No. 10-928

In the Supreme Court of the United States

IRA NATHEL, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Under the Internal Revenue Code, shareholders of a Subchapter S corporation report their pro rata shares of the corporation's income and losses on their personal income tax returns. 26 U.S.C. 1366(a)(1)(A). Passthrough income increases a shareholder's basis in stock, while passthrough losses and deductions reduce a shareholder's basis in stock and may also decrease a shareholder's basis in loans to the corporation. 26 U.S.C. 1367(a) (2006 & Supp. III 2009). If a passthrough loss reduces the shareholder's basis in loans, any subsequent "net increase" in passthrough income and loss in a year will increase the shareholder's loan basis before increasing his stock basis. 26 U.S.C. 1367(b)(2)(A) and (B). Loan basis is significant because if the loan is repaid in an amount that exceeds the shareholder's basis in the loan, the shareholder must report the difference as ordinary income. The question presented in this case is as follows:

Whether petitioners' contributions to the capital of two Subchapter S corporations constituted income to the corporations that passed through to increase petitioners' bases in loans, thereby offsetting loan repayments that would otherwise have constituted ordinary income to petitioners.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-32) is reported at 615 F.3d 83. The opinion of the Tax Court (Pet. App. 33-53) is reported at 131 T.C. 262.

JURISDICTION

The judgment of the court of appeals was entered on June 2, 2010. A petition for rehearing was denied on September 20, 2010 (Pet. App. 54-55). On December 13, 2010, Justice Ginsburg extended the time within which to file a petition for a writ of certiorari to and including January 18, 2011, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Under the Internal Revenue Code, a Subchapter S corporation's profits and losses pass through to the corporation's shareholders on a pro rata basis and are reported on the shareholders' income tax returns. See *Gitlitz* v. *Commissioner*, 531 U.S. 206, 209-210 (2001); *Bufferd* v. *Commissioner*, 506 U.S. 523, 525 (1993). Specifically, Section 1366(a)(1)(A) and (B) of Title 26 of the United States Code provides that a Subchapter S corporation shareholder's tax liability is based on his pro rata share of the corporation's income (including tax-exempt income), loss, deduction, or credit that separately might affect the shareholder's tax liability, plus "nonseparately computed income or loss," which Section 1366(a)(2) defines as gross income minus allowable deductions when computed by excluding all items described in Section 1366(a)(1). To prevent double taxation, income that passes through to the shareholders increases their bases in corporate stock. 26 U.S.C. 1367(a)(1). Corporate losses and deductions are passed through in a similar manner and decrease the shareholders' bases in stock. 26 U.S.C. 1367(a)(2) (2006 & Supp. III 2009).

If a shareholder makes a loan to a Subchapter S corporation, the loan's initial basis is equal to its face amount; subsequent repayments of the loan decrease that basis. See, *e.g., Cornelius* v. *Commissioner*, 494 F.2d 465, 469 (5th Cir. 1974). Loan basis may also decrease by virtue of 26 U.S.C. 1367(b)(2)(A), which provides that a shareholder's pro rata share of deductions and losses reduces his basis in indebtedness (although not below zero) if his basis in stock has already been reduced to zero. If loan basis has been decreased by virtue of Section 1367(b)(2)(A), a "net increase" in the shareholder's pro rata share of the corporation's income and loss will increase loan basis before it increases stock basis. 26 U.S.C. 1367(b)(2)(B).[1]

2. Petitioners Sheldon Nathel and Ira Nathel are brothers who, along with Gary Wishnatzki, organized three Subchapter S corporations to operate food distribution businesses in New York, Florida, and California. Pet. App. 3, 5.[2] The corporations were called Wishnatzki & Nathel, Inc. (W&N), G&D Farms, Inc. (G&D Farms), and Wishnatzki & Nathel of California, Inc. (W&N California). *Ibid.* As a result of capital contributions, each petitioner owned 25% and Wishnatzki owned 50% of each corporation. *Id.* at 5.

