

COMMENT

THE TREATMENT OF CANCELLATION OF
INDEBTEDNESS INCOME OF INSOLVENT S
CORPORATIONS, *GITLITZ V. COMMISSIONER*:
A TAX CONTROVERSY OR AN EXAMPLE OF
THE EFFECTS OF JUDICIAL DECISION-
MAKING*

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* 2002 J.D. candidate from the University of Houston Law Center. This paper was selected as the recipient of the Chamberlain, Hrdlicka, White, Williams & Martin 2001 Writing Award for Distinguished Paper in Taxation.

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I. INTRODUCTION

*Gitlitz v. Commissioner*¹ and the divergence it created among the circuit courts² illustrates how judicial resolution of the

1. 182 F.3d 1143 (10th Cir. 1999), *affg* Winn v. Comm’r, 75 T.C. (CCH) 1840 (1998), *rev’d* 531 U.S. 206 (2001). In *Gitlitz*, the Tenth Circuit held that the tax attribute reduction scheme in I.R.C. § 108(b) must be applied at the corporate level. *See* 182 F.3d at 1151. As explained by the circuit court, this required the S corporation to offset its tax attributes under section 108(b), with any discharge of indebtedness income that is excluded from gross income under section 108(a), before such excluded income can pass through to the S corporation shareholders and be used by the shareholders to increase the basis in their stock. *Id.*

2. Other circuit courts have addressed the issue in *Gitlitz* and ruled differently on whether the tax attribute reductions under section 108(b) are made at the corporate level, thereby absorbing the “excluded income” (*i.e.*, the income from discharge of indebtedness (“DOI”) or cancellation-of-debt (“COD”) which is excluded from gross income under section 108(a) before it can pass through to S corporation shareholders and compel an upward adjustment in the basis of their stock. *See* Gaudiano v. Comm’r, 216 F.3d 524, 535 (6th Cir. 2000) (holding that “tax attributes [under § 108(b)], including shareholder suspended losses, must be reduced at the corporate level by the amount of COD income realized by the S corporation” and that “[i]f any COD income remains after losses and suspended losses are deducted, [then] that income may flow through to the shareholders pursuant to § 1366 and increase the shareholder’s basis pursuant to § 1367”), *vacated*, 531 U.S. 1108

simplest relationships between legal rules and their underlying policies has become a highly controversial issue in modern American jurisprudence.³ In the *Gitlitz* line of cases, the courts had to reconcile the interaction between the Internal Revenue Code (“Code”) sections governing income from discharge of indebtedness (“DOI”) or cancellation of debt (“COD”),⁴ with those governing the taxation of S corporations.⁵ In doing so, it was not unusual for the courts to rely on extrinsic sources to interpret the statutes and resolve the relationships between the applicable rules and policies.⁶

The *Gitlitz* line of cases generally follow the same fact pattern: An S corporation shareholder, relying on sections 1366 and 1367, takes a pro-rata share of DOI income, which has been excluded from gross income under section 108(a), and uses it to increase the basis in his S corporation stock so that he can take a deduction for ordinary or suspended losses.⁷ This results in a

(2001); *Pugh v. Comm’r*, 213 F.3d 1324, 1330 (11th Cir. 2000) (holding that “an S corporation’s COD income passes through pro-rata to its shareholders under [I.R.C.] § 1366(a)(1)” and that “§ 1367 requires [that the shareholder’s] basis be increased by the amount of COD income” without addressing whether the tax attribute reduction scheme under § 108(b) “occurs at the corporate level before the pass-through”), *cert. denied*, 531 U.S. 1111 (2001); *United States v. Farley*, 202 F.3d 198, 206 (3d Cir. 2000) (holding that “the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through” to the S corporation shareholders; therefore, “in the case of an insolvent S corporation, [DOI] income that is excluded from gross income by section 108(a), passes through to the shareholders, increases the shareholder’s basis in their S corporation stock” and thus allows the S corporation shareholders to take a deduction for suspended losses under section 1366(d)(1)), *cert. denied*, 531 U.S. 1111 (2001); *Witzel v. Comm’r*, 200 F.3d 496, 498 (7th Cir. 2000) (holding that *Witzel* “was rightly forbidden to deduct his existing suspended losses, because they were offset at the corporate level by the amount of his corporation’s COD income” in conformance with the Tenth Circuit’s decision in *Gitlitz*, but expressing the view that the rule did not necessarily prevent the S corporation shareholders from ever using the COD income to increase their stock basis), *vacated*, 531 U.S. 1108 (2001).

3. See KENNETH J. VANDEVELDE, THINKING LIKE A LAWYER 66 (1998) (positing that “[t]he relative role of rules and polices is perhaps the most debated issue in modern American jurisprudence”).

4. See I.R.C. § 108 (1994 & Supp. V 1999) (Income from Discharge of Indebtedness); see also discussion *infra* Part II.C. The terms cancellation of debt (“COD”) and discharge of indebtedness (“DOI”) are equivalent and used synonymously in this paper. See *Witzel*, 200 F.3d at 496 (explaining that “discharge of indebtedness” is equivalent to “cancellation of debt”).

5. See I.R.C. §§ 1366–1367; see also discussion *infra* Part II.A.

6. See *Pugh*, 213 F.3d at 1326 n.5, 1327–31; *Farley*, 202 F.3d at 206 n.5, 209–11; *Witzel*, 200 F.3d at 497–98; *Gitlitz*, 182 F.3d at 1149–50 & n.5.

7. See *Guadiano*, 216 F.3d at 526; *Pugh*, 213 F.3d at 1325; *Farley*, 202 F.3d at 199–200; *Witzel*, 200 F.3d at 496–97; *Gitlitz*, 182 F.3d at 1144–45. Suspended losses are the amount of ordinary losses that exceed a shareholder’s adjusted basis in the stock, and may be carried over indefinitely. See I.R.C. § 1366(a)(1), (d); see also *Nelson v. Comm’r*, 110 T.C. 114, 124 n.6 (1998) (defining suspended losses), *aff’d*, 182 F.3d 1152 (10th Cir. 1999).

substantial windfall for the shareholder because he receives the benefit of an increased basis in his stock at the economic expense of the S corporation's creditors.⁸

In *Gitlitz*, the Commissioner of the Internal Revenue Service ("IRS") was not pleased with the taxpayers receiving a kind of windfall. Therefore, the Commissioner assessed tax deficiencies against the shareholders on grounds that the taxpayers improperly used the excluded income to adjust the basis in their S corporation stock.⁹ The shareholders brought their case before the United States Tax Court.¹⁰ Initially, the tax court ruled in their favor, but reversed its decision on reconsideration.¹¹

The case was appealed to the Tenth Circuit, which also denied the shareholders their tax windfall and affirmed the lower court's ruling.¹² The Tenth Circuit emphasized that its decision was confined to excluded DOI income,¹³ stating that "discharge of indebtedness income, which is excluded from gross income under [section] 108(a), does not pass through to shareholders of subchapter S corporations."¹⁴

Some commentators believe that *Gitlitz* has caused the greatest tax controversy of the past two years.¹⁵ One commentator has even accused the Tenth Circuit of impermissible judicial legislation to create a foundation for its decision.¹⁶ The problem underlying these controversies stems

8. See *Nelson*, 110 T.C. at 128–30.

9. See *Gitlitz*, 182 F.3d at 1144.

10. See *Winn v. Comm'r*, 73 T.C.M. (CCH) 3167 (1997), *withdrawn*, 75 T.C.M. (CCH) 1840 (1998).

11. See *id.* at 3168–69; *Winn v. Comm'r*, 75 T.C.M. (CCH) 1840, 1841 (1998).

12. See *Gitlitz*, 182 F.3d at 1151.

13. See *id.* (emphasizing that *Gitlitz* "focuses only on excluded discharge of indebtedness income vis-à-vis insolvent subchapter S corporations").

14. *Id.* at 1145.

15. See James F. Loebel, *Does the Excluded COD Income of an Insolvent S Corporation Increase the Basis of Shareholders' Stock?*, 52 FLA. L. REV. 957, 957–58 (2000) (stating that whether shareholders can use COD income to increase the basis of their S corporation stock is "one of the most controversial issues in tax law" in the past two years). See also Gregg D. Polsky, *Another Gitlitz Windfall: Double Basis Increases for S Corp. Shareholders?*, 1 TAX NOTES TODAY 131-102 (July 9, 2001) (noting that *Gitlitz* "has been described and discussed extensively by courts and commentators"); Timothy R. Koski, *S Corporation Shareholders Allowed Tax Windfall: Supreme Court Resolves Controversy Regarding the Impact of Cancellation of Indebtedness Income on S Corporation Shareholders*, 77 N. DAK. L. REV. 247, 247–48 (2001) (pointing out that courts addressing *Gitlitz* "have differed significantly in both the result reached and the analysis used" and that commentators have "also disagree[d] on the proper resolution of the issue").

16. See Richard M. Lipton, *The Impact of Excluded COD Income on S Shareholders—The Tenth Circuit Gets Lost in Gitlitz*, 91 J. TAX'N 197, 197 (1999) (stating that the Tenth Circuit was unhappy with the Tax Court's reasoning and developed its own reasoning to reach its desired result; concluding that when courts legislate in this

from conflicts among the courts in their judicial decision making and statutory interpretations.

The *Gitlitz* line of cases reflect the idea that the outcome of any case depends on the method of judicial decision-making that the judges apply.¹⁷ In the circuit court decisions, the courts applied the same statutes to similar fact patterns, yet their decisions diverged because they employed different methods of judicial decision-making. Included in the different judicial decision-making themes are the modern natural law method, the formalistic method, and the Holmesian method.¹⁸

While none of the circuit court decisions are necessarily wrong, the Tenth Circuit's opinion is the most vivid display of the "competing" theory of judicial decision-making.¹⁹ When compared to the other decisions, the Tenth Circuit's reasoning is attenuated; the court developed an extrinsically supported and unorthodox line of logic to deny a windfall to the shareholders of an insolvent S corporation.²⁰

Given the controversy in these cases over the meaning and interaction of the relevant Code sections, *Gitlitz* has placed the statutes in a state of flux and has resulted in confusion among the IRS, the courts, practitioners, and taxpayers.²¹ The Supreme Court recently ended the confusion among the circuit courts by conducting a simple review of the "plain language"²² of the applicable statutes²³ to conclude that "the discharge of indebtedness passes through before any attribute reduction takes place,"²⁴ thus allowing the shareholders the windfall they had been seeking.²⁵

manner, the result is often confusing).

17. See discussion *infra* Part III.

18. See discussion *infra* Parts III & V.

19. See *infra* notes 76, 135–54, 169–74 and accompanying text.

20. See discussion *infra* Part IV.C.

21. See discussion *infra* Parts V & V.A.

22. See R. Randall Kelso, *Statutory Interpretation Doctrine on the Modern Supreme Court and Four Doctrinal Approaches to Judicial Decision-Making*, 25 PEPP. L. REV. 37, 51 (1997) (stating that some courts have construed the Plain Meaning Rule too narrowly by restricting a court from considering intrinsic materials associated with a statute and that such a narrow use of the rule is not a proper application); see also *infra* notes 98–105 and accompanying text (detailing the Plain Meaning Rule).

23. See *Gitlitz v. Comm'r*, 531 U.S. 206, 212–18 (2001) (detailing how "[t]he sequencing question is expressly addressed in the statute").

24. See *id.* at 217 n.7.

25. See *Gitlitz v. Comm'r*, 182 F.3d 1143, 1147 (10th Cir. 1999) (noting that the taxpayers "acknowledge the windfall, but insist the statutory language dictates such a result").

The impact of the Supreme Court's decision is threefold but the magnitude of its effect is likely to be minimal. First, the holding applies only to insolvent S corporations having DOI prior to 1998 when new treasury regulations went into effect.²⁶ Its primary effect may be to cause the small number of qualifying taxpayers to file amended returns or apply for refunds. The decision may also cause the Tax Court and circuit courts to limit their use of extrinsic sources in interpreting the Code. In addition, these courts may look more cautiously at the plain language of a statute before resorting to the legislative history to resolve a created or perceived ambiguity.

Secondary effects of the holding also are likely to be minimal. For instance, book publishing and changes to standard documents will not be greatly affected because they are usually updated each year anyway. The decision could prompt President G. W. Bush to ask Congress to close the loophole,²⁷ or it could set the stage to invalidate the new treasury regulations. Moreover, it is difficult to imagine the holding of this case rapidly spreading to other business forms such as partnerships because the Court opinion focused only on excluded DOI income vis-à-vis insolvent S corporations.²⁸

Part II of this paper introduces the applicable statutes and provides a working analysis of subchapter S. Part III explains the general theory of legal reasoning and the methods of judicial decision-making. This part also states which theories of interpretation are used by each Justice on the current Supreme Court and uses the principles of statutory interpretation to provide a critical interpretation of IRC § 108(b)(4)(A). Part V outlines the pertinent facts of *Gitlitz* and explains the Tenth Circuit's holding and reasoning. Part VI analyzes the opinions of the Tax Court and the circuit courts. Additionally, this part describes the confusion among the courts, the commissioner, taxpayers and commentators, and then discusses practical issues and tax consequences of these decisions on shareholders of S corporations. Part VII concludes that the Tenth Circuit legislated when it should have followed the Calbresi model to prompt action by Congress.

26. In 1999, the Treasury published final regulations adopting the position that excluded DOI income does not pass through to S corporation shareholders. See Treas. Reg. § 1.1366-1(a)(2)(viii) (1999); see also *infra* note 283 and accompanying text. The regulations further state that it applies only to "taxable years of an S corporation beginning on or after August 18, 1998." Treas. Reg. § 1.1366-5 (1999).

27. See discussion *infra* Part V.E.

28. See *Gitlitz*, 531 U.S. at 208-09.

II. THE APPLICABLE STATUTES: A FRAMEWORK FOR DISCHARGE OF INDEBTEDNESS INCOME OF S CORPORATIONS

The legal issue to be decided in *Gitlitz* is whether income from the discharge of indebtedness of an insolvent S corporation, that is excluded income of the S corporation, passes through to the shareholders and increases the basis of their stock thereby allowing them to claim deductions for suspended losses.²⁹ The circuit courts³⁰ agree that the key to deciding this issue is to understand “how the relevant statutory provisions interact.”³¹ The relevant provisions are found in the sections of the Code that govern the treatment of COD income and taxation of S corporations.³²

Generally, subchapter S describes the taxation of S corporations and section 108 provides the rules for treatment of COD income. Subchapter S includes the rules for passing items of income, losses, deductions, and credits through the S corporation to shareholders and provides the framework for increasing and decreasing the basis of S corporation stock.³³ These subchapter S provisions have to be reconciled with the section 108 provisions, which allow a taxpayer to exclude COD from gross income in some situations,³⁴ and with section 61, which defines and lists sources of gross income.³⁵

29. See *Gitlitz*, 182 F.3d at 1144–45, 1147–48 (reviewing the transaction; stating that the outcome of the case is determined by the timing of the pass-through; and explaining the effect of attribute reduction and basis adjustments).

30. Courts other than the circuit courts have also considered this issue. These cases are not addressed here because they follow one of the circuit court or Tax Court opinions. See, e.g., *Hogue v. United States*, Civ. No. 99-302-KI, 2000 U.S. Dist. LEXIS 601, at *6 (D. Or. Jan. 30, 2000).

31. *United States v. Farley*, 202 F.3d 198, 204, (3d Cir. 2000) (stating that “[t]he key to unraveling this case is understanding how the relevant statutory provisions interact”); see also *Gaudio v. Comm’r*, 216 F.3d 524, 534 (6th Cir. 2000) (recognizing, as the Tenth Circuit did, that the timing of the attribute reduction brings two subparagraphs of section 108 into conflict with each other); *Pugh v. Comm’r*, 213 F.3d 1324, 1326 (11th Cir. 2000) (stating that “[t]he answer involves the interplay between the way the Code treats COD income and the way the Code treats the tax liability of S corporation shareholders”); *Witzel v. Comm’r*, 200 F.3d 496, 497 (7th Cir. 2000) (stating that the government’s interpretation is possibly correct but that it ignores the references and interaction between subparagraphs (b) and (d) of section 108).

