11 of the United States Bankruptcy Code on September 25, 1991. The bankruptcy was dismissed in September of 1992, with no confirmed plan of reorganization or discharge. However, in December of 1992, RDF realized COD income<sup>3</sup> in the amount of \$9,157,503, as a result of a compromise agreement between RDF and the Resolution Trust Corporation (RTC) involving debts owed to RTC. Prior and subsequent to the events giving rise to the COD income, RDF was insolvent. Consequently, RDF correctly excluded from its gross income the entire amount of COD income pursuant to the insolvency exception set forth in section 108(a)(1)(B).<sup>4</sup> Despite the fact that the income was not recognized at the S corporation level, appellants nonetheless reported the income as “pass-through” income on their individual return and also increased the basis of their stock in RDF by the amount of COD income.

The present dispute arose because respondent disallowed the claimed increased basis in appellants’ RDF stock, on the rationale that COD income was not properly includable in income at the individual level. This issue was recently addressed by the United States Tax Court in Nelson v. Commissioner (1998) 110 T.C. 114.<sup>5</sup> In Nelson, the tax court concluded that COD income excluded from gross income under section 108(a) does not pass-through to a shareholder of an S corporation. Therefore, the shareholder’s stock basis does not increase. Respondent has informed us that it has adopted the holding of the court in Nelson as its legal position in this and all other appeals concerning the issue of whether a shareholder is entitled to increase his basis of stock in an S corporation by the amount of COD income realized by the insolvent corporation. We have reviewed the decision of the tax court in Nelson (and its progeny), and adopt its conclusion.

(..continued)

<sup>3</sup> Generally, when a taxpayer incurs an obligation and the obligation is later canceled or forgiven, the taxpayer recognizes income to the extent of the reduction in the obligation. This rule is based on the premise that the taxpayer has an increase in wealth due to the reduction in valid claims against the taxpayer’s assets.

<sup>4</sup> Under California law, the tax treatment of S corporations and their shareholders is determined in accordance with Subchapter S of the Internal Revenue Code with certain exceptions not pertinent to the instant appeal. (Rev. & Tax. Code, § 23800.)

<sup>5</sup> The Nelson opinion was followed in Winn v. Commissioner (1998) ¶ 98,071 T.C.M. (RIA), filed on February 19, 1998. Both Nelson and Winn have been appealed to the Court of Appeals for the Tenth Circuit. The Winn case is the lead case with Nelson held in abeyance pending the outcome of Winn. Our research of this issue found that despite numerous appeals, the tax court continues to issue decisions that follow the holding of Nelson. (See Cronin v. Commissioner (1999) ¶ 99,022 T.C.M. (RIA), issued Feb. 1, 1999; Pugh v. Commissioner (1999) ¶ 99,038 T.C.M. (RIA), issued Feb. 9, 1999; Conviser v. Commissioner (1999) ¶ 99,047 T.C.M. (RIA), issued Feb. 17, 1999; Witzel v. Commissioner (1999) ¶ \_\_\_\_\_ T.C.M. (RIA), issued Mar. 4, 1999.)

The Nelson court began its analysis by highlighting certain key statutory concepts. Section 61 requires that certain items be included in gross income. Generally, COD income is included in gross income. (Int.Rev. Code, § 61(a).) Sections 108(a) and (b) permit, conditionally, the exclusion of COD income to the extent that a taxpayer is insolvent when the discharge of indebtedness occurs. In the context of an S corporation, section 108(d)(7)(A) provides that subsections (a) and (b) of section 108 shall be applied at the corporate level. Section 1366(a)(1)(A) provides that in computing a shareholder's tax liability,

“there shall be taken into account the shareholder's pro rata share of the corporation's

(A) 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....”

Tax exempt interest will pass-through to the shareholder as such and will increase the shareholder's basis in his Subchapter S stock. (Int.Rev. Code, § 1366(a)(1)(A).) With these parameters in mind, the Nelson court examined the juxtaposition of the Subchapter S provisions and section 108 to determine whether a shareholder's basis in S corporation stock may be increased by the amount of COD income attributed to the insolvent corporation.