Prior to 2001, G&D Farms and W&N California had suffered losses that reduced petitioners' stock bases to zero. Pet. App. 5, 36. Under Section 1367(a)(2), subsequent losses reduced petitioners' bases in loans they had made to the two corporations. *Ibid.* As of January 21, 2001, each petitioner had a basis of $112,547 in loans made to G&D Farms, which had outstanding balances of $649,775, and each petitioner had a basis of $3,603 in loans made to W&N California, which had outstanding balances of $161,250. *Id.* at 5-6. In 2001, G&D Farms and W&N California made loan repayments to petitioners in the amounts of $649,775 and $161,250, respectively. *Ibid.*[3]

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[1] A "net increase" occurs when a shareholder's pro rata share of Subchapter S income items exceeds his share of items of loss or deduction in a taxable year. 26 C.F.R. 1.1367-2(c)(1).

[2] Petitioners' wives, Ann M. Nathel and Tracy Nathel, filed joint income tax returns with their husbands and are also petitioners in this Court. Pet. App. 35 n.1.

[3] The chart at Pet. App. 36 is inaccurate, apparently as a result of a printing error. The actual amounts of petitioners' bases in stock and

When a loan is repaid in an amount that exceeds the lender's basis in the loan, the lender receives ordinary income. When petitioners filed their income tax returns for 2001, however, they failed to report as income the amounts by which the loan repayments that each of them had received from G&D Farms and W&N California exceeded their bases in those loans. Pet. App. 7. Instead, petitioners noted that as part of a 2001 reorganization plan in which petitioners ended their relationship with Wishnatzki and reorganized the three corporations, each petitioner had made a capital contribution of $537,228 to G&D Farms and a capital contribution of $181,396 to W&N California. *Id.* at 6. Petitioners treated those capital contributions as income to the corporations that passed through to increase the bases in their loans to the corporations, thereby offsetting the amount of the loan repayments and resulting in no income to petitioners. *Id.* at 7.

During an audit, the Commissioner determined that petitioners' capital contributions to G&D Farms and W&N California did not constitute income to the corporations and therefore did not pass through to increase the bases of petitioners' loans. Pet. App. 7, 39-40. Based on his conclusion that each petitioner had therefore received $694,875 of ordinary income from loan repayments, the Commissioner issued notices of deficiency to petitioners for the tax that resulted from including that ordinary income in petitioners' gross income for 2001. *Ibid.*[4]

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loans are set forth above.

[4] In the Commissioner's redetermination, petitioners' 2001 capital contributions were applied to increase their bases in stock held in G&D Farms and W&N California. Pet. App. 7. Because petitioners previously had zero bases in the stock, and since the stock was redeemed as

2. Petitioners filed suit in the Tax Court to challenge the Commissioner's notices of deficiency. Petitioners contended that 26 U.S.C. 118(a)'s exclusion of capital contributions from a corporation's gross income would be unnecessary if capital contributions were not "income" in the first place. According to petitioners, capital contributions are therefore "tax-exempt income," which passes through to increase a shareholder's basis in loans to a subchapter S corporation under 26 U.S.C. 1366(a)(1) and 1367(b)(2)(B). Petitioners argued that their capital contributions were sufficient to offset the loan repayments they had received from the corporations in 2001, and that the loan repayments therefore resulted in zero income to petitioners. In support of this argument, petitioners relied in part on *Gitlitz* v. *Commissioner*, 531 U.S. 206 (2001), in which this Court held that discharge of a subchapter S corporation's indebtedness was income to the corporation that flowed through to increase the stock bases of the corporation's shareholders, even though discharge of indebtedness was excluded from the corporation's gross income under 26 U.S.C. 108(a)(1)(B).