32. See I.R.C. §108 (1994 & Supp. V 1999); *id.* §§ 1361–1379 (Subchapter S provisions).

33. See *Farley*, 202 F.3d at 204 (stating that section 1366 “describes how and when income, losses, and deductions, and credits pass through to S corporation shareholders” and section 1367 “sets forth the framework for increasing and decreasing the basis of S corporation stock”).

34. See *id.* (stating that sections 1366 and 1367 “must be read in conjunction with section 108”); see also discussion *infra* Part II.C.

35. See I.R.C. § 61 (1994); see also discussion *infra* Part II.B.

A. *S Corporations Generally*

S corporations are corporations that make a valid election to be taxed as a small business corporation.³⁶ S corporations are not subject to the corporate income tax under the Code.³⁷ Instead, the tax character of items passes through to shareholders in a manner similar to the way that partnerships pass items through to partners.³⁸ Stated another way, the items of income or losses that the shareholder receives from the S corporation have the same character as if the shareholder realized these items from the same source as the corporation. Therefore, S corporation shareholders merely report their pro rata share of the S corporation's income and losses on their tax returns.³⁹ Assuming the S corporation has no accumulated earnings and profits, then the distributions are taxable to the shareholder only to the extent that they exceed the shareholder's adjusted basis⁴⁰ in the S corporation stock.⁴¹

The basis adjustment rules of subchapter S are essential to the tax regime that allows these items to flow through. Under

36. See I.R.C. §1362(a)(1) (providing that "a small business corporation may elect, in accordance with provisions of this section, to be an S corporation").

37. See *id.* § 1363(a) (stating the general rule that S corporations shall not be subject to income tax under Subtitle A, Chapter 1, except as provided for in subchapter S).

38. See *id.* § 1366(a)–(b); see also *Gitlitz v. Comm'r*, 182 F.3d 1143, 1146 (10th Cir. 1999) (explaining that S corporations are taxed in a similar fashion as partnerships); *Loebl*, *supra* note 15, at 959–60 (discussing the similarities in the income recognition rules of S corporations and partnerships).

39. See I.R.C. §1366(a)(1) (requiring shareholders to take into account their "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, and (B) nonseparately computed income or loss"); see also BORRIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATION AND SHAREHOLDERS* ¶ 6.06[3], at 6-24 (6th ed. 1998) (explaining that "shareholders . . . consolidate their allocated shares of [S corporation income, loss, deductions, and credits] with any similar items arising from their individual activities, reporting the aggregated amounts on their individual returns subject to any pertinent restrictions or elections").

40. Generally, the basis of corporate stock, assets, or other property is its acquisition cost, subject to special rules for property acquired in a manner other than purchase, such as property acquired by bequest or gift. See *BLACK'S LAW DICTIONARY* 151–52 (6th ed. 1990). In regards to S corporation stock, the shareholders are required, at the end of the corporation's taxable year, to adjust the basis of their stock by their share of items of income, loss, and deduction. See *JACOB MERTENS, JR., MERTENS LAW OF FEDERAL INCOME TAXATION* § 41B:147 (2001), at WL Mertens § 41B:147; see also *infra* notes 43–45 and accompanying text.

41. See I.R.C. § 1368(b)(2). Section 1368(b)(2) provides in pertinent part that:
In the case of a distribution [of property to which section 301(c) would otherwise apply] by an S corporation which has no accumulated earnings and profits . . . [i]f the amount of the distribution exceeds the adjusted basis of the stock, [then] such excess shall be treated as gain from the sale or exchange of property.

Id.

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these rules, shareholders are generally allowed to increase the basis of their stock by the their pro rata share of the corporation's items of income, including tax-exempt income, and to reduce their basis by taking their pro rata share of the corporation's losses, deductions, or credits that would affect the shareholder if the item was treated separately.⁴² The increase in basis eliminates the double taxation associated with corporate earnings.⁴³ Furthermore, each increase in basis allows the

42. See I.R.C. § 1367(a)(1)–(2). The following is the general rule under section 1367(a)(1) and (2) for increases and decreases in S corporation stock basis:

(1) Increases in basis.—The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis.—The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

Id.; see also BITTKER & EUSTICE, *supra* note 39, ¶ 6.06[4][a], at 6-25 (describing the adjustments made to a S corporation shareholder's stock basis).

43. See *Gitlitz*, 182 F.3d at 1146 (stating that double taxation is prevented because shareholders are required "to adjust their corporate basis by the items identified in § 1366(a)"). The court provided the following example to explain how the statutes operate:

Assume the sole shareholder of a subchapter S corporation has a basis of \$100 in the corporation's stock. The corporation realizes \$200 in taxable income. At the end of the tax year, the shareholder pays tax on the \$200 of income under the pass through principles described above. The corporation distributes the \$200 to the shareholder the following year. In the absence of an upward basis adjustment, the shareholder would be liable for additional tax upon the distribution pursuant to § 1368(b)(2)

taxpayer to raise the limit on losses under section 1366(d)(1).⁴⁴ This regime leads to the fact pattern examined in the *Gitlitz* line of cases: the S corporation is insolvent and has no regular items of income to pass through, the shareholder's basis has been reduced to zero, and the only alternatives for increasing basis to deduct ordinary or suspended losses are to contribute capital or attempt to use excluded DOI.⁴⁵

B. *Discharge of Indebtedness Income: Section 61(a)(12)*

An analysis of tax cases generally begins by determining the taxpayer's gross income.⁴⁶ Gross income is defined broadly in section 61 of the Code with the catchall phrase "gross income means all income from whatever source derived."⁴⁷ Section 61

because the amount of the distribution (\$200) exceeds his preexisting basis in the stock. Sections 1366 and 1367 prevent this double taxation by mandating a \$200 basis increase when the corporation first realizes the income and a \$200 basis decrease upon the corporation's distribution of the income.

Id. at 1146–47; see also David E. Lampp, *S Corporations and Absorption of Discharged Debt Income "At the Corporate Level": Gitlitz v. Commissioner*, 53 TAX LAW. 543, 544 n.8 (2000). Lampp states:

Absent a basis increase, corporate earnings would be taxed once in the year in which they are income to the corporation due to the pass-through mechanism for S corporations. They would be then taxed again in the year in which they were distributed to the shareholder, if the amount of the distribution was greater than the shareholder's basis in the corporation. This would always be the case for a corporation like PDW & A [sic](the taxpayer's corporation in *Gitlitz*), which has no earnings or profits of its own.

Id. (citations omitted).

44. See I.R.C. § 1366(d)(1). Section 1366(d)(1) provides that losses and deductions: (1) Cannot exceed shareholder's basis in stock and debt.—The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

Id.; see also *id.* § 1366(a)–(b).

45. This is the general scenario in the cases discussed herein, except that the shareholders look to the excluded DOI to provide the basis increase. See *supra* notes 7–8 and accompanying text. While it may seem strange that a taxpayer would contribute funds to an insolvent corporation, the shareholder could be bullish on the corporation, believing that the company will recover and be profitable in the future.

46. See MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 8 (8th ed. 1999) (stating that "gross income" is the starting point for a study of the federal income tax").

47. I.R.C. § 61(a) (1994); see also CHIRELSTEIN, *supra* note 46, at 8.

provides an exhaustive list of items of income that includes “most or all of the common classes of income—salaries, wages, business profits, dividends, . . . [and] income from the discharge of indebtedness.”⁴⁸

Section 61(a)(12), income from discharge of indebtedness, operates consistently with the rule that borrowed funds are not included in the debtor’s gross income because the debtor has an offsetting obligation to repay the loan.⁴⁹ However, section 61(a)(12) may cause a debt to be characterized as income to the taxpayer.

Section 61(a)(12), DOI income, operates when a creditor releases or no longer requires a debtor to repay an outstanding debt.⁵⁰ When section 61(a)(12) applies, it “requires a taxpayer who has incurred a financial obligation, which is later discharged in whole or in part,” to recognize taxable income in the amount of the discharge.⁵¹ However, COD income may not always result in gross income because the Code also includes rules that may operate to limit the scope of, or provide an exception to, the general rule. The limiting rules often identify circumstances and situations where the general rule does not apply.⁵² Sections 101 through 135 of the Code function as rules that limit or provide exceptions to the definition of gross income under section 61.⁵³

48. CHIRELSTEIN, *supra* note 46, at 8; *see also* I.R.C. § 61(a)(12) (defining gross income to include “income from discharge of indebtedness”).

49. *See, e.g.*, U.S. v. Centennial Savings Bank FSB, 499 U.S. 573 (1991). In *Centennial*, the Court states:

Borrowed funds are excluded from income in the first instance because the taxpayer’s obligation to repay the funds offsets any increase in the taxpayer’s assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of his debt, and the basis for the original exclusion thus evaporates.

Id. at 582 (citing U.S. v. Kirby Lumber Co., 284 U.S. 1, 3 (1931); *Comm’r v. Jacobson*, 336 U.S. 28, 38 (1949)). Stated another way, borrowing money does not result in income to the borrower because his net worth is the same before and after the transaction. For example, consider a debtor’s balance sheet in isolation as to a new loan. Prior to the borrowing transaction, the debtor has no assets but also has no liabilities. After the transaction, the debtor has new assets in the form of cash but also has an offsetting liability to the creditor making the change in his net worth equal to zero.

50. *See* Robert A. Briskin, *The Treatment of Cancellation of Debt Income by S Corporations*, L.A. LAW., June 2000, at 24 (listing examples of financial events in the case of an S corporation that can result in COD income).

51. *See* Gitlitz v. *Comm’r*, 182 F.3d 1143, 1147 (10th Cir. 1999); *see also* I.R.C. § 61(a)(12).

52. *See* VANDEVELDE, *supra* note 3, at 42 (stating that in synthesizing the applicable laws in a case one may identify rules that “serve as a limitation on the scope of another rule . . .”).

53. *See* I.R.C. §§ 101–135 (1994 & Supp. V 1999) (enumerating exclusions and

C. *Section 108: The Bankruptcy and Insolvency Exceptions to Section 61(a)(12)*

Section 108(a)(1) provides an exception to the broader provision of section 61(a)(12) for discharge of indebtedness and identifies specific situations where DOI does not result in income.⁵⁴ In the line of cases considered for this article, DOI income is excluded from gross income if the discharge of the debt occurs when the taxpayer is insolvent.⁵⁵ Therefore, for purposes of this analysis, section 108(a)(1)(B) provides the general rule that if the taxpayer is insolvent at the time of the discharge then the COD income is excluded from gross income.⁵⁶ These special situations in section 108(a) are supported by the tax policy that seeks to provide bankrupt or insolvent taxpayers with a clean slate by allowing them to emerge from financially difficult conditions without paying tax on COD income.⁵⁷ These provisions allow taxpayers to leave the local U.S. Bankruptcy Court and have a fresh start because they do not have to pay the IRS at the court's exit door.⁵⁸ However, commentators agree that

deductions in the Code).

54. *See id.* § 108(a)(1). Section 108(a)(1) provides in pertinent part:

Gross income does not include any amount which . . . would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

(C) the indebtedness discharged is qualified farm indebtedness, or

(D) in the case of taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Id.; *see also* *Gitlitz*, 182 F.3d at 1147 (stating that section 108(a)(1) provides an exception to section 61(a)(12) which requires the taxpayer to recognize COD income).

55. *See* *Pugh v. Comm'r*, 213 F.3d 1324 (11th Cir. 2000); *United States v. Farley*, 202 F.3d 198 (3d Cir. 2000); *Witzel v. Comm'r*, 200 F.3d 496 (7th Cir. 2000); *Gitlitz v. Comm'r*, 182 F.3d 1324 (10th Cir. 1999). Insolvency is generally defined as a “[f]inancial condition such that businesses’ or person’s debts are greater than the aggregate of such debtor’s property at a fair valuation.” BLACK’S LAW DICTIONARY 797 (6th ed. 1990). Under section 108(d)(3), the Code defines insolvency as “the excess of liabilities over the fair market value of assets.” I.R.C. § 108(d)(3).

56. *See supra* note 54.

57. *See* Kenneth J. Kies, *Taking a Fresh Look at the Stock-for-Debt Exception*, 56 TAX NOTES 1619, 1624 (1992) (stating that exclusion from income of amounts realized on the cancellation of indebtedness by bankrupt or insolvent debtors under section 108 is deemed advisable to reconcile economic policies with tax policies).

58. *See id.* (stating that section 108 is sufficient to satisfy the bankruptcy policy that a debtor in financial distress should be given a fresh start); *see also* S. REP. NO. 96-1035, at 10 (1980) (stating that to provide “the debtor’s ‘fresh start’ after bankruptcy, the [Bankruptcy Tax Act] provides no income recognized due to debt discharge in bankruptcy,

Congress intended to provide taxpayers with a “fresh start” but not a “head start.”⁵⁹

The insolvency exclusion in the case of shareholders and S corporations leads to two questions in the cases explored in this article. First is the classic tax question: who is the taxpayer? The second question is: when is the test of insolvency applied? Section 108(d) defines the elements of the insolvency exclusion and describes how they apply to S corporations.⁶⁰

Stated another way, the first question is: Who is the taxpayer, the S corporation or the shareholder? In the cases examined in this article, the courts agree that for purposes of section 108, the taxpayer is the S corporation and therefore insolvency is determined at the corporate level.⁶¹ The second question is answered by section 108, which provides that insolvency is “determined . . . immediately before the discharge.”⁶²

While the COD exclusion is beneficial to the taxpayer who is relieved of an obligation to pay tax on COD income, both courts and commentators have noted that Congress intended that a taxpayer must pay a “price”⁶³ for this exclusion by reducing his

so that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability”).

59. See Kies, *supra* note 57, at 1620 (explaining the operation of tax attribution under section 108 “so that bankrupt or insolvent debtors who receive a ‘fresh start’ by having their debts cancelled do not also get a ‘head start’ against other taxpayers similarly situated . . .”); Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. TAX REV. 1, 112 (1990) (stating that “Congress intended section 108 to operate as a ‘fresh start’ from a federal income tax perspective” and that “the government must guard against interpretations of section 108 that operate to provide a ‘head start’ rather than a ‘fresh start’”).

60. See I.R.C. § 108(d) (1994 & Supp V 1999).

61. See *id.* § 108(d)(7)(A) (stating that “[i]n the case of an S corporation, [section 108](a) . . . shall be applied at the corporate level”); see also Pugh v. Comm’r, 213 F.3d 1324, 1327 (11th Cir. 2000) (stating that “[i]n the case of S Corporations, [section 108] ‘shall be applied at the corporate level’”); United States v. Farley, 202 F.3d 198, 205 (3d Cir. 2000) (stating that “section 108(d)(7)(A) requires the solvency determination in section 108(a)(1)(b) to be made at the corporate level”); Witzel v. Comm’r, 200 F.3d 496, 497 (7th Cir. 2000) (stating that “[i]n the case of subchapter S corporations, [section 108] ‘shall be applied at the corporate level’”); Gitlitz v. Comm’r, 182 F.3d 1143, 1148 (10th Cir. 1999) (stating that “[w]ith subchapter S corporations, [section 108] . . . ‘must be applied at the corporate level’” (emphasis added)).

62. See I.R.C. § 108(d)(3). This section provides in pertinent part that “[w]ith respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer’s assets and liabilities immediately before discharge.” *Id.*

63. See, e.g., Gitlitz, 182 F.3d at 1147 (stating that the “[e]xclusion of discharge of indebtedness from gross income, however, does not come without a price”); see also Farley, 202 F.3d at 203 (stating that “[t]he exclusion of discharge of indebtedness income from gross income provided for in section 108(a)(1)(B) is not without a price”); Richard M. Lipton, *Different Courts Adopt Different Approaches to the Impact of COD Income on S*

tax attributes listed in section 108(b)(2) in the order specified in section 108(b).⁶⁴ In the case of an S corporation, like the test for insolvency, attribute reduction takes place at the corporate level.⁶⁵ “The first tax attribute to be reduced . . . is the net operating loss.”⁶⁶ The “price” exclusion thus becomes evident given the rule that “for purposes of attribute reduction, the shareholders’ suspended losses for the taxable year of discharge are to be treated as the S corporation’s net operating loss.”⁶⁷ Finally, the most important and most widely disputed issue among the courts is the timing of the attribute reduction.