Appellants argue that the issue turns on whether COD income is an item of income that passes through to the S corporation shareholders under section 1366(a)(1)(A) as a separately stated item of income.<sup>6</sup> Appellants conclude that because COD income is not subject to tax in this case, it is tax exempt income; therefore, it must pass-through to the shareholder which results in an increased shareholder basis. In contrast, appellants contend that the only function of section 108(d)(7)(A) is to determine whether COD income is excludable or not at the corporate level, and that section does not mean that the income is passed through to the shareholders under the general pass-through regime of Subchapter S. According to appellants, the governing statute in this case is section 1366(a)(1)(A).

As noted by the Nelson court, the two statutes appear to be contradictory. Section 1366(a)(1)(A) requires a shareholder to take into account his pro rata share of the corporation's items of income at the shareholder level; however, section 108(d)(7)(A) requires that the COD income exclusion be considered at the corporate level. By this opinion, we will attempt to reconcile the two

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<sup>6</sup> Appellants' reply brief consists of a copy of the appellate brief filed in the Winn case. This case provides a nearly identical factual situation and addresses each of appellants' arguments in great detail. (See fn. 5, supra.)

statutes. In doing so, we observe that a specific statutory provision will override a general provision. (Bulova Watch Co. v. United States (1961) 365 U.S. 753.) The Nelson court believed, and we agree, that section 108(d)(7)(A) regulates the treatment of excluded COD income in the context of the Subchapter S regime. Following the reasoning in the Nelson opinion, we construe section 1366(a)(1)(A) in combination with section 108(d)(7)(A) to preclude COD income from recognition at the shareholder level on the facts of the instant case. (Nelson, supra, at p. 121.) Because COD income of an insolvent S corporation is excludable at the corporate level pursuant to section 108(d)(7)(A), it does not pass through to the shareholder under section 1366 (a)(1)(A). Therefore, a shareholder's basis in corporate stock cannot be increased by his share of the excluded COD income.

Appellants also contend that the tax court's conclusions in Nelson and Winn were regrettable and clearly erroneous. Appellants allege that Nelson and Winn decisions thwart the obvious purpose of the legislation which established fundamental rules regarding the operation of Subchapter S. Appellants believe that academic commentators are unanimous in their view that the Internal Revenue Service's position (ultimately adopted by the tax court) in this and like cases is without merit, and represents an ill-considered attempt to legislate tax law through the judicial process. (See Eustice & Kuntz, *S Corporations; Federal Taxation* (1991), § 9.10.) Be that as it may, we believe that this opinion, which follows the tax court's reasoning in Nelson, comports with congressional intent. Prior to 1984, the exclusion at issue was made at the shareholder level and not at the entity level for both partnerships and S corporations.<sup>7</sup> In 1984, Congress cleaved a distinction between partnerships and S corporations by mandating that COD income exclusion with respect to S corporation shareholders only be made at the corporate level. As the Nelson court suggested, if Congress had intended a step-up in basis to accompany the recognition of excluded COD income at the shareholder level, it would have provided for statutory language reaching that result. (Id., at p. 122.)

Accordingly, respondent's action, subject to its concession stated in footnote 1, supra, is hereby sustained.

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<sup>7</sup> The legislative history of the 1984 amendments to section 108(d)(7)(A) states:

“In order to treat all shareholders in the same manner, the bill provides that the exclusion of income arising from the discharge of indebtedness and the corresponding reductions in tax attributes including losses which are not allowed by reason of any shareholder's basis limitations are made at the corporate level.”

(H. Rept. 98-432, at 1019 (1984).)

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of a proposed assessment of additional franchise tax in the amount of \$ 41,024 for 1994 be and the same is hereby sustained.

Done at Sacramento, California, this 22nd day of April, 1999, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Andal and Mr. Parrish present.

Johan Klehs \_\_\_\_\_, Chairman

Dean F. Andal \_\_\_\_\_, Member

\_\_\_\_\_, Member

Claude Parrish \_\_\_\_\_, Member

\_\_\_\_\_, Member