The Tax Court concluded that petitioners' characterization of capital contributions as income would "undermine three cardinal and longstanding principles of the tax law," namely that: (1) a shareholder's contributions to capital increase the basis of his stock in the corporation, not the basis of his loans, (2) corporate equity (represented by contributions to capital) and corporate debt (represented by shareholder loans) are treated differently by both the Internal Revenue Code

part of the restructuring of the corporations, the Commissioner's treatment of the capital contributions allowed petitioners a long-term capital loss for 2001 in the amount of the capital contributions. *Ibid.*

and the courts, and (3) contributions to capital are not income to a corporation. Pet. App. 45-46. The Tax Court declined to interpret this Court's decision in *Gitlitz* "to override these three longstanding principles of tax law." *Id.* at 46.

The Tax Court distinguished *Gitlitz*, noting that while discharge of indebtedness is specifically included in the definition of "gross income" under 26 U.S.C. 61(a)(12), capital contributions to an S corporation are not. Pet. App. 46. The court further explained that Treasury regulations specifically state that capital contributions do not constitute income to an S corporation. *Id.* at 46-47; see 26 C.F.R. 1.118-1 ("[I]f a corporation requires additional funds for conducting its business and obtains such funds through * * * payments by its shareholders * * * such amounts do not constitute income."). The Tax Court concluded that petitioners' capital contributions were not income to the corporations for purposes of Section 1366(a)(1), and that the payments therefore did not pass through to increase petitioners' bases in loans to those corporations under Section 1367(b)(2)(B). Pet. App. 49.

3. The court of appeals affirmed. Pet. App. 1-32. The court rejected petitioners' "novel argument" that capital contributions constitute income for purposes of Section 1366(a)(1)(A). *Id.* at 9. The court explained that this Court has historically recognized a clear distinction between income and capital, initially defining income as "the gain derived from capital, from labor, or from both combined." *Id.* at 10-11 (citing, *e.g.*, *Eisner* v. *Macomber*, 252 U.S. 189, 207 (1920)). While acknowledging that this Court has subsequently broadened the definition of "income" beyond *Macomber*'s formulation, the court of appeals observed that this Court has always

been "careful to maintain the distinction between capital and income." Pet. App. 10-11, 13. The court further explained that 26 U.S.C. 118(a) expressly excludes capital contributions from corporate income. Pet. App. 15. The court observed as well that it owed *Chevron* deference to 26 C.F.R. 1.118-1, which makes clear that capital contributions do not constitute income to a Subchapter S corporation. Pet. App. 15-16.

The court of appeals rejected petitioners' argument that this Court's decision in *Gitlitz* altered the traditional distinction between income and capital and required that capital contributions be treated as income for purposes of Section 1366(a)(1)(A). Pet. App. 17-19. The court recognized a "critical" distinction between the discharge of indebtedness that was at issue in *Gitlitz* and the capital contributions at issue in this case, in that discharge of indebtedness is statutorily defined as income by Section 61(a), even though it is excluded from income in some circumstances by Section 108(a). *Id.* at 18. Capital contributions, on the other hand, "traditionally have not been included in gross income in the first instance," and "the fact that [Section] 118(a) explicitly excludes them [from gross income] does not transform them into 'items of income' for the purposes of [Section] 1366(a)(1)(A)." *Ibid.* The court of appeals found unpersuasive petitioners' argument that Congress's decision to exclude capital contributions from gross income in Section 118(a) proves that such payments would otherwise be income. The court explained that Section 118(a) was enacted to codify case law holding that capital contributions from non-shareholders, like contributions from shareholders, did not constitute income to a corporation. *Id.* at 19.

The court of appeals also rejected petitioners' argument that earlier decisions distinguishing between income and capital had been overruled by *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955). Pet. App. 21. The court explained that the Court in *Glenshaw Glass*, in holding that a punitive damages award constituted income to a corporation, had recognized that *Macomber*'s definition "was 'useful' precisely because it distinguish[ed] gain from capital." *Ibid.* The court of appeals concluded that petitioners' capital contributions did not constitute income to the corporations under Section 1366(a)(1)(A), and therefore could not pass through to restore their bases in loans pursuant to Section 1367(b)(2)(B). *Id.* at 26.