The judicial decision-making method and rules of statutory interpretation that the courts apply to determine the timing of the attribute reduction becomes crucial to the outcome and results of the cases. Section 108(b)(4) states that “[t]he [attribute] reductions described in [section 108(b)(2)] shall be made after the determination of the tax imposed by this chapter for the taxable year of discharge.”⁶⁸

Corporations, 92 J. TAX’N 207, 209 (2000) (stating that “[t]he price for this exclusion is the reduction under Section 108(b) of tax attributes that otherwise might yield future tax benefits”).

64. See I.R.C. § 108(b)(1)–(2) (1994) (stating that tax attributes are reduced in the following order: (1) net operating losses (“NOL”) for the year of the discharge, and any NOL carryover to such taxable year; (2) general business credits under section 38, carried over to or from the year of discharge; (3) minimum tax credits under section 53(b); and (4) capital losses and capital loss carryovers).

65. See *id.* § 108(d)(7)(A) (providing that in Title 11 and insolvency cases attribute reductions shall be applied at the corporate level). *But compare id.* § 108(d)(6) (stating that in the case of partnerships, attribute reduction shall be applied at the partner level).

66. See *Gitlitz v. Comm’r*, 531 U.S. 206, 216–17 (2001) (citing section 108(b)(2)(A)); see also James D. Lockhart & James E. Duffy, *Tax Court Rules in Nelson That S Corporation Excluded COD Income Does not Increase Shareholder Stock Basis*, 25 WM. MITCHELL L. REV. 287, 291–92 (1999) (stating that the first attribute to be reduced is net operating losses and that the taxpayer may also elect to reduce the basis of depreciable property).

67. See *Gitlitz*, 531 U.S. at 217; see also Briskin, *supra* note 50, at 26, 49 n.7 (stating that S corporation suspended losses are included in the attribute reduction). *But see* Lockhart & Duffy, *supra* note 66, at 299 stating that:

By reading these Sections in the way that most commentators and the authors submit is the correct interpretation, Section 108(d)(7) does not operate to convert shareholder suspended losses into S corporation NOLs. Rather, Section 108(d)(7) requires that the insolvency determination and the reduction of S corporation attributes, not including the suspended losses of the shareholders, occur at the corporate level. Suspended losses are the S corporation equivalent of a C corporation’s NOL carryover. By treating suspended losses as an NOL carryover, Section 108(d)(7)(B) provides the mechanism by which the shareholder attribute (suspended losses) will be subject to the existing corporate attribute reduction regime under 108(b)(2)(A).

68. See I.R.C. § 108(b)(4). One must almost immediately question how the attribute reduction could possibly be determined during the year of the discharge when the Code

The courts have battled over the timing of attribute reduction because the parties in this line of cases argue that it can be interpreted in two different ways. The first interpretation is that attribute reduction precedes the pass-through, and therefore has the effect of net operating losses and suspended losses, which absorbs the DOI before the DOI can pass to shareholders.⁶⁹ The other interpretation is that attribute reduction occurs after pass-through. This interpretation has the effect of passing DOI through to shareholders who can then increase their stock basis by the amount of the DOI and possibly deduct net operating losses, suspended losses, or capital losses.⁷⁰ The effect of this interpretation can result in a tax windfall to the shareholder.⁷¹

The resulting question is how could several courts be presented with the same facts and rules, and yet reach completely opposite decisions.⁷² The divergence of opinion may be attributed to the courts' use of different methods of judicial decision-making and differing applications of the rules of statutory interpretation.

III. PRINCIPLES OF STATUTORY INTERPRETATION: THE CRITICAL INTERPRETATION OF SECTION 108(B)(4)(A)

The two theories developed to explain how judges apply rules and policies to interpret statutes that are not determinate⁷³

says for the taxable year. A taxpayer could never determine his tax liability before the taxable year has ended. *See* Loebel, *supra* note 15, at 980 (stating that tax liability cannot be determined until the taxable year closes, thus the attribute reduction "takes place as of the beginning of the taxable year succeeding the taxable year of the discharge").

69. *See, e.g.*, *Gitlitz v. Comm'r*, 182 F.3d 1143, 1148 (10th Cir. 1999) (affirming that attribute reduction takes place at the corporate level and that DOI income does not pass through to shareholders). For example, if an S corporation had DOI of \$100,000 and losses of \$100,000, then \$0 would be passed through to shareholders on a pro rata basis because the loss attribute would be fully absorbed by the DOI. *See id.* at 1150 n.6 (demonstrating in examples one and three that DOI is absorbed at the corporate level to the extent of losses and that any excess is disregarded DOI).

70. *See, e.g.*, *United States v. Farley*, 202 F.3d 198, 206 (3d Cir. 2000) (explaining the court's view that while attribute reduction takes place at the corporate level, DOI income passes through to shareholders which increases their basis in the stock by this amount). For example, if an S corporation had DOI of \$100,000 and losses of \$100,000, the \$100,000 DOI income would be passed through to shareholders on a pro rata basis that they could use to increase their stock basis and thus offset previously suspended losses. *See id.* at 205-06 & n.4 (explaining that the Third Circuit does not agree and holding that tax attribute reduction takes place after DOI passes through).

71. *See Gitlitz*, 182 F.3d at 1147.

72. *See supra* notes 1-2.

73. *See* Lawrence B. Solum, *On the Indeterminacy Crisis: Critiquing Critical Dogma*, 54 U. CHI. L. REV. 462, 462 (1987) (explaining the indeterminacy thesis as "the existing body of legal doctrines - statutes, administrative regulations, and court decisions

are (1) the orthodox theory and (2) the competing theory.⁷⁴ “The orthodox theory is that judges apply rules through the logical processes of deduction and analogy, turning to policies only in the occasional *hard* case.”⁷⁵ “The competing theory is that judges in reality intuit the best result, that is, the result that is most

[that] permits a judge to justify any result she desires in any particular case” and noting that “the idea is that a competent adjudicator can square a decision in favor of either side in any given lawsuit with the existing body of legal rules”).

74. See VANDELDE, *supra* note 3, at 66.

75. See *id.*; see also Solum, *supra* note 73, at 473. Solum states that:

The rhetoric about easy cases and hard cases is useless unless we first flesh out exactly what is meant by “easy” and “hard” cases and by “indeterminacy.” The distinctions between determinacy, indeterminacy, and a third concept – “underdeterminacy” – can be explained by considering the relationship between two sets of possible results of a given legal dispute. The first set consists of all imaginable results – the set of all the various orders that a judge could issue, however ridiculous or improbable. The second set consists of results that can be squared with the law – the set of all legally reasonable outcomes. “Law” means the legal materials taken as whole, including constitutions, statutes, and case law. On this basis, I offer the following definitions:

– The law is *determinate* with respect to a given case if and only if the set of results that can be squared with the legal materials contains one and only one result.

– The law is *indeterminate* with respect to a given case if and only if the set of results in the case that can be squared with the legal materials is identical with the set of all imaginable results.

– The law is *underdeterminate* with respect to a given case if and only if the set of results in the case that can be squared with the legal materials is a nonidentical subset of the set of all imaginable results.

* * * *

We also should consider precisely why some cases are considered “hard.” I offer two related formulations of the concept of a “hard case”:

– Cases are “hard” when they are underdeterminate in a way such that the judge must choose among legally acceptable results that include outcomes that constitute victory (or loss) for each litigant, or various combinations of victory (or loss) for all parties to the litigation.

– Hard cases are those in which the judge’s choice among the set of legally acceptable results will substantially affect a significant practical interest of the litigants.

The main point of these formulations is that a case need not be completely indeterminate to be hard; cases that are underdeterminate can also be hard.

Id. at 473.

satisfactory to them as a matter of policy, and only then do they turn to the rules to explain and justify the result they have reached on other grounds.”⁷⁶ Professor Vandeveldel believes that judges applying the competing theory may feel good about their decisions or have the “sensation of following the rules.”⁷⁷ He suggests cautious use of this method because a judge’s interpretation is based on his or her initial decision of the best result in the case and, therefore, application of this theory only “seem[s] to produce the correct result.”⁷⁸ However, commentators appear to agree that courts need the power to interpret statutes because the law is often written in a very general form.⁷⁹ But, some commentators claim that indeterminacy allows a judge to decide a case for either party merely through skillful or artful application of the existing body of legal rules.⁸⁰

Two of the methods available to help courts determine rights or duties under certain factual predicates and general rules are deduction or analogy.⁸¹ The application of either of these methods often leads to indeterminacy because a court cannot determine with sufficient certainty whether the facts of the case are described by or are similar enough to the factual predicate of the rule.⁸² If application of these methods leads the court to an indeterminate result, then the court *must* turn to extrinsic sources and the underlying policies of the law to determine the

76. See VANDEVELDE, *supra* note 3, at 66.

77. *Id.*

78. *Id.*

79. See Stephen Breyer, *The 1991 Justice Lester W. Roth Lecture: On the Issues of Legislative History in Interpreting Statutes*, 65 S. CAL. L. REV. 845, 854 (1991) (stating his opinion that rules are of a general form and lack precision because drafters fear that they will not be able to imagine every possible set of facts that should be covered by a statute and noting that the lack of precision is not a basis for criticizing the legislature because if the legislature could envision all possible circumstances, courts would not need the power to interpret statutes, but only the power to find facts); see also VANDEVELDE, *supra* note 3, at 68–69 (citing an example from tort law concerning the word “touching” in the context of battery to demonstrate that the word “touching” is so general that it creates problems of indeterminacy and dispute among lawyers as to its proper definition).

80. See Solum, *supra* note 73, at 462 (criticizing the “indeterminacy” thesis); see also Caleb Nelson, *Stare Decisis and Demonstrably Erroneous Precedents*, 87 VA. L. REV. 1, 48 (2001).

81. See VANDEVELDE, *supra* note 3, at 67–100 (describing the use of analogy and deduction in legal reasoning). A lawyer using deduction determines whether or not the facts of a case *are described* by the factual predicate of a rule of law in determining whether or not the legal consequences imposed by the rule of law applies. See *id.* at 75 (emphasis added). A lawyer using analogy determines whether or not the facts of a case *are similar enough to those described* by the factual predicate of a rule of law in determining whether or not the legal consequences imposed by that rule apply to the case. See *id.* at 87.

82. See *id.* at 67–68 (presenting an example of the factual predicate in the context of a battery).

rights and duties that exist in the case.⁸³ Applying policies to a case involves a process that does not require the use of deduction or analogy, but instead requires weighing the costs and benefits of the policies and assessing the relationship between the means and the end.⁸⁴ As courts have employed these basic theories over time, common methods of judicial decision-making have evolved.

Professor Kelso claims that there are “four major judicial decision making styles: natural law, formalism, Holmesian, and instrumentalism.”⁸⁵ With the exception of the instrumentalism, which rarely appears in today’s opinions, each style is outlined below.⁸⁶

The natural law approach is one that focuses on the intent of the framer and has great respect for precedent and judges exercising “practical reason” to resolve conflicting interpretations.⁸⁷ It “calls for a judge to interpret a statute in light of the framers’ intent, as revealed by the traditional sources for determining intent.”⁸⁸ Traditional sources of intent include the plain meaning of the words of the statute, the law’s purpose or “mischief to be remedied,” and maxims of statutory construction.⁸⁹ As Justice Breyer noted and Professor Kelso and others agree, judges operating under the natural law approach appear to understand the limits of a drafter’s human capacity to express his or her intent perfectly with the literal use of words.⁹⁰ Therefore, a judge using the natural law approach would make an inquiry into the purpose and intent behind the words after determining the ordinary meaning of words used in the statute.⁹¹ The early natural law approach limited the use of legislative

83. *See id.* at 64–68.

84. *See id.* at 65.

85. Kelso, *supra* note 22, at 41–58, 41 n.20 (outlining the four doctrines and noting other sources authored or co-authored by R. Randall Kelso); *see also* VANDEVELDE, *supra* note 3, at 109–40 for a broader discussion and historical perspective on these theories and their application.

86. *See* Kelso, *supra* note 22, at 59 & n.111 (stating that “the modern Supreme Court has rejected the judicial creativity approach of instrumentalism” and that “[s]uch judicial creativity or policy-making typically appears today only in the occasional opinion from Justice Stevens in dissent”).

87. *See id.* at 41–44, 41 n.21 (defining the natural law approach and citing additional references discussing framer’s intent and natural law).

88. *Id.* at 41

89. *See infra* notes 98–105 and accompanying text; *see also* Kelso, *supra* note 22, at 41–42 (noting that intent can be determined by applying traditional maxims of statutory construction); VANDEVELDE, *supra* note 3, at 70–73 (providing an excellent summary of statutory interpretation rules based on textual analysis).

90. *See* Breyer, *supra* note 79, at 854 (referring to the limit of the willingness of a drafter to attempt to include all of the circumstances); *see also* Kelso, *supra* note 22, at 42.

91. *See* Kelso, *supra* note 22, at 42.

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history to cases of interpreting ambiguous statutes whose plain meaning could lead to an absurd result.⁹² The modern natural law approach takes a broader view and suggests always resorting to the legislative history to determine legislative intent.⁹³

Under a formalistic approach a lawyer or judge applies existing positive law that likely “tout[s] the virtues of following the original positive intent of the legislature”⁹⁴ A formalist sees the law as “a science, like biology or physics.”⁹⁵ Formalist judges prefer mechanical application of clear, bright-line rules because inquiries into the intent of the legislature can be difficult.⁹⁶ In the face of an inquiry into the original intent of the legislature, these judges are more likely to turn away and determine merely the ordinary meaning of the words of the statute.⁹⁷

According to Professor Kelso, three variations of the formalistic approach exist: the Golden Rule, the Plain Meaning Rule, and the Literal Rule.⁹⁸ Only the Golden Rule and the Plain Meaning Rule are discussed here because the Literal Rule is an extreme approach not often followed in the United States.⁹⁹ In the famous case of *Hamilton v. Rathbone*,¹⁰⁰ the Supreme Court articulated the Golden Rule as follows:

where a statute is of doubtful meaning and susceptible upon its face of two constructions, the court may look into prior and contemporaneous acts, the reasons which induced the act in question, the mischiefs intended to be remedied, the extraneous circumstances, and the purpose intended to be accomplished by it, to determine its proper construction. But where the act is

92. See *id.* at 46.

93. See *id.*

94. See *id.* at 48; see also BLACK’S LAW DICTIONARY 1162 (6th ed. 1990) (defining “positive law” as “[l]aw actually and specifically enacted or adopted by proper authority for the government of an organized jural society”).

95. See VANDEVELDE, *supra* note 3, at 114–15 (indicating that Christopher Columbus Langdell, dean of Harvard Law School in 1870, proposed this idea).

96. See Kelso *supra* note 22, at 48.

97. See *id.* at 48–49 (commenting that formalist judges are likely to resort to the dictionary meaning of words and grammatical maxims of construction to determine the meaning of the words).