ARGUMENT

Petitioners contend (Pet. 10-37) that their capital contributions to two Subchapter S corporations constituted income to those corporations within the meaning of Section 1366(a)(1), which then passed through to restore the bases in loans they had made to those corporations under Section 1367(b)(2)(B), thereby ensuring that the loan repayments would not result in income to petitioners. The court of appeals correctly rejected that argument, and its decision does not conflict with any decision of this Court or of another court of appeals. Further review is not warranted.

1. a. Contrary to petitioners' contention (Pet. 10-19), the court of appeals' decision does not conflict with this Court's decision in *Gitlitz* v. *Commissioner*, 531 U.S. 206 (2001). The question presented in *Gitlitz* was whether the shareholders of an insolvent Subchapter S corporation could increase their stock bases by their pro rata shares of the corporation's discharge of

indebtedness income. Although 26 U.S.C. 108(a)(1)(B) excludes discharge of indebtedness from the gross income of an insolvent taxpayer, the Court concluded that this statutory exclusion did not alter the "character" of discharge of indebtedness as an income item, and that discharge of indebtedness therefore is tax-exempt income that can pass through to increase stock basis under Sections 1366(a)(1) and 1367(b)(2)(B). *Gitlitz*, 531 U.S. at 214-215.

The Court in *Gitlitz* addressed an economic item wholly different from the capital contributions at issue here. The Court in *Gitlitz* noted that, under 26 U.S.C. 61(a), discharge of indebtedness "generally is included in gross income." 531 U.S. at 213.[5] Although Section 108(a)(1)(B) establishes "an express exception to this general rule" by excluding discharge of indebtedness from the income of an insolvent taxpayer, the Court read the statute to provide "that discharge of indebtedness ceases to be *included in gross income*" of an insolvent Subchapter S corporation, not that it "ceases to be an *item of income* when the S corporation is insolvent." *Ibid.* Based on the "language and logic of [Section] 108," the Court concluded that discharge of indebtedness results in an item of income within the meaning of Section 1366(a)(1). *Id.* at 215.

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[5] Contrary to petitioners' assertion (Pet. 26), the court of appeals in this case did not distinguish discharge of indebtedness income from capital contributions solely on the ground that Section 61(a) specifically identifies the former as an item of income. The court of appeals considered whether there was any authority holding that shareholder capital contributions constitute gross income even though they are not identified as such in Section 61(a), but the court found no case "that has held that capital contributions are 'income' under [Section] 1366(a)(1)(A) or any other provision of the Code." Pet. App. 21.

Petitioners argue (Pet. 10-19) that capital contributions must be treated as income for purposes of Section 1366(a)(1) because, like the discharge of indebtedness in *Gitlitz*, contributions to capital are statutorily excluded from gross income, albeit by Section 118(a) rather than by Section 108(a)(1)(B). Petitioners assert that the Court in *Gitlitz* held "that all income excluded from gross income by statute is an 'item of tax-exempt income' for purposes of the S corp basis adjustment rules." Pet. 10. Petitioners read *Gitlitz* too expansively. The Court in *Gitlitz* considered only whether Section 108(a)(1)(B)'s exclusion of discharge of indebtedness from gross income means that such income cannot be used to increase the stock bases of the shareholders of an insolvent Subchapter S corporation. To the extent that the Court considered any of the other income exclusions set out in Sections 101-136 of the Code, the Court rejected the "sweeping" proposition that all such amounts would be excluded from income for purposes of Section 1366(a)(1). *Gitlitz*, 531 U.S. at 213. But the Court did not endorse the opposite proposition—*i.e.*, it did not hold or suggest that every item specifically excluded from gross income by Sections 101-136 is *included* in income under Section 1366(a)(1).

Petitioners' attempt to bring their capital contributions within the scope of the Court's holding in *Gitlitz* also rests on a misunderstanding of the nature of a capital contribution. Petitioners argue that contributions to capital constitute income for purposes of Section 1366(a)(1) because they "would otherwise be gross income if not excluded by section 118(a)." Pet. 16. As the court of appeals recognized, however, "[c]apital contributions are not gains to a corporation." Pet. App.