98. See *id.* at 49.

99. See *id.* (noting that he could not find an example of a court located in a United States jurisdiction applying the Literal Rule). The Literal Rule requires that as long as the words of a statute are clear, the court must follow them “even if that meaning leads to an absurd result.” *Id.*

100. 175 U.S. 414 (1899).

clear upon its face, and when standing alone it is fairly susceptible of but one construction, that construction must be given to it.¹⁰¹

The Plain Meaning Rule differs from the Golden Rule because it allows the court to consider purposes other than those internal to the statute being interpreted.¹⁰² For example, Justice Marshall provided the “classic phrasing of the [P]lain [M]eaning [R]ule . . . in *Sturges v. Crowninshield*,” that “any other provision in the same instrument’ may be consulted, including statements of purpose, to determine a statute’s plain meaning.”¹⁰³ However, in contrast to the Plain Meaning Rule, the Golden Rule requires that “the purpose intended to be accomplished’ by the statute and the ‘mischiefs intended to be remedied’ cannot be considered to create an ambiguity even if that purpose is stated in the statute itself.”¹⁰⁴ Although these rules contrast each other when interpreted in this context, they both maintain that absent an ambiguous meaning or absurd result, courts are precluded from considering legislative history, “such as committee reports, hearings, or debates, to ascertain the meaning of a statutory provision.”¹⁰⁵

Judges applying the Holmesian approach share a common ground with the formalistic judges “that the judge must follow the specific commands of the sovereign where such specific commands exist.”¹⁰⁶ In general, this method requires that legislatures, not courts, balance public policy concerns.¹⁰⁷ Under this approach, Holmesian judges do not make policy decisions but instead believe that “a judge should follow the in-fact intent of the legislature.”¹⁰⁸ While a Holmesian judge finds it appropriate to investigate and review the legislative history in every case of statutory interpretation, he only gives effect to the in-fact

101. *Id.* at 419.

102. *See* Kelso, *supra* note 22, at 50–51 (stating that the Plain Meaning Rule does not preclude the court from considering the purpose of the statute whereas under the Golden Rule the purpose of the statute can not be considered).

103. *See* Kelso, *supra* note 22, at 50 (quoting *Sturges v. Crowninshield*, 17 U.S. 122, 202–03 (1819)).

104. *Id.* at 50–51 (quoting from *Hamilton v. Rathbone*, 175 U.S. 414, 419 (1899), and stating that the difference in the Golden Rule and Plain Meaning Rule is not always carefully noted by courts and some courts have incorrectly held that the Plain Meaning Rule “counsels a court not to consider material intrinsic to the statute such as the statute’s title and preamble”).

105. *Id.* at 52–53.

106. *Id.* at 54.

107. *See id.*

108. *Id.* at 54–55.

legislative intent.¹⁰⁹ Furthermore, the Holmesian judge does not attempt to maintain any interpretation of a statute based on a social policy by resorting to legislative history.¹¹⁰

The Holmesian approach has a narrow and broad version similar to the natural law and formalist approaches.¹¹¹ Modern Holmesians follow the broader view that “if the legislature had a broad purpose in mind, the court should give effect to that purpose.”¹¹²

Professor Kelso states that to varying degrees “six Justices on the current Supreme Court share a basic agreement on how to approach questions of statutory interpretation.”¹¹³ With this understanding of judicial decision-making and statutory interpretation, it is appropriate to turn to the principal case.

IV. *GITLITZ V. COMMISSIONER*: THE TENTH CIRCUIT OPINION

A. *Facts of Gitlitz v. Commissioner*

Gitlitz and Winn were business partners in a real estate venture. They “each owned a fifty-percent interest in PDW & A, Inc., a Colorado corporation that elected to be taxed under subchapter S of the Internal Revenue Code.”¹¹⁴ PDW & A was also a partner in a real estate partnership (*i.e.*, the Parker Properties Joint Venture).¹¹⁵

In 1991, the joint venture encountered financial difficulty when “Parker Properties realized \$4,154,891 in discharge of indebtedness income.”¹¹⁶ “PDW & A’s pro rata share [of the DOI] was \$2,021,296.”¹¹⁷ PDW & A was insolvent at the time, owing \$2,181,748 to creditors.¹¹⁸ Because of its insolvency, PDW & A

109. *See id.* at 55.

110. *See id.*

111. *See id.* at 56.

112. *Id.* In contrast, under the narrow approach, “the judge adopts a strict originalist vision, and follows precisely the specific intent of the legislature which enacted the statute, without any reference to broader legislative purpose” *Id.*

113. *Id.* at 65 (concluding that five Justices (O’Connor, Kennedy, Souter, Ginsburg, and Breyer), to varying extents, interpret laws from a modern natural law approach and the balance of the court is comprised of “one clear Holmesian (Chief Justice Rehnquist); two formalists (Justices Scalia and Thomas); and one moderate instrumentalist (Justice Stevens)”). Professor Kelso deduces that Chief Justice Rehnquist would agree with the majority because the broad Holmesian and modern natural law approaches agree on a basic model of statutory interpretation. *See id.*

114. *Gitlitz v. Comm’r*, 182 F.3d 1143, 1144 (10th Cir. 1999).

115. *See id.*

116. *Id.*

117. *Id.*

118. *See id.*

excluded its share of the DOI from taxable income and had no tax liability for the DOI because the amount of its insolvency exceeded the amount of the DOI income.¹¹⁹ Although PDW & A did not include its respective shares of DOI in taxable income, Winn and Gitlitz used their respective shares of the DOI to increase the basis of their stock in PDW & A.

“Entering the 1991 tax year, both Gitlitz and Winn had suspended (*i.e.*, unused) losses because each lacked sufficient basis in PDW & A to deduct losses in prior years.”¹²⁰ In 1991, Gitlitz and Winn’s operating losses and suspended losses totaled \$1,010,648.¹²¹ Gitlitz and Winn would need to treat these losses as suspended losses because their bases had been previously reduced to zero and were insufficient to allow recognition of their losses.¹²² In addition, they used the DOI income to “claim[] increases in the bases of their PDW & A stock in the amount of their pro rata shares of the excluded discharge of indebtedness income.”¹²³ Armed with this increase in the basis of their stock, Gitlitz and Winn received a windfall by claiming the full amount of their pro rata share of PDW & A’s suspended losses.¹²⁴

The Commissioner of the IRS was not pleased with the taxpayers receiving this windfall and assessed tax deficiencies against Gitlitz and Winn after determining the taxpayers improperly utilized excluded DOI to increase their subchapter S corporate stock basis.¹²⁵ Gitlitz and Winn appealed to the United States Tax Court, which initially ruled in their favor, but on reconsideration upheld the decision of the Commissioner.¹²⁶ When the Tax Court reversed its prior decision, Gitlitz and Winn appealed to the Tenth Circuit.¹²⁷ Gitlitz and Winn “maintained the excluded [DOI] was an ‘item of income (including tax exempt income),’ as that term is used in § 1366(a)(1)(A), thereby facilitating their basis increases pursuant to 26 U.S.C.

119. *See id.* (stating that PDW & A was insolvent to the extent of \$2,181,748); *see also* I.R.C. § 108(d)(3) (1994) (stating that the amount of the DOI exclusion is limited to the amount of the insolvency of the taxpayer).

120. *Gitlitz*, 182 F.3d at 1144–45.

121. *See id.* at 1145.

122. *See id.*

123. *Id.*

124. *See id.* at 1145, 1147. The Commissioner sought to prevent the DOI from passing through to prevent Gitlitz and Winn from claiming their respective shares of net operating losses due to the increased basis. *Id.*

125. *See Winn v. Comm’r*, 75 T.C.M. (CCH) 1840, 1840 (1998) (stating that the Commissioner accessed Winn a deficiency of \$242,555 and Gitlitz a deficiency of \$251,192); *see also Gitlitz*, 182 F.3d at 1145.

126. *Gitlitz*, 182 F.3d at 1145.

127. *See id.* at 1144.

§ 1367(a)(1)(A).¹²⁸ When the Tenth Circuit questioned this act, Gitlitz and Winn acknowledged that increasing their stock basis and deducting net operating losses and suspended losses without making any personal outlay resulted in a tax windfall, but they maintained that the language of the relevant statutes dictated this result.¹²⁹

B. *The Tenth Circuit's Holding is Confined to Excluded Discharge of Indebtedness Income of S Corporations*

In *Gitlitz*, the court concluded that “when § 108(a)’s discharge of indebtedness income exclusion is triggered, a shareholder’s pro rata share of the corporation’s net operating losses passes through to him only to the extent such losses are not absorbed by the shareholder’s pro rata share of the excluded canceled debt.”¹³⁰ The court emphasized that its holding “focuse[d] only on excluded discharge of indebtedness income vis-à-vis insolvent subchapter S corporations.”¹³¹ Explaining its position, the court stated that “[t]he special exception for treating such excluded income at the corporate level in § 108(d)(7)(A) and the tax attribute reduction scheme in § 108(b) have no application to other forms of tax-exempt income.”¹³² The court further reasoned that the “distinction is particularly logical when one considers that subchapter S corporation shareholders generally are not entitled to include the corporation’s indebtedness to third parties in calculating their basis.”¹³³ The court noted that its principle theory behind the ruling was the fact “the shareholders themselves [had] made no economic outlay.”¹³⁴

C. *The Tenth Circuit's Reasoning*

The Tenth Circuit seems to follow the competing theory of judicial decision-making¹³⁵ by simply making a policy decision that Gitlitz and Winn must be prevented from receiving a windfall.¹³⁶ However, in reaching its conclusion the court’s logic

128. *Id.* at 1145.

129. *See id.* at 1147 (stating that the “[t]axpayers acknowledge the windfall, but insist the statutory language dictates such a result”).

130. *Id.* at 1149.

131. *Id.* at 1151.

132. *Id.*

133. *Id.* (citing *Uri v. Comm’r*, 949 F.2d 371, 373 (10th Cir. 1991)).

134. *Id.*

135. *See* discussion *supra* Part III.

136. *See Gitlitz*, 182 F.3d at 1147–48 (stating that “[i]f we embrace taxpayers’

and reasoning become attenuated: the court asserts the rules and underlying policies explain and justify the result it actually reached on other grounds.

The Tenth Circuit opinion focuses on denying the tax windfall the taxpayers sought.¹³⁷ Analyzing the issue, the court explained that “the outcome of this case is ultimately determined by the timing of the pass-through.”¹³⁸ Two scenarios are possible. In the first, “[i]f the attribute reduction procedures¹³⁹ precede the pass-through, the corporation’s excluded discharge of indebtedness income is absorbed before it can pass through to shareholders and compel basis adjustments.”¹⁴⁰ This seems to prevent possible windfalls.¹⁴¹ Alternatively, if “attribute reduction takes place *after* the pass-through, the taxpayers’ theory must prevail” and a windfall occurs.¹⁴²

The court made several observations about the general nature of the windfall. First, the court explained that if it subscribed to the taxpayers’ theory, shareholders of insolvent S corporations would receive a windfall in the form of suspended losses.¹⁴³ Second, the court stated that a windfall could also arise through the shareholders avoiding tax by combining the effect of the DOI exclusion with an upward basis adjustment in their stock, which would permit the shareholders to report a greater capital loss from the sale of their stock.¹⁴⁴ Finally, the court commented that “shareholders would be able to use the corporation’s net operating losses to reduce their own non-corporate related gross income without having to decrease the net operating losses by the amount of the corporation’s discharged debt.”¹⁴⁵

After noting the benefits of the windfall to taxpayers, the court proceeded with its result-oriented analysis, quickly discarding any extrinsic evidence or arguments that did not support denying the windfall. For example, the court stated that it found the legislative history of the Subchapter S Revision Act of 1982 and the Tax Reform Act of 1984 largely unhelpful.¹⁴⁶ The

position, subchapter S corporate shareholders would receive a windfall”).

137. *See id.*

138. *Id.* at 1148.

139. *See* discussion *supra* Part II.C (explaining attribute reduction procedures).

140. *Gitlitz*, 182 F.3d at 1148.

141. *Id.*

142. *Id.*

143. *See id.* at 1147–48.

144. *See id.* at 1147.

145. *Id.*

146. *See id.* at 1148 (stating that this legislation adopted 26 U.S.C. §§ 1366–1368 and

court distinguished the taxpayers' analogous arguments that the Code allows other types of tax-exempt income such as non-taxable life insurance proceeds and municipal bond income by reasoning that these items are allowed because taxpayers make the initial economic outlays to get them.¹⁴⁷ The court continued, saying it discerned "no intent by Congress to treat certain subchapter S corporation income at the corporate level, while treating other income at the shareholder level."¹⁴⁸ The court also added that "[s]ection 1366(a)(1) makes clear that *all* items of income are attributed initially to the corporation."¹⁴⁹ Finally, the court considered the operation of section 108 in order to evaluate the timing of the pass-through.¹⁵⁰

After collecting segments of court opinions, commentator views, and anything else that could be construed to support its result, the Tenth Circuit adhered to the first interpretation.¹⁵¹ The court indicated that the rationale behind its ruling was "that the shareholders themselves have made no economic outlay."¹⁵² The court was also concerned that following the taxpayers' theory would circumvent the "price"¹⁵³ that Congress intended to accompany the exclusion of discharged debt income.¹⁵⁴

V. AN ANALYSIS OF THE CONFUSION—IT STARTED WITH THE COMMISSIONER LONG AGO

Apparently, everyone involved in the principal case, including the taxpayers, the Commissioner, and the courts, was

amended 26 U.S.C. § 1366).

147. *See id.* at 1151.

148. *Id.* at 1148.

149. *Id.*

150. *See id.* at 1148–49.

151. *See id.* at 1149–50 (observing that, despite division on the issue among commentators and no applicable case law, the taxpayers' theory was incorrect).

152. *Id.* at 1151 (citing *Goatcher v. United States*, 944 F.2d 747, 751 (10th Cir. 1991), which in turn cites *Estate of Leavitt v. Comm'r*, 875 F.2d 420, 422 (4th Cir. 1989)).

153. *Id.* at 1147, 1149 (stating that the "price" for excluding DOI income from gross income in a bankruptcy is that the taxpayer "must make correlated reductions in various 'tax attributes' that could otherwise yield future tax benefits" and "any 'remaining debt discharge amount is disregarded, *i.e.*, does not result in income or have other tax consequences"(citation omitted)); *see also supra* note 63 and accompanying text; *United States v. Farley*, 202 F.3d 198, 203 (3d Cir. 2000) (stating that the "price" for excluding DOI income from gross income under section 108(a)(1)(B) is that the taxpayer "must make corresponding reductions in certain tax attributes, attributes that might otherwise yield future tax benefits"); Lipton, *supra* note 63, at 209 (stating that the "price" for excluding DOI income under section 108(a) is the corresponding attribute reduction under section 108(b)).

154. *See Gitlitz*, 182 F.3d at 1149.

either confused or else contributed to the conflicting interpretations of the relevant statutes.¹⁵⁵

One must wonder where this confusion and conflicting interpretation started. At least some of the confusion began with the Commissioner. From the first time the IRS addressed the DOI exclusion in technical advice memorandums, commentators have been raising questions about the interpretation of the statutes.¹⁵⁶ Some courts and other commentators reach the same conclusion and question whether the IRS believed in any of its ever-changing theories.¹⁵⁷ The Supreme Court also recognized the Commissioner's confusion by noting several situations where the Commissioner flatly changed his view in arguments before the lower courts.¹⁵⁸ The Commissioner, however, was not alone in misconstruing the statutes.

The taxpayers themselves probably contributed to the confusion in the resolution of these cases. For example, Gitlitz and Winn undoubtedly contributed to the confusion because they used the excluded DOI in different ways in different tax years.¹⁵⁹

155. See discussion *infra* Part V.D.

156. See JAMES S. EUSTICE & JOEL D. KUNTZ, *FEDERAL INCOME TAXATION OF S CORPORATIONS* ¶ 14.04[2] (3d ed. 1993 & Supp. 1998) (stating that, if the Code is read literally, COD income flows through to increase the basis of the shareholder's stock).

157. See *Farley*, 202 F.3d at 211 (stating that among other legislative history, "the Omnibus Budget Reconciliation Act of 1993 [is relevant because] . . . Congress extended the section 108 discharge of indebtedness exclusion to income from the discharge of 'qualified real property business indebtedness'"). In *Farley*, the court stated that:

The language in the legislative history could be interpreted, as the Government suggests, to mean that discharge of indebtedness income does not pass through to shareholders of an S corporation and therefore does not allow shareholders to increase the basis of their S corporation stock. As one commentator has noted, however, "[w]ere this interpretation applied to all discharges of debt (and not just discharges under Section 108(a)(1)(D)), it could be viewed as a change in pre-existing law."