21. They are instead "'an additional price paid for[] the shares of stock held by the individual shareholders' of a corporation, and are treated as a part of the operating capital of the company." *Id.* at 21-22 (citing 26 C.F.R. 1.118-1).

b. Although petitioners contend (Pet. 13) that Congress has sometimes included capital contributions in gross income, the authorities they cite do not support that proposition. Petitioners assert (Pet. 13 n.13), for example, that Congress has treated capital contributions as gross income in Section 108(e). Section 108(e)(6) provides generally that, if a shareholder contributes corporate indebtedness to a corporation, the corporation will be deemed to have received discharge of indebtedness income that is measured as if the corporation had satisfied the contributed debt with an amount of money equal to the shareholder's adjusted basis in the loan. The effect of Section 108(e)(6) is to impute income to a corporation if a shareholder who contributes a loan to the corporation has a basis in the loan that is less than its full amount.

The legislative history of Section 108(e)(6) indicates that the provision was enacted in response to *Putoma Corporation* v. *Commissioner*, 601 F.2d 734, 751 (1979), in which the Fifth Circuit held that a shareholder's forgiveness of corporate indebtedness was a contribution to capital that did not result in income to the corporation. See S. Rep. No. 1035, 96th Cong., 2d Sess. 18-19 (1980). Section 108(e)(6) overrode that decision, providing that cancellation of indebtedness constitutes income even if it would otherwise would be excluded from income by the general rule governing capital contributions.

Petitioners also rely (Pet. 13 n.13, 24-25) on Section 118(b), which they suggest represents another instance in which capital contributions are included in gross income. The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2120, 90 Stat. 1520, added Section 118(b) to the Code to provide that "contributions in aid of construction" would not be treated as contributions to capital, except in the case of contributions to water and sewage utilities. The Revenue Act of 1978, Pub. L. No. 95-600, § 364, 92 Stat. 2763, extended that provision to electric and gas utilities. The Tax Reform Act of 1986, Pub. L. No. 99-514, § 824(a), 100 Stat. 2374, struck out the exceptions for public utilities and provided generally that "the term 'contribution to the capital of the taxpayer' does not include any contribution in aid of construction or any other contribution as a customer or potential customer."

The House Ways and Means Committee explained the 1986 amendment as follows:

> The committee believes that all payments that are made to a utility either to encourage, or as a prerequisite for, the provision of services should be treated as income of the utility and not as a contribution to the capital of the utility. The committee believes that present law allows amounts that represent prepayments for services to be received by corporate regulated public utilities without the inclusion of such payments in gross income. Accordingly, the committee bill repeals the present law treatment and requires the recipient utility to include the value of such contributions in income at the time of their receipt and to depreciate the value of any asset contributed, or purchased with

> a contribution of cash, over the recovery period of the asset.

H. R. Rep. No. 426, 99th Cong., 1st Sess. 643-644 (1985). Thus, Congress viewed "contributions in aid of construction" as "prepayments for services," not as capital contributions. The inclusion in income of these "prepayments" does not demonstrate that capital contributions themselves should be treated as items of income. Because the court of appeals in this case correctly recognized and relied upon the critical difference between capital contributions and cancellation of indebtedness, its decision does not conflict with *Gitlitz*.

2. Petitioners further contend (Pet. 19-30) that the court of appeals' decision conflicts with the definitions of "income" set forth in *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955), and *Commissioner* v. *Kowalski*, 434 U.S. 77 (1977). The core premise of petitioners' argument is that the distinction between capital and income no longer exists. As the court of appeals explained, however, although this Court has expanded the definition of "income" beyond the formulation articulated in *Eisner* v. *Macomber*, 252 U.S. 189 (1920), the Court has consistently distinguished between capital and income. Pet. App. 21-22.