Id. (quoting Richard M. Lipton, *IRS Challenges S Corporation Basis Increase for COD Income*, 81 J. TAX'N 340, 344 (1994)). The court then concluded that "[i]f the Internal Revenue Service really viewed the language in section 108(a)(1)(D) as a change in pre-existing law, certainly it would have taken that position in TAM 9423003. Its failure to do so is telltale." *Id.*; see also Lockhart & Duffy, *supra* note 66, at 289 n.9, 292-94 (discussing history of TAM 9423003, stating that the IRS first considered the issue in TAM 9423003 and citing a list of commentators analyzing and criticizing TAM 9423003).

158. See *Gitlitz v. Comm'r*, 531 U.S. 206, 212 n.5 (2001) (stating that "[t]he Commissioner has altered his arguments throughout the course of this litigation").

159. See *Gitlitz v. Comm'r*, 182 F.3d 1143, 1145 n.3 (10th Cir. 1999) (stating that "Gitlitz reflected the adjusted basis on his 1991 return and Winn reflected the adjustment on his 1992 return. Winn did not employ a basis adjustment to facilitate an ordinary loss deduction on his 1991 joint tax return because he believed passive activity loss limitations prevented him from doing so").

The inconsistent treatment of tax issues within S corporations was likely the event that alerted the Commissioner to a problem and led to the investigation of tax returns of shareholders such as Gitlitz and Winn.

A. *The Tax Court Decisions – Winn v. Commissioner and Nelson v. Commissioner*

The Tax Court seems to be the origin of conflicting interpretations of the statutes that spread the confusion to the court system. Initially, the Tax Court in *Winn v. Commissioner*¹⁶⁰ rejected the position of the IRS that COD income was not realized for purposes of sections 108 and 1366, and consequently granted partial summary judgment for the taxpayers, holding that “discharge of indebtedness is an ‘item of income’ for purposes of determining a shareholder’s basis in [his S] corporation stock by its inclusion in the definition of gross income under section 61(a)(12).”¹⁶¹ Under this holding, the shareholders were allowed to increase the basis in their S corporation stock by their pro rata share of DOI income.¹⁶² Shortly thereafter, the Tax Court granted the IRS’s motion for reconsideration.¹⁶³

On reconsideration, less than one year later,¹⁶⁴ the Tax Court reversed, withdrew the memorandum opinion, and reissued the *Winn* decision in a published Tax Court opinion,¹⁶⁵ apparently realizing the significance of the issue. The Tax Court held that the outcome of *Winn* was controlled by its decision in *Nelson v. Commissioner*.¹⁶⁶ In *Nelson*, the taxpayer sought to increase the basis of his S corporation stock to increase capital losses, and the Tax Court determined that exclusion and attribute reduction

160. 73 T.C.M. (CCH) 3167 (1997).

161. *Id.* at 3177.

162. *See id.*

163. *See Winn v. Comm’r*, 75 T.C.M. (CCH) 1840, 1840 (1998).

164. The Tax Court filed TCM 1997-286 on June 24, 1997. *Winn v. Comm’r*, 73 T.C.M. (CCH) 3167 (1997). The Tax Court filed T.C.M. 1998-71 on February 19, 1998. *Winn v. Comm’r*, 75 T.C.M. (CCH) 1840 (1998).

165. *See Winn*, 75 T.C.M. (CCH) at 1840; *see also* Mary Ann Cohen, *How to Read Tax Court Opinions*, 1 HOUS. BUS. & TAX L. J. 1, 7–10 (2001) (stating that “[w]hen reading Tax Court opinions, [one] should consider why an opinion is released as a memorandum opinion instead of a published Tax Court opinion, or division opinion” and further explaining that cases involving application of familiar legal principles or arguments patently lacking merit are classified as memorandum opinions).

166. *See Winn*, 75 T.C.M. (CCH) at 1840–41; *see also Nelson v. Comm’r*, 110 T.C. 114, 116 (1998).

occurred at the corporate level.¹⁶⁷ The Tax Court held “that an S corporation shareholder may not increase the basis [of his] stock due to excluded COD income.”¹⁶⁸ Upon Winn’s appeal, these issues and problems of interpretation moved to the Tenth Circuit.

B. *Problems with the Tenth Circuit’s Decision*

1. Application of the Unorthodox Theory of Judicial Decision-making: A Result-Oriented Conclusion

Generally speaking, the Tenth Circuit employs a non-textualist or non-formalistic technique.¹⁶⁹ The Tenth Circuit appears to concur that a judge applying a formalist, modern natural law, or Holmesian approach would conclude differently by stating that if the Code “is read narrowly and in isolation, it is plausible to conclude Congress intended tax attributes to be reduced only in the tax year following the taxable year of the discharge.”¹⁷⁰ Because the language of the applicable statutes did not correlate with its intended result, the Tenth Circuit concluded that it must read the Code as a whole and that not doing so could defeat the intent of the legislation.¹⁷¹ To resolve the perceived indeterminacy, the Tenth Circuit employed a competing theory methodology and based its decision on the policy that windfalls should be denied.¹⁷² Following similar citations and reasoning of the Tax Court, and relying on Supreme Court precedent, the court stated that the Code “should not be interpreted to allow [taxpayers] the practical equivalent of [a] double deduction absent a clear declaration of intent by Congress.”¹⁷³ The Court analogized the windfall to a double deduction.¹⁷⁴

167. See *Nelson*, 110 T.C. at 115–16, 119; see also *Winn*, 75 T.C.M. at 1841 (stating that *Nelson* is the controlling opinion and that the court agreed with the IRS that a shareholder of an insolvent S corporation may not increase his basis to reflect COD income of the S corporation).

168. *Nelson*, 110 T.C. at 130.

169. See *Kelso*, *supra* note 22, at 54 (stating that a textualist or formalistic judge does not consult extrinsic sources other than a dictionary). In *Gitlitz v. Commissioner*, for example, the Tenth Circuit ignored the majority of commentators and found the legislative history largely unhelpful. See *infra* notes 178–80 and accompanying text.

170. *Gitlitz v. Comm’r*, 182 F.3d 1143, 1150 (10th Cir. 1999).

171. See *id.*

172. See *id.* at 1149.

173. See *id.* at 1147–48 (quoting *United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969)).

174. See *id.* (stating that the principle of denying double deductions is “equally

The Tenth Circuit's opinion stands for the rule that DOI of a Subchapter S Corporation that is excluded from gross income due to insolvency does not automatically pass through to shareholders.¹⁷⁵ Further, it flows from the Tenth Circuit's rationale that shareholders cannot use any of the excluded DOI to adjust the basis of their stock in the S corporation notwithstanding whether the net operating loss tax attribute fully absorbs the DOI at the corporate level—any remaining DOI is disregarded because it is considered to have no tax consequences.¹⁷⁶ However, the court would allow any net operating losses to pass through to a shareholder only to the extent that the losses are not absorbed by the shareholder's pro rata share of excluded canceled debt.¹⁷⁷

2. The Flawed Methods of Legal Reasoning

The court started with a flawed methodology of analysis by first addressing the legislative history of the relevant statutes rather than identifying applicable law.¹⁷⁸ Next, it turned to case law and implied that it was about to decide a subject never addressed, stating that “[u]nfortunately, there is no case law and commentators are divided on the proper operational mechanics of § 108(b)(4)(A).”¹⁷⁹ It seems inappropriate, however, for the court to have discarded the legislative history before considering the applicable laws and cases.¹⁸⁰ Regardless of the outcome that the court desired, it should have identified the applicable cases and law and followed sound legal reasoning in addressing the legislative history to resolve an actual ambiguity. Instead, the court allowed the *parties* to create an ambiguity in the statutes,

applicable” to windfalls).

175. See *id.* at 1148, 1151.

176. See *id.* at 1149–50 (explaining in Examples one and three that any excluded DOI remaining after the requisite tax attribute reduction is disregarded because it has no tax consequences); see also *infra* notes 201, 203–05 and accompanying text.

177. See *Gitlitz*, 182 F.3d at 1149–50 (explaining in Examples two and four that any net operating losses flow through to the shareholder); see also *infra* notes 201, 203–04 and accompanying text.

178. See *Gitlitz*, 182 F.3d at 1148 (acknowledging that the parties devoted significant effort to the legislative history and that it is not helpful in resolving the operation of the statutes); see also *infra* note 180 and accompanying text.

179. *Gitlitz*, 182 F.3d at 1149.

180. See *id.* at 1148; see also VANDEVELDE, *supra* note 3, at 7 (stating that the first step in the legal reasoning process is to identify the applicable existing body of law, which includes both statutory and case law). Courts should only turn to extrinsic sources, such as legislative history in hard cases. See VANDEVELDE, *supra* note 3, at 66 (referring to the orthodox theory).

which required the court to search for some other basis to support its conclusions. This search led to problems in the court's analysis.

3. The Tenth Circuit's Analysis of Commentator Positions

After the court dismissed the legislative history as largely unhelpful, it went on to develop a basis for its conclusion by searching the opinions of commentators.¹⁸¹ Staying true to its course, the court threw out any commentators' opinions that did not support its unorthodox and result-oriented conclusion. For example, the court cites to James S. Eustice to support some of its strained logic,¹⁸² but cleverly discards his opinion when it does not correlate with the court's opinion on the issue of the timing of the attribute reduction.¹⁸³ In a bit of irony, Eustice represented Gitlitz and Winn in the Supreme Court and defeated the reasoning of the Commissioner and the Tenth Circuit.¹⁸⁴

Not only was the Tenth Circuit wrong about Eustice's arguments related to the timing of the attribute reduction,¹⁸⁵ it also incorrectly found an absence of general consensus among the commentators.¹⁸⁶ It was simply incorrect to say that commentators were split on the issue of the timing of attribute reduction. The court cited only two commentators, one on each side of the argument, and quickly concluded that commentators were split on the timing of attribute reduction.¹⁸⁷ Unfortunately for the court, not only did Eustice opine that the attribute reduction occurred after excluded DOI passed through, but he

181. See *Gitlitz*, 182 F.3d at 1148–50.

182. See *id.* at 1146 (citing BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 606[2][c] (6th ed.1998)).

183. See *id.* at 1149–50.

184. See *S Corporation Shareholders Argue Discharged Indebtedness Increases Stock Basis*, 2000 TAX NOTES TODAY 98-18 (reprinting the brief of respondent stating that James S. Eustice was also a counsel for the petitioners).

185. Compare BITTKER & EUSTICE, *supra* note 39, ¶ 606[2][c], at 6-22 (stating that if the code is read literally attribute reduction takes place after items are passed through to shareholders), with *Gitlitz*, 182 F.3d at 1149 (holding that nothing passes through).

186. See *supra* note 179 and accompanying text.

187. See *Gitlitz*, 182 F.3d at 1149. The court based its conclusion that commentators are divided by comparing “C. RICHARD MCQUEEN and JACK F. WILLIAMS, *TAX ASPECTS OF BANKRUPTCY LAW AND PRACTICE* § 25:6, at 25-6 (3d ed.1997) (tax attribute reductions made in year of discharge) with 15 COLLIER ON BANKRUPTCY ¶ 6.03[4][b][i], at 6-103 (Lawrence P. King ed., 15th ed. 1999) (tax attribute reductions made in year following discharge).” *Id.*

also observed that commentators were not divided at the time.¹⁸⁸ In fact, many commentators believed that attribute reduction followed pass-through.¹⁸⁹ The Tenth Circuit either did not research written opinions on the issue of the timing of attribute reduction or chose to ignore the data readily available in electronic databases and recognized tax publications.¹⁹⁰ Recently, other commentators also concluded that the majority of commentators offering an opinion on the subject agree that the tax attribute reduction under section 108(b)(4)(A) occurs the first moment of the tax year after the debt discharge.¹⁹¹ Upon composing its legislating opinion, the court drafted examples to support its novel interpretation of the statutes.¹⁹²

4. The Flaws in the Court's Examples

In dicta, the court continued to apply a result-oriented method of decision-making, offering four examples to support its novel interpretation and explain the operation of the statutes.¹⁹³ In regards to format, the court's examples are drafted well enough to qualify as examples for the Treasury Regulations.¹⁹⁴

Yet, the examples are flawed on several grounds.¹⁹⁵ First, the examples do not reflect the actual scenario in *Gitlitz* where DOI equals net operating losses plus suspended losses; the examples fail to show the effect of the holding on the windfall

188. See Lockhart & Duffy, *supra* note 66, at 288–89 & n.9 (stating that a book co-authored by James S. Eustice notes that “a basis increase should result from excluded COD income if the code is read literally”).

189. See *id.* (stating that many commentators agree that shareholders are allowed to increase their stock basis by their share of the corporations COD income).

190. See *id.* At least one article cites a list of commentators and their published opinions from popular tax publications during the mid 1990s, most of which were available in electronic form to the court, that addressed the issues of attribute reduction and basis increases and concluded that shareholders of an insolvent S corporation can increase the basis of their stock by their share of realized COD income that is excluded from section 61. See *id.*

191. See Briskin, *supra* note 50, at 26 & n.15 (stating that “[m]ost commentators agree that the tax attribute reduction under I.R.C. § 108(b)(4)(A) occurs on the first moment of the tax year after the year of the discharge of the debt discharge” (citing Richard M. Lipton, *The Impact of Excluded COD Income on S Shareholders—The Tenth Circuit Gets Lost in Gitlitz*, 91 J. TAX’N 197 (1999))).

192. See *Gitlitz v. Comm’r*, 182 F.3d 1143, 1150 n.6 (10th Cir. 1999) (providing four examples that underscore the court’s interpretation of the interaction between section 108 and sections 1366–1368); see also *infra* note 201 (listing the court’s examples).

193. See *Gitlitz*, 182 F.3d at 1150 n.6; see also *infra* note 201 and accompanying text.

194. See *Gitlitz*, 182 F.3d at 1150 n.6; see also *infra* note 201 and accompanying text.

195. See VANDEVLEDE, *supra* note 3, at 78–80 (discussing the special problems of dicta in court opinions).

that the court seeks to deny.¹⁹⁶ Second, as noted by some commentators, the operation of the statute outlined in the examples contradicts the court's reasoning and language taken from other areas in the opinion.¹⁹⁷ Third, the court does not show how the pricing structure of the examples rationally relates to underlying policy and the Congressional intent that taxpayers pay a "price" in the form of the attribute reduction.¹⁹⁸ Finally, the examples fail to consider the effect of affirming *Nelson* in the context of capital losses compared with suspended losses.¹⁹⁹ It

196. See *Gitlitz*, 182 F.3d at 1150–51.

197. See Mark R. Martin & James E. Tierney, *Cancellation of Debt Income: Debt Discharge Controversy for Owners of S Corporations*, 65 PRAC. TAX. STRATEGIES 331, 335 (2000). The commentators state that:

It is one thing to say that corporate level and suspended shareholder-level losses must be reduced by excluded COD income (especially in view of Section 108(d)(7)(B)). In fact, that was all that the court needed to say in *Gitlitz* to resolve that case on its facts. It is quite another thing to say (without clear citation to authority), however, that excluded COD income in excess of such losses does not pass through. Indeed, it seems contradicted by the court's earlier indication that it did not wholly adopt the Service's position regarding COD income as an exception to the usual pass-through regime of subchapter S and its statement that "[b]ecause the subchapter S corporation is not a taxpaying entity, however, the items must pass through to the shareholders unless they are absorbed by tax attribute reductions." Where the COD income exceeds the suspended losses, it can hardly be described as having been "absorbed by tax attribute reductions," to use the court's terminology.

The Tenth Circuit may have meant that if there are any tax attributes to be reduced, then COD income is to be used only for that purpose and thereafter plays no further role, irrespective of the amount by which it exceeds the tax attributes that must be reduced. This interpretation, however, is at odds with the court's seeming reluctance to adopt the Service's position and the language of its opinion cited earlier. This explanation is also difficult to square with its terse affirmation of *Nelson* ("[f]or the same reasons outlined in . . . *Gitlitz v. Commissioner* . . .") since that case involved no suspended losses or other tax attributes to absorb the corporation's excluded COD income.

Id. For example, as shown in Table 1 and Figure 1, the court's Examples one and three do not allow excess DOI to pass through, cloaking it as "disregarded excess DOI", however, Examples two and four allow excess losses to flow through to shareholders. See *infra* note 201 and accompanying text.

198. See *supra* notes 63, 153 and accompanying text.

199. It should be noted that *Gitlitz*, *Guadiano*, *Farley*, and *Witzel* were cases that involved "suspended losses" and *Pugh* and *Nelson* were cases that involved "capital losses." See Martin & Tierney, *supra* note 197, at 335–36 (arguing that the Tenth Circuit's summary conclusion in *Nelson*, where the taxpayer had no suspended losses, is difficult to reconcile with its decision in *Gitlitz*, where the taxpayer's did have suspended losses, and that given the court's decision "it is immaterial whether the taxpayer has suspended losses (as in *Gitlitz*) or has no such losses and is simply seeking an increased stock basis in order to claim a larger capital loss (as in *Nelson*)" whereas the commentators "believe that the suspended loss cases (e.g., *Gitlitz*, *Gaudiano*, and *Witzel*)

seems that these flaws are present because the court abandoned the language of the statutes, determined that there is no applicable case law, asserted that commentators are split on the timing of attribute reduction, and overstepped its authority by legislating without addressing the issues in a proper policy analysis.²⁰⁰

The operation of the statutes is much clearer when examined in tabular and graphic formats. Figure 1 and Table 1 below show the operation of the examples enumerated by the Tenth Circuit.²⁰¹

can be distinguished from cases not involving suspended losses (*e.g.*, *Nelson and Pugh*) and that a different result may be justified based on these factual differences and relevant statutory provisions”).

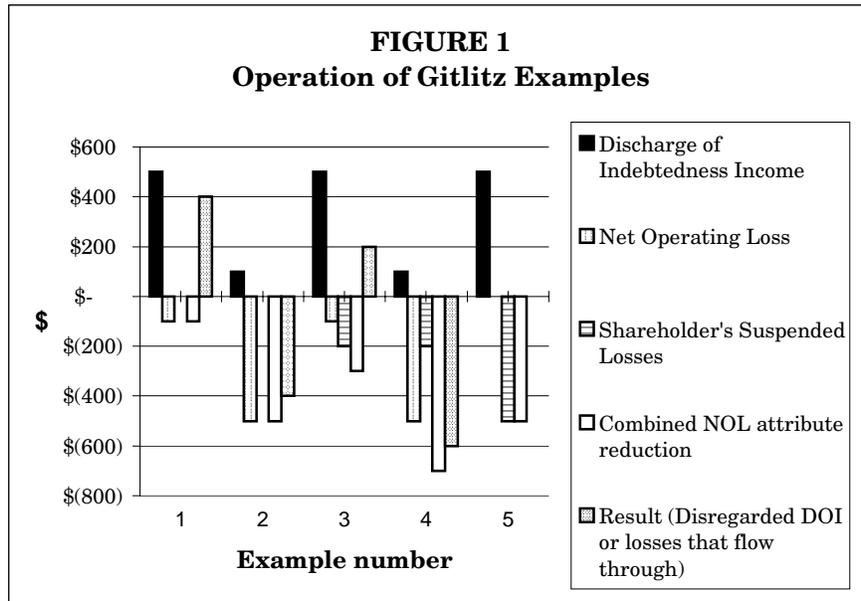
200. See JOEL S. NEWMAN, FEDERAL INCOME TAXATION 24–26 (1998) (stating that a policy analysis of a tax provision includes examining horizontal and vertical equity among taxpayers, economic impact, complexity, other policies such as health in the case of a tobacco tax, and addressing issues such as whether the court’s decision or legislation makes tax sense).

201. See *Gitlitz*, 182 F.3d at 1150 n.6. In order to clarify its interpretation of the statutes, the Tenth Circuit explained:

The following examples underscore how our interpretation of the interplay between §§ 108 and 1366–1368 operates in practice. In each example, X is the sole shareholder of an insolvent subchapter S corporation.

Example 1: In 1991, the corporation realizes \$500 of discharge of indebtedness income and has \$100 of net operating losses. The corporation has no other tax attributes and X has no suspended losses. In calculating its 1991 tax return, the corporation first computes its discharged debt income and sets this figure aside temporarily (*i.e.*, it does not pass through immediately to X). The corporation then calculates its net operating losses for the year. Finally, the corporation applies the excluded discharged debt to reduce its tax attributes in accordance with §§ 108(b)(2) and 108(d)(7)(B). After reducing the \$500 in discharged debt by the \$100 in net operating losses, \$400 of canceled debt remains. Because any remaining debt discharge amount is disregarded following the required reduction of tax attributes, this \$400 is ignored and has no tax consequences. Thus, there are no items of income to pass through to X. X cannot utilize any net operating losses incurred by the corporation to offset his own gross income nor can he adjust his corporate basis.

Example 2: Same facts as example 1, but now the corporation realizes \$100 of discharge of indebtedness income and \$500 of net operating losses. In calculating its 1991 tax return under the method described above, after reducing the \$100 in discharged debt, dollar for dollar, by the net operating losses, \$400 of net operating losses remains. The \$400 of net operating losses flows through to X and, assuming he has a sufficient basis in the corporation, may be used by him to offset his own gross income.



Example 3: In 1991, the corporation realizes \$500 of discharge of indebtedness income and has \$100 of net operating losses. The corporation has no other tax attributes. X has \$200 in suspended losses. In calculating its 1991 tax return, the corporation first computes its discharged debt income and sets this figure aside temporarily. The corporation then calculates its net operating loss tax attribute (\$100 + \$200 = \$300). Finally, the corporation applies the excluded discharged debt to reduce its tax attributes. After reducing the \$500 in discharged debt by the \$300 net operating loss tax attribute, \$200 of canceled debt remains. Because any remaining debt discharge amount is disregarded following the required tax attribute reductions, this \$200 is ignored and has no tax consequences. As a result, there are no items of income to pass through to X. X cannot utilize any net operating losses incurred by the corporation to offset his own gross income nor may he adjust his corporate basis. X has also permanently lost the use of \$200 in suspended losses.

Example 4: Same facts as example 3, but now the corporation realizes \$100 of discharge of indebtedness income and has \$500 of net operating losses. In calculating its 1991 tax return, the corporation first computes its discharged debt income and sets this figure aside temporarily. The corporation then calculates its net operating loss tax attribute (\$500 + \$200 = \$700). Finally, the corporation applies the excluded discharged debt to reduce its tax attributes. After reducing the \$100 in discharged debt, dollar for dollar, by the net operating losses, \$400 of 1991 net operating losses remains in addition to X's \$200 of suspended losses. The \$600 combined amount flows through to X and, depending on his basis, may be used by him (in whole or in part) to offset his own gross income.

Id. Because the court failed to include an example that followed the actual fact pattern given in *Gitlitz*, Example 5 has been added by the Author to reflect the actual scenario addressed in that case.

Table 1 Summary of the Tenth Circuits Examples					
Example Number	1	2	3	4	5
Discharge of Indebtedness Income	\$ 500	\$ 100	\$ 500	\$ 100	\$ 500
Net Operating Loss	\$ (100)	\$ (500)	\$ (100)	\$ (500)	—
Shareholder's Suspended Losses	—	—	\$ (200)	\$ (200)	\$ (500)
Combined NOL Attribute Reduction	\$ (100)	\$ (500)	\$ (300)	\$ (700)	\$ (500)
Result (disregarded DOI or losses that flow through)	\$ 400	\$ (400)	\$ 200	\$ (600)	—
Basis Increase Resulting from Excluded DOI	—	—	—	—	—
"WINDFALL FOR THE YEAR OF DISCHARGE"	—	—	—	—	—
Character of Result	disregarded DOI	NOL that flows thru	disregarded DOI	NOL that flows thru	0
Under <i>Gitlitz</i> , amount available to offset other shareholder income if shareholder provides funds for basis increase	—	\$ 400.00	—	\$ 600.00	—

After examining Figure 1 and Table 1, it becomes clearer that the fifth example reflects the actual scenario in *Gitlitz* and shows the court's determination to deny the taxpayers any benefit from the excluded DOI income.²⁰²

Commentators have noted that the operation of the statutes under the court's examples contradict the language in the court's opinion regarding attribute reduction.²⁰³ These commentators correctly claim, as shown in the table and figure above, that the results of the court's first and third examples contradict with the results of the second and fourth examples because the court

202. See *id.*

203. See Martin & Tierney, *supra* note 197, at 335.

allowed excess losses to flow through but not excess DOI.²⁰⁴ These commentators credit the court for its proposition that COD income is reduced by the net operating loss attribute and that any amount of excess losses passes through to the shareholder.²⁰⁵ However, they challenge the Tenth Circuit's view that any amount of COD income exceeding the net operating loss attribute does not flow through to increase the shareholder's basis.²⁰⁶ They argue that the court's proposed operation of the statute contradicts its earlier language that the S corporation is not a tax paying entity and items of income must pass through unless they are absorbed by tax attributes.²⁰⁷ According to these commentators, the excess COD income "can hardly be described as having been 'absorbed by tax attribute reductions.'"²⁰⁸ This contradiction in the court's opinion illustrates the problems associated with dicta, but the result clearly advanced the court's intent to deny a windfall to taxpayers.²⁰⁹

The commentators also argue that the result in *Gitlitz* is inconsistent with the result in *Nelson* because the cases are factually distinguishable.²¹⁰ *Gitlitz* and *Nelson* are easily distinguished in the context of capital and suspended losses. The taxpayers in *Gitlitz* were seeking to deduct ordinary and suspended losses,²¹¹ but the taxpayer in *Nelson* had no suspended losses and instead merely sought to increase the basis in his stock in order to claim a larger capital loss on the sale of the business.²¹² In *Gitlitz*, the court claimed that the objectives of the taxpayers become irrelevant as to whether they are seeking to deduct capital or suspended losses because COD income would not flow through to increase the stock basis under its holding.²¹³ However, if the court had conducted a proper policy analysis it would have realized that capital losses might only take effect when the shareholder sells the stock of the corporation and

204. *See id.*

205. *See id.*

206. *See id.* at 335–36.

207. *See id.* (discussing the Tenth Circuit's opinion).

208. *Id.*

209. *See Gitlitz v. Comm'r*, 182 F.3d 1143, 1150 n.6 (10th Cir. 1999).

210. *See Martin & Tierney, supra* note 197, at 335 (stating that the explanation does not square with *Nelson* because that case involved no suspended losses or other tax attributes to absorb the corporations excluded COD income).

211. *See Gitlitz*, 182 F.3d at 1145 (stating that *Gitlitz* and *Winn* deducted ordinary losses and suspended losses and that the Commissioner denied the ordinary losses).

212. *See Nelson v. Comm'r*, 110 T.C. 114, 115–16 (1998) (stating that the Commissioner denied long-term capital loss of the taxpayer).

213. *See Gitlitz*, 182 F.3d at 1149–50 & n.6.

suspended losses can be deducted immediately.²¹⁴ Therefore, cases of suspended and capital losses could have different outcomes. In the case of suspended losses, it may seem that the taxpayer has a shady business because he is unwilling to invest in it. However, in the case of capital losses, the shareholder may be seeking to reinvest in new business or allow someone else to use its assets and goodwill to contribute to the economy. Like Judge Posner, Congress may find the presence of capital losses relevant and material in formulating the price extracted in the attribute reduction.²¹⁵ The court in a proper policy analysis may have decided to extract a lower price from the taxpayers with capital losses by constructing a rule that allowed any excess COD income to flow through and increase the shareholder basis.

The Tenth Circuit also appears to ignore the most important element in its policy analysis: namely, the “price” to be paid by the shareholder in the attribute reduction process. This price would seem to be important considering the timing of the taxpayer’s realization of tax benefits in both *Gitlitz* and *Nelson*. The court’s disregard of legislative history in *Gitlitz* fails to point to the price to be paid and leaves a string of questions unanswered. If Congress in fact intended to extract a “price,” the unresolved questions here seem to be: what is the appropriate pricing and should the pricing vary in different factual settings?²¹⁶ Or should a court ask, instead of pricing, how much tax windfall is appropriate? From an even broader perspective,

214. See *Pugh*, 213 F.3d at 1328–29 & n.8 (explaining that in *Farley*, *Witzel*, and *Gitlitz*, the taxpayer shareholders all carried suspended losses into the years that their S corporations received DOI income and directly changed their tax liability; however, *Pugh*, had a capital loss and as such his tax liability was not directly affected).

215. See *id.*; see also *Witzel v. Comm’r*, 200 F.3d 496, 498 (7th Cir. 2000) (Judge Posner explaining the Seventh Circuit’s conclusion that:

Witzel was rightly forbidden to deduct his existing suspended losses, because they were offset at the corporate level by the amount of his corporation’s COD income, the basis in his stock was increased by that income, and this may enable him someday to deduct *future* suspended losses. We offer this view tentatively, in part because the Tenth Circuit has held the contrary and we are reluctant to precipitate an intercourt conflict, in part because Mr. *Witzel* may never again have suspended losses, making the issue rather moot as to him unless he someday sells his stock and his capital-gains tax liability is affected by his basis.)

(emphasis added); *Martin & Tierney*, *supra* note 197, at 338 (stating that Judge Posner’s comments indicate that he would have decided *Nelson* differently by allowing excess excluded DOI income to pass through with respect to capital losses thereby increasing the shareholders basis). Capital losses may only be recognized when the stock is sold. Suspended losses may be recognized to the extent of the shareholders stock basis.

216. See *supra* note 63 and accompanying text.

who should determine the relevant factors and the calculation of the pricing—the courts or Congress?

Comparing the use of legislative history in the Tax Court's opinion in *Nelson* with the Tenth Circuit's opinion in *Gitlitz* illustrates another flaw. The Tax Court examined not only the legislative history of the Code but also the legislative history of other acts,²¹⁷ while the Tenth Circuit found "[the] legislative history largely unhelpful."²¹⁸ Nonetheless, the Tenth Circuit affirmed *Nelson*.²¹⁹ It would be interesting to hear the Tenth Circuit's explanation for this divergence. The court's decision can be justified on the basis of deference, institutional competency, or special courts' expertise, but would still pose questions about when a court should legislate and how far a court should go into the legislative history before the use of this tool becomes abusive.²²⁰ It seems that in *Gitlitz*, the Tenth Circuit determined, with relatively no analysis, that the legislative history did not support the result it sought.²²¹ As others have noted, a judge's use of legislative history may not differ functionally from looking out over the courtroom and picking out his friends.²²²

217. See *Nelson*, 110 T.C. at 118–19, 122, 125, 127–28 (using the legislative history as a guidance tool to the operation of section 1366; considering the legislative history in the basis adjustments of section 1367; examining the legislative history of the 1984 amendments to section 108 to determine the effect of the statutes on S corporation shareholders and partnerships; using the legislative history to determine whether the nature of COD income causes it to be tax-exempt; stating that the Tax Court uses the legislative history of a statute to determine "its intended purpose and to resolve ambiguity in the words used therein"; using the legislative history of the Bankruptcy Act to determine the purpose of section 108; and using the legislative history to determine effect of any excess COD income after tax attribute reduction).

218. *Gitlitz*, 182 F.3d at 1148.

219. See *Nelson v. Comm'r*, 182 F.3d 1152 (10th Cir. 1999). In the opinion, the Tenth Circuit merely affirmed *Nelson* for the same reasons as outlined in its opinion in *Gitlitz* without providing any additional explanation or discussion. See *id.* at 1152–53.