Petitioners fault the court of appeals for citing *Macomber* and *Edwards* v. *Cuba R.R.*, 268 U.S. 628 (1925), stating (Pet. 19) that this Court's decisions in *Glenshaw Glass* and *Kowalski* "clearly rejected" the definition of income that emerged from those cases. That argument is based on a misunderstanding of the court of appeals' opinion. To the extent the court of appeals gave weight to the decision in *Macomber*, it was only to point out, correctly, that the Court there "drew a clear distinction between income and capital." Pet. App. 11. The Court in *Macomber* addressed the question whether a shareholder's receipt of a stock dividend resulted in income that was subject to tax, or whether it represented a "capital increase" that did not constitute a realization of income. 252 U.S. at 212-213. In analyzing the issue, the Court noted that "[t]he fundamental relation of 'capital' to 'income' has been much discussed by economists." *Id.* at 206-207. The Court concluded, however, that it needed only "to distinguish between what is and what is not 'income,'" and it defined income as "the gain derived from capital, from labor, or from both combined." *Ibid.*

The court of appeals acknowledged that this "limited definition" of income was expanded in *United States* v. *Kirby Lumber Co*., 284 U.S. 1 (1931), and again in *Glenshaw Glass*, to include items like punitive damages, which did not fit within *Macomber*'s formulation. Pet. App. 12. The court of appeals explained, however, that this Court has "repeatedly emphasized the distinction between capital and income," and that *Glenshaw Glass* "did not overrule" that distinction. *Id.* at 21. Petitioners are thus incorrect in contending that the court of appeals mistakenly relied on overturned precedent to reach a conclusion that is at odds with the Court's decision in *Glenshaw Glass*.[6]

[6] Although petitioners rely principally on *Glenshaw Glass* to assert that the decision in this case conflicts with the governing definition of "income," they also rely on *Commissioner* v. *Kowalski*, *supra*, for the same proposition. Pet. 20-21. The Court in *Kowalski* concluded that meal allowance payments to New Jersey state troopers should be included as part of the recipients' "gross income." 434 U.S. at 83. In doing so, the Court relied on *Glenshaw Glass* and noted that *Macomber*'s definition of income was too narrow. *Ibid.* Given that the court of ap-

Petitioners further contend (Pet. 19) that the court of appeals mistakenly relied on this Court's decision in *Edwards* v. *Cuba R.R., supra*. That argument is wrong for several reasons. First, the court of appeals did not attribute undue significance to *Edwards*, but rather described it as one of several cases in which this Court considered the meaning of the term "income." Pet. App. 10-14. Moreover, the court of appeals recognized that the nonshareholder capital contributions at issue in *Edwards* were different from the shareholder capital contributions at issue here. *Id.* at 24. Finally, the court of appeals properly acknowledged that the "scope" of the *Edwards* decision "has been clarified" by several subsequent decisions of this Court, and that the decision in *Edwards* therefore no longer commands the result that the Court reached there. *Ibid.*[7]

The court of appeals reviewed this Court's precedents defining the scope of "income" and concluded

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peals in this case recognized that the *Macomber* definition of income has been supplanted by a broader definition, petitioners have not demonstrated that the decision below conflicts with *Kowalski*.

[7] The Court in *Edwards* held that government subsidies to a railroad to encourage the construction of facilities in Cuba did not constitute income. The Court later held, in *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 102-103 (1943), that prospective customers' payments to an electric utility for the utility's use in extending service lines were not contributions to capital and were therefore items of income. See also *United States* v. *Chicago, Burlington & Quincy R.R.*, 412 U.S. 401, 413-414 (1973) (government payments received by a railroad for improvements at grade crossings and intersections were not contributions to capital because they had none of the hallmarks of a contribution to capital). As explained above, pp. 11-13, *supra*, Congress addressed nonshareholder contributions in Section 118(b) of the Code, which provides that "contribution[s] in aid of construction" are treated as income rather than as capital contributions.

that the Court has consistently maintained a "careful" distinction between income and capital. Pet. App. 12-13. Because petitioners have identified no decision of this Court or another court of appeals holding that capital contributions constitute income for purposes of Section 1366(a)(1), further review is not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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