220. See Patrica M. Wald, *Some Observations on the Use of Legislative History in the 1981 Supreme Court Term*, 68 IOWA L. REV. 195, 214 (1983) (quoting Judge Leventhal for the proposition that some courts use legislative history arbitrarily and that using legislative history to aid in the interpretation of statutes is like "looking over a crowd and picking out your friends"); see also Breyer, *supra* note 79, at 847, 874 (agreeing that judges sometimes abuse the use of legislative history). Breyer also acknowledges "[o]ne can easily find examples of vague or conflicting legislative history." Breyer, *supra* note 79, at 862. However, he defends the proper use of legislative history against the proposition for abandoning it. *Id.* at 874; see also *United States v. Farley*, 202 F.3d 198, 212 (3rd Cir. 2000) (stating that "[a]lthough many other pieces of legislative history are cited by the Government, the Farleys, and commentators writing on this subject, the legislative history as a whole conflicts and provides little insight").

221. See *Gitlitz*, 182 F.3d at 1148 (stating preliminarily "that the parties have devoted significant discussion to the legislative history of []Subchapter S" but that the Tenth Circuit found the "legislative history largely unhelpful").

222. See Wald, *supra* note 220, at 214 (citing a conversation with Judge Harold Leventhal).

In summary, the court's analysis is flawed in several areas; the court does little more than blindly affirm *Nelson*, while adhering closely to its purpose of denying the windfall to the taxpayer and preventing him from getting a "head start."²²³

A better solution for the court might be to consider the complex nature of the Code and think carefully about whether the court or Congress should decide whether the law needs to be changed. The court could have made a formidable argument that the statute was obsolete, or that the details of the statutes were a signal to stay out of the Code,²²⁴ except in the case of special courts,²²⁵ and supported this argument with statements of current and former justices.²²⁶

223. See *supra* notes 59, 135–54, 218 and accompanying text.

224. See Frank H. Easterbrook, *Statutes' Domains*, 550 U. CHI. L. REV. 533, 547–48 (1983) [hereinafter Easterbrook I] (stating that "[a] legislature that tries to approach the line where costs begin to exceed benefits is bound to leave a trail of detailed provisions," which on his approach would limit the judges' interpretations of complex statutes); see also Frank H. Easterbrook, *The Court and the Economic System*, 98 HARV. L. REV. 4, 16 (1984) [hereinafter Easterbrook II] (concluding that laws are detailed and complex because of interest-group compromise and that judges should adhere to the law and not alter it due to the extent of compromise in its creation). As Easterbrook explains:

The more detailed the law, the more evidence of interest-group compromise and therefore the less liberty judges possess. General-interest statutes, on the other hand, are designed to vest discretion in courts, to transfer the locus of decision; courts implementing general statutes (such as the antitrust laws) become the decisionmakers. The decisions of courts are the things for which the parties bargained, and so judicial power to extemporize is at its greatest.

Easterbrook II, *supra* note 224, at 16; see also *Witzel v. Comm'r*, 200 F.3d 496, 497 (7th Cir. 2000) (stating that "not all tax statutes have a public-interest rationale, many being the product of favoritism or an interest-group pressure" prior to attending to the statute).

225. See POPKIN, *MATERIALS ON LEGISLATION* 635 (3d ed. 2001) (comparing the nature and competency of specialized and general courts and stating that "[a] specialist court might be more willing to grapple with an issue that it feels competent to resolve, rather than defer to the legislature").

226. See *United California Bank v. United States*, 439 U.S. 180, 211 (1978) (Stevens, J., dissenting). In his dissent, Justice Stevens concludes:

[i]n final analysis, this case requires us to consider how the law in a highly technical area can be administered most fairly. I firmly believe that the best way to achieve evenhanded administration of our tax laws is to adhere closely to the language used by Congress to define taxpayers' responsibilities. Occasionally there will be clear manifestations of a contrary intent that justify a nonliteral reading, but surely this is not such a case.

Id. Compare *James v. United States*, 366 U.S. 213, 230–31 (1961) (Black, J., dissenting). In dissent, Justice Black states:

[a]ll of us know that the House and Senate Committees responsible for our tax laws keep a close watch on judicial rulings interpreting the Internal Revenue Code. . . . When Congress is dissatisfied with a tax decision of this Court, it can and frequently does act very quickly to overturn it. On one occasion such an overruling enactment was passed by both the House and Senate and signed by the President all within one

C. *An Analysis of Circuit Court Opinions and their Holmesian, Formalistic, and Modern Natural Law Approaches*

1. Generally

This section of the paper examines the opinions from three circuit courts and the Supreme Court in chronological order.²²⁷ The circuits diverge on the issue of whether the tax attribute reduction occurs at the corporate level before the pass through or whether the reduction takes place after the COD income passes through to the shareholder.

2. The Holmesian Approach in the Seventh Circuit: *Witzel v. Commissioner*²²⁸

The Seventh Circuit employs a Holmesian approach and reaches a conclusion that differs from the holding of the Tenth Circuit. The Seventh Circuit opinion has a Holmesian tone because it only attempts to give effect to what it believes is the “in fact intent”²²⁹ of Congress.²³⁰ When the court faced legislative history that would have treated S corporations like partnerships that was not the “in-fact intent” of Congress, it refused to follow the Tenth Circuit.²³¹ However, the Seventh Circuit did agree with the Tenth Circuit that S corporation shareholders’ suspended losses were first to be offset against the excluded DOI at the corporate level.²³² However, the Seventh Circuit found that the shareholder’s stock basis was increased by the amount of the

day after the decision was rendered by this Court.

Id.

227. It should be noted that *Guadiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000), is not explored here because the other opinions better demonstrate the formalistic, modern natural law, and Holmesian approaches.

228. 200 F.3d 496 (7th Cir. 2000), *vacated*, 531 U.S. 1108 (2001).

229. See *supra* note 106–12 and accompanying text (discussing the Holmesian approach).

230. See *Witzel*, 200 F.3d at 497–98 (considering the legislative history and that the government’s interpretation is plausible, but does not address the “at the corporate level” language in the statutes).

231. See *id.* at 498 (stating that the government would have the court consider the legislative history and treat the S corporation the same as a partnership by interpreting the statutes in the same manner as the Tenth Circuit).

232. See *id.* at 497–98 (stating that the taxpayer “was rightly forbidden to deduct his existing suspended losses, because they were offset at the corporate level by the amount of his corporation’s COD income”).

excess of the DOI income over the amount of the shareholder's suspended losses.²³³

3. Formalism in the Third Circuit: *U.S. v. Farley*

Only days after the *Witzel* decision,²³⁴ the Third Circuit offered its opinion on the timing of the attribute reduction. In *Farley*, the taxpayers owned stock in two S corporations.²³⁵ Over time, the taxpayers' basis had been reduced to zero, and after 1987, these continued business losses became suspended losses due to the zero basis of the stock.²³⁶ Five years later, the secured creditors of the corporation forgave the balance of debts that were not satisfied by the sale of the corporation's assets, resulting in COD income for the corporations.²³⁷ The IRS filed a complaint to recover refunds paid to the taxpayers because the taxpayers had previously claimed that their basis had been increased by the excluded COD income and deducted the previously suspended losses.²³⁸

The Third Circuit employed a formalistic approach, examining only the language of the statutes and holding that the statutes "clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders."²³⁹ The court also stated that it was not necessary to examine the legislative history because the statutes were clear.²⁴⁰ The court refused to make any constructive use of the legislative history, finding two parts of the legislative history contradictory to each other.²⁴¹ The Third Circuit apparently shares the belief that statements made in Congress are those of compromise and that ambiguous items in legislative history may cause a court to determine that it is unreliable.²⁴² Finally, siding

233. See *id.* at 498 (stating that the basis of the taxpayer's stock was increased after the COD income was offset by suspended losses).

234. See *Briskin*, *supra* note 50, at 26 (stating that the decisions were separated by eleven days).

235. See *United States v. Farley*, 202 F.3d 198, 199 (3rd Cir. 2000).

236. See *id.* at 199–200.

237. See *id.* at 200.

238. See *id.* at 200–01.

239. *Id.* at 206 (noting that "[t]he statutory language is unambiguous, and the operation of the statutory language is straightforward").

240. See *id.* at 210 (stating that "[d]elving into the legislative history is unnecessary . . .").

241. See *id.* at 211–12.

242. See Jack Schwartz & Amanda Stakem Conn, *The Court of Appeals at the Cocktail Party: The Use and Misuse of Legislative History*, 54 MD. L. REV. 432, 456–57 (1995). They state:

For instance, if a lobbyist wants X for a client but lacks the votes to

with the Holmesians,²⁴³ the formalistic court noted that “if policy [reasons] suggest that the Code should be amended, [such as a windfall to the taxpayer,] the Congress can do so” but the court cannot.²⁴⁴

The court held that the suspended losses are reduced on the first day of the tax year following the year of the DOI and only after shareholders have already received an increase in the basis of their stock.²⁴⁵ Unlike the Tenth Circuit, this holding allows the shareholders to increase the basis in a manner that allows them to deduct suspended losses.²⁴⁶

4. The Modern Natural Law Approach in the Eleventh Circuit: *Pugh v. Commissioner*

The Eleventh Circuit employed a modern natural law approach in interpreting the applicable statutes. The court’s use

achieve X directly, the lobbyist could adopt the alternative strategy of pushing for ambiguous language in the bill. Those opposed to X might accept the ambiguity in order to move the bill along, and then the lobbyist need only make sure that the file contains a letter contending that the bill language means X (even though the committee members might think quite otherwise), and later argue in court that the bill’s purpose was to achieve X, as evidenced by material in the file. Such a strategy might fail, for a host of reasons, but why should a lobbyist not try it? Perhaps X will seem to the Court of Appeals to be sound policy, and the existence of the letter in the bill file will be just the bootstrap that the court needs to reach its desired result.

Id.

Apparently, the Third Circuit agreed that the legislative histories behind section 1366 and section 108 conflict and, like the Tenth Circuit, concluded that the legislative history was largely unhelpful. *See Farley*, 202 F.3d at 210–12. The court does not list a set of factors that could make the legislative history unreliable or “largely unhelpful” other than to imply that the legislative history is unreliable because it is conflicting. *See id.* at 212 (quoting the Tenth Circuit).

243. *See supra* notes 106–12 and accompanying text (discussing the Holmesian approach).

244. *See Farley*, 202 F.3d at 212 n.10.

245. *See id.* at 205–06 & n.4 (stating that “[h]owever, the Tenth Circuit conceded that if it read section 108(b)(4) narrowly and in isolation, the taxpayers’ argument was plausible, that is, that Congress intended tax attributes to be reduced only in the tax year following the taxable year of the discharge” and that “*Giltitz* ignores the plain meaning of the statute”).

246. *See id.* at 205 n.4, 209–10 (declining to follow the Tenth Circuit’s decision in *Giltitz* and instead holding that COD income excluded from gross income under section 108 passes through to the S corporation’s shareholders, increasing the basis of their S corporation stock:

In the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by section 108(a) increases the shareholder’s basis in their S corporation stock after it passes through to the shareholders of the corporation. This allows shareholders to take deductions for S corporation losses previously suspended under section 1366(d)(1)).

of a modern natural law approach is evident because it first determines that the meaning of the language in the statute is clear and then goes further by examining and explaining the legislative history.²⁴⁷

The court acknowledged that this is a case of first impression and stated that the outcome of the case is governed by an interpretation of the treatment of COD income and the tax liability of S corporation shareholders under the Code.²⁴⁸ However, it immediately proceeded to distinguish *Pugh* from other cases in the circuit courts because the taxpayers in the other cases “carried suspended losses into the years their corporations received COD income” whereas *Pugh* did not have suspended losses.²⁴⁹ The court concluded that it was irrelevant whether *Pugh* would have included his S corporation’s COD income as his own because it would not have directly altered his tax liability given the fact he did not have any suspended losses.²⁵⁰ However, the court acknowledged that the COD income would “ultimately affect [the shareholder’s] tax liability by flowing through under [section]1366 and . . . increasing his basis pursuant to [section] 1367(a)(1)(A).”²⁵¹ The court concluded that COD income that is excluded at the corporate level passes through to shareholders as an item of income and increases the basis of the shareholder’s stock.²⁵² The court stated that it did not have to reach the issue of the timing of the attribute reduction.²⁵³

247. See *Pugh v. Comm’r*, 213 F.3d 1324, 1326–27 (11th Cir. 2000) (stating that “[b]ecause the Code clearly provides that all S corporation income passes through . . . and increases [the stockholder’s] basis by the amount of the pass-through, we must reverse the tax court” and then examining the legislative history and explaining that “[t]axpayers who exclude COD income must offset the exclusion” and stating that it must continue to explore and determine whether COD income is an item of income).

248. See *id.* at 1326. The court stated that the Eleventh Circuit:
has not addressed the issue of whether COD income realized and excluded from gross income under 26 U.S.C. § 108(a) passes through to shareholders of an S corporation as an item of income under 26 U.S.C. § 1367(a)(1), and whether S corporation shareholders can increase their individual stock basis to reflect the corporation’s COD income.

Id.

249. See *id.* at 1328–29 (explaining that *Pugh* differs from *Gitlitz*, *Farley*, and *Witzel* because the taxpayers carried suspended losses into the year that their S corporations received DOI income).

250. See *id.* at 1329.

251. See *id.*

252. See *id.* at 1330–31.

253. See *id.* at 1330 n.13 (stating that “[b]ecause neither [the shareholder] nor [S corporation] possessed tax attributes to reduce, we need not reach the issue”).

5. Summary

The outcome of any case requiring statutory interpretation depends upon which rules of statutory construction the justices decide to apply. As discussed in this paper, the circuit courts disagree on the timing issue of when excluded DOI passes through to shareholders. The Holmseians of the Seventh Circuit interpreted the statutes to allow the shareholders to increase the basis of their stock by the amount and excess of DOI after attribute reduction.²⁵⁴ The Formalists of the Third Circuit would have allowed the COD to pass through before attribute reduction, granting the shareholders the tax windfall that they sought.²⁵⁵ The chart below shows the clear divergence of the holdings of the Seventh Circuit,²⁵⁶ Third Circuit,²⁵⁷ and Tenth Circuit,²⁵⁸ when the facts of these three cases are applied to the five examples derived from *Gitlitz*.²⁵⁹ It also shows the effect that the method of judicial decision-making can have on the outcome of a case. First, it represents a continuum of the price that the shareholder is to pay with the Tenth circuit adhering to its result oriented conclusion that the shareholders should not receive a windfall and therefore none of the excluded DOI passes through in any scenario, whatsoever. Chief Judge Posner and the Seventh Circuit take the middle ground reducing attributes at the corporate level in the year of receipt of the DOI income; however, they differ from the Tenth Circuit allowing the excess DOI to pass through to shareholders thereby increasing the stock basis. Finally, the Third Circuit allows the attribute reduction to occur in the taxable year following the discharge and the entirety of the excluded DOI income passes through to the shareholder increasing his basis. These results empirically verify that the method of judicial decision-making that the court employs can have a dramatic effect on the outcome of the case.

254. See *supra* notes 232–33 and accompanying text.

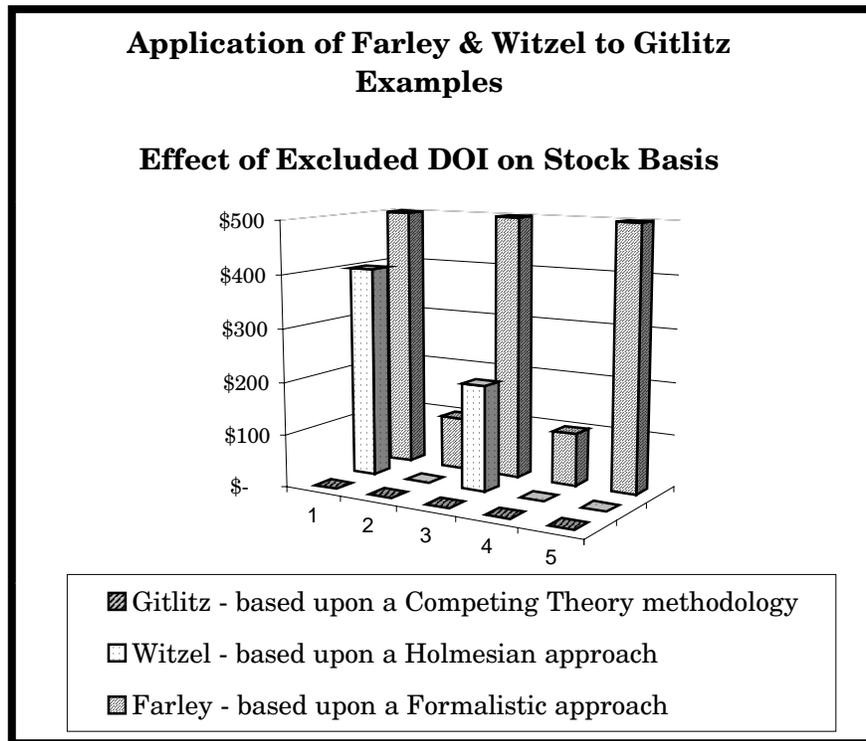
255. See *supra* notes 245–46 and accompanying text.

256. See *Witzel v. Comm'r*, 200 F.3d 496 (7th Cir. 2000); see also *supra* notes 2, 232–33 and accompanying text.

257. See *United States v. Farley*, 202 F.3d 198 (3d Cir. 2000); see also *supra* notes 2, 239, 245–46 and accompanying text.

258. See *Gitlitz v. Comm'r*, 182 F.3d 1143 (10th Cir. 1999); see also *supra* notes 1, 130, 175–77 and accompanying text.

259. See *supra* note 201 and accompanying text (listing the four examples the court created in *Gitlitz* and mentioning the fifth example the Author added that shows the actual scenario in that case).



D. The Supreme Court Rules in Favor of the Former U.S. Ambassador to Switzerland, Former Colorado Gubernatorial Candidate and Real Estate Developer²⁶⁰

In an 8-1 decision, Justice Thomas first addressed the Commissioner's argument "that the discharge of indebtedness of an insolvent S corporation is not an 'item of income'" within section 1366 and therefore, never passes through to the corporation's shareholders.²⁶¹ The Court rejected this argument based on the language and structure of the Code.²⁶² The Court stated that the Code "provides that discharge of indebtedness ceases to be *included in gross income*" if the discharge occurs

260. See John Rebchok, *Former Developer's Tax Dispute Heads to Supreme Court S Corporations Have Drawn Varied Rulings*, ROCKY MOUNTAIN NEWS, May 2, 2000, at 8B (reporting that Winn was a former U.S. Ambassador to Switzerland and an unsuccessful Colorado gubernatorial candidate in 1982). Rebchok also reports that Winn had other legal problems. For example, in 1993, Winn "[pled] guilty to a felony count of bribing federal officials" and paid a fine of nearly \$1 million. See *id.*

261. *Gitlitz v. Comm'r*, 531 U.S. 206, 208, 211 (2001) (J. Thomas delivering the opinion of the court and J. Breyer dissenting).

262. See *id.* at 211.

when the taxpayer is insolvent.²⁶³ The Court also stated that the Code “does not say that discharge of indebtedness ceases to be an *item of income* when the S corporation is insolvent.”²⁶⁴ The Court reasoned that “[n]ot all items of income are included in gross income, . . . so [the] mere exclusion of an amount from gross income does not imply” nor does the exclusion “alter the character of discharge of indebtedness as an item of income.”²⁶⁵ The Court also rejected the Commissioner’s arguments regarding the status of DOI as “tax-deferred,” rather than “tax-exempt” income.²⁶⁶

Easily determining that DOI is an item of income that can be passed through to shareholders under section 1366, the court next addressed the “sequencing question.”²⁶⁷ Namely, the court turned to the question that confused the Tenth Circuit: “whether pass-through is performed before or after the reduction of the S corporation’s tax attributes under [section] 108(b).”²⁶⁸ Applying a formalistic approach, the Court examined the express language of the Code and concluded that DOI passes through before any attribute reduction takes place, providing the taxpayers the windfall sought throughout the course of these proceedings.²⁶⁹ The Court noted other courts’ discussions and acknowledged the policy concern that “if shareholders were permitted to pass through the discharge of indebtedness before reducing any tax attributes, [they] would wrongly experience ‘double windfall.’”²⁷⁰ The windfall would arise because “[the shareholders] would be exempted from paying taxes on the full amount of the discharge of indebtedness, *and* they would be able to increase [their stock] basis and deduct their previously suspended losses.”²⁷¹ The Court declined to address this policy concern because the plain language of the Code allowed such a result—the shareholders receiving a double windfall.²⁷² Justice Breyer predictably dissented.²⁷³

263. *See id.* at 213.

264. *Id.*

265. *Id.* at 213–14.

266. *See id.* at 216.

267. *See id.*

268. *See id.*

269. *See id.* at 218.

270. *Id.* at 219.

271. *Id.* at 220.

272. *See id.*

273. *See id.* at 220–24. Justice Breyer concurs in the judgment except to the reasoning of two footnotes, objecting to the courts claim that the plain language dictates

Professor Kelso's observations seem relevant here in predicting the outcome of this case in the Supreme Court. Some commentators assert that the outcome of a Supreme Court decision cannot be predicted,²⁷⁴ but this is not always true. At least one former Chief Justice believes that a fundamental goal of the study of law is prediction.²⁷⁵

A more correct statement is that the methods individual judges employ may be predictable with a higher probability than the overall outcome of the case. By observing statistical data²⁷⁶ and using written opinions, some attorneys can predict the outcome of the case. For example, it would seem predictable in a case like *Gitlitz* that Justice Breyer would dissent when the court relies solely on the plain language of the statute.²⁷⁷ Other parts

the result with respect to attribute reduction at the corporate level, and proceeds in dissent to examine the legislative history related to attribute reduction. *See id.* at 221; *see also* Kelso *supra* note 22, at 40 (stating that Justice Breyer follows a modern natural law approach); Breyer, *supra* note 79, at 846–47 (stating that in the late 1980s and early 1990s, the Supreme Court's use of legislative history was declining and arguing that the classical practice of using legislative history should continue to be used).

274. *See* Briskin, *supra* note 50, at 49 (stating that “[i]t cannot be predicted how the Supreme Court will decide the *Gitlitz* case”).

275. *See* OLIVER WENDELL HOLMES, *THE PATH OF LAW* 5 (Appelwood Books). Holmes argued that:

People want to know under what circumstances and how far they will run the risk of coming against what is so much stronger than themselves, and hence it becomes a business to find out when this danger is to be feared. The object of our study, then, is prediction, the prediction of the incidence of the public force through the instrumentality of the courts.

Id.

276. *See* VANDEVELDE, *supra* note 3, at 178–79 n.12 (noting that “[t]he Harvard Law Review publishes annually a table that indicates the percentage of the time that each [Supreme Court] Justice voted consistently with each other justice in the prior term”).

277. *See* Kelso, *supra* note 22, at 40 (stating that “Ginsburg and Breyer clearly reject the New Textualism model of statutory interpretation”). In discussing Justice Breyer's approach to statutory interpretation, Kelso notes that:

Justice Breyer's approach to statutory interpretation reflects this modern natural law approach to statutory interpretation. Justice Breyer's approach places great weight on statutory language, purpose, and precedent. Justice Breyer also supports the use of legislative history to move beyond literal interpretation of a statute and to aid consideration of legislative purpose in interpreting a statute. This is particularly true, Justice Breyer has noted, in five kinds of cases: “(1) avoiding an absurd result; (2) preventing the law from turning on a drafting error; (3) understanding the meaning of specialized terms; (4) understanding the ‘reasonable purpose’ a provision might serve; and (5) choosing among several possible ‘reasonable purposes’ for language in a politically controversial law.” Justice Breyer also supports the use of practical reason to aid interpretation when the statute is not otherwise clear.

Id. at 47 (citations omitted). Justice Breyer has routinely lectured and written on the topic of using legislative history, and he advocates its use to interpret statutes. *See, e.g.,*

of the outcome may be less predictable, such as the fact that the majority of the court would be comprised of those persons identified by Professor Kelso.²⁷⁸ Finally, maybe the least predictable element is the actual outcome of the case.

E. Practical Considerations and Unresolved Issues: COD is not Tax Exempt Income After 1998 and the Impact of Gitlitz Outside of S Corporations

Some practitioners have stated that for those affected by the Supreme Court ruling, “it’s a gigantic, not a big, a gigantic benefit,” because some refunds could be millions of dollars.²⁷⁹ Following the ruling, shareholders of S corporations with suspended, capital, or operating losses whose S corporation encountered DOI that can be excluded under one of the special circumstances of section 108 of the Code could apply for a refund.²⁸⁰ Under the Supreme Court’s holding, more small businesses may elect to be taxed as S corporations because the holding mitigates the risk of loss for S corporation shareholders.²⁸¹ Some tax attorneys are also encouraging taxpayers to file amended returns.²⁸²

In light of the courts rejecting the arguments of the Commissioner, the treasury regulations have been changed.²⁸³ The regulations now specifically state that COD income is not tax-exempt.²⁸⁴ The question that remains in the wake of these

supra note 79 and accompanying text.

278. See *supra* note 113 and accompanying text (noting that five Justices, O’Conner, Kennedy, Souter, Ginsberg and Breyer interpret laws based on modern natural law to varying effects).

279. See Albert B. Crenshaw, *S-Corp Investors to Get Tax Break*, WASHINGTON POST, Feb. 12, 2001, at E3 (quoting Jeffrey Kelson, a tax partner in the New York office of the accounting firm of BDO Seidman).

280. See *id.*

281. See *id.* (stating that “being able to deduct more of your losses if they occur would reduce the risk”).

282. See Briskin, *supra* note 50, at 24 (explaining to taxpayers how to apply for a refund under the Third Circuit case of *Farley v. Commissioner*, 202 F.3d 198 (3d Cir. 2000)).

283. See Treas. Reg. § 1.1366-1(a)(2)(viii) (1999). The new regulation states in pertinent part that:

Tax-exempt income is income that is permanently excludible from gross income in all circumstances For example, income that is excludible from gross income under section 101 (certain death benefits) or section 103 (interest on state and local bonds) is tax-exempt income, while income that is excludible from gross income under section 108 [income from discharge of indebtedness] . . . is not tax-exempt income.

Id.

284. See *Pugh v. Comm’r*, 212 F.3d 1324, 1329 n.11 (11th Cir. 2000) (stating the new

cases is the validity of the new regulations.²⁸⁵ Taxpayers who qualify for refunds under the Supreme Court ruling will probably attack the validity of these regulations unless the Supreme Court overrules its decision in a later case or Congress enacts legislation that closes the loophole. Some practitioners agree that:

[T]his loophole will be an inviting target for President Bush or any lawmaker looking for revenue to offset a tax cut or spending increase. Furthermore, if a change were hooked to a Bush tax cut, which Bush hopes to make retroactive to Jan[uary] 1, that will be the end of it.²⁸⁶

VI. CONCLUSION

Gitlitz v. Commissioner and the divergence it recently created among the circuit courts in related cases²⁸⁷ illustrate why a determination of relationships between legal rules and their underlying policies is perhaps the most debated issue in American jurisprudence today. In the *Gitlitz* line of cases, courts are required to examine the interaction of the sections of the Code that govern the treatment of DOI income and the taxation of S corporations to decide if shareholders can use excluded DOI income to increase the basis of their stock.²⁸⁸ The outcomes of the cases in the circuit courts, *Pugh v. Commissioner*, *Gaudio v. Commissioner*, *Witzel v. Commissioner*, and *United States v. Farley*, vary widely and diverge on the construction of the same statutes under slightly varying facts.²⁸⁹ The wide variance in these decisions causes unfair administration of technical and complex law and gives rise to confusion among shareholders, practitioners, agencies, and other interested parties.

The courts decision-making method and its effect on the outcome of the cases can be described on a continuum of pricing of the attribute reduction of section 108. At one end, employing a result-oriented decision method, the Tenth Circuit interprets the

regulations are effective on August 18, 1998 and that “[t]he IRS does not treat § 108 income as tax-exempt in its final regulations”).

285. See *Witzel v. Comm’r*, 200 F. 3d 496, 498 (7th Cir. 2000).

286. See *Crenshaw*, *supra* note 279, at E3 (quoting Jeffrey Kelson, a tax partner in the New York office of the accounting firm of BDO Seidman).

287. See *supra* notes 1–2 and accompanying text.

288. See *supra* notes 4–8, 31–32 and accompanying text.

289. See *supra* note 2; see also *supra* notes 228–53 and accompanying text.

statutory language to prevent taxpayer windfalls by denying shareholders a basis increase from excluded DOI income—from the taxpayer’s view this results in the most costly structure of the attribute reduction scheme.²⁹⁰ On the opposite end of the continuum, the Supreme Court reads the plain language of the statute to allow shareholders to pass through excluded DOI income—this results in the lowest possible pricing structure of the attribute reduction scheme.²⁹¹ Generally, the other circuit courts fall at different locations on this continuum between the Tenth Circuit and the Supreme Court.²⁹² Empirically, these decisions show how the decision-making methods employed influence the outcome of the cases. Lawmaking, especially in a complex area such as tax, is for Congress.

When courts resort to unorthodox decision-making methods or legislate to reach a preferred conclusion in a difficult case, as the Tenth Circuit did in *Gitlitz*, their decisions lead to confusion, unintended consequences, and uncertainty. As evidenced by the cases considered in this article, “[t]he choice between interpreting a statute by reference to its language alone and interpreting it by reference to extrinsic sources, such as the legislative history or current notions of public policy, [will continue to be] a fundamental tension that pervades the legal reasoning process.”²⁹³

Cases like these result in increased scrutiny. When courts employ different methods of decision-making there can be an undermining effect that may cause the public to question the independent judgment of the court, and the legal and judicial system may suffer from a lack of the public confidence. I want to reiterate that I am not arguing “disingenuousness or opportunism; rather, in the present state of the law, the various approaches to statutory construction are drawn out as needed, much as a golfer selects the proper club when he gauges the distance to the pin and the contours of the course.”²⁹⁴

It is certainly true, perhaps more now than ever, that electing to be taxed as an S corporation “offer[s] favorable tax treatment to the owners of closely held businesses.”²⁹⁵ However,

290. See *supra* Part IV.C.

291. See *supra* notes 22–25 and accompanying text.

292. See *supra* note 2; see also *supra* notes 228–53 and accompanying text.

293. See VANDEVELDE, *supra* note 3, at 27.

294. See Wald, *supra* note 220, at 215–16.

295. See Laurie Asseo, *High Court Rules for ‘S Corp.’ Owners: Colorado Pair Wins IRS Dispute on Appeal*, DENVER POST, Jan. 10, 2001, at C-02.

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the Supreme Court's decision in *Gitlitz* may not stand up to the proposed tax cuts of President Bush and new legislation enacted by Congress.

VII. ADDENDUM

Shortly before this comment was sent to press, President G. W. Bush signed the Job Creation and Worker Assistance Act of 2002.²⁹⁶ Section 402 of the Act effectively closes the pro taxpayer loophole identified in *Gitlitz*. That section states that COD income excluded from an insolvent S corporation's income is expressly not treated as an "item of income."²⁹⁷ This means that COD income that is excluded from income under section 108 is not passed through as an "item of income" to the shareholders. Because this COD is not treated as "item of income," shareholders may not use it to increase the basis in their S corporation stock. Generally, section 402 of the Act applies to discharges of indebtedness after October 11, 2001.²⁹⁸ However, the new rule does not apply to any discharge of debt occurring before March 1, 2002, "pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001."²⁹⁹

It bears noting, however, that this change in the law has no effect on the analysis in this comment. The outcome of any case requiring a controversial interpretation depends on which rules of statutory interpretation judges decide to apply.

Tommy D. Overton, Jr.

296. See Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 2002 U.S.C.C.A.N. (116 Stat.) 21.

297. See *id.* § 402(a), at 40 (providing that "[s]ubparagraph (A) of section 108(d)(7) (relating to certain provisions to be applied at corporate level) is amended by inserting before the period " , including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section").

298. See *id.* § 402(b)(1), at 40.

299. *Id.* § 402(b)(2), at 40.