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DEPARTMENT OF THE TREASURY

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Internal Revenue Service

26 CFR Part 1

TD 9080

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Reduction of Tax Attributes Due to Discharge of Indebtedness

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the reduction of tax attributes under sections 108 and 1017 of the Internal Revenue Code. These temporary regulations affect taxpayers that exclude discharge of indebtedness income from gross income under section 108. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These temporary regulations are effective July 17, 2003.

Applicability Date: These temporary regulations apply to discharges of indebtedness occurring after July 17, 2003.

FOR FURTHER INFORMATION CONTACT: Theresa M. Kolish (202 622-7930) of the Office of the Associate Chief Counsel (Corporate) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The Debt Discharge Rules

Pursuant to section 61(a)(12), gross income includes income from the discharge of indebtedness (COD income). Section 108(a)(1), which reflects the amendments enacted in the Bankruptcy Tax Act of 1980, Public Law 96-589, section 2, 94 Stat. 3389 (1980) (1980-2 C.B. 607), however, provides that, where the discharge occurs in a title 11 case, where the taxpayer is insolvent, or where the indebtedness is “qualified farm indebtedness” or “qualified real property business indebtedness,” gross income does not include any amount that otherwise would be includible in gross income by reason of that discharge (in whole or in part) of the indebtedness of the taxpayer.

Although section 108(a) excludes COD income from gross income under those circumstances, section 108(b) requires the reduction of certain tax attributes in an amount that reflects the amount excluded from gross income, thereby generally deferring, rather than permanently eliminating, the inclusion of COD income. Section 108(b)(2) requires the reduction of the following tax attributes of the taxpayer in the following order: (A) net operating losses; (B) general business credits; (C) minimum tax credits; (D) capital loss carryovers; (E) adjusted basis of property; (F) passive activity losses and credit carryovers; and (G) foreign tax credit carryovers. Section 108(b)(4)(A) provides that the reductions are made after the determination of the tax imposed for the taxable year of the discharge. Section 108(b)(4)(B) provides that the reductions of net operating losses and capital loss carryovers are made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose. If the excluded COD income exceeds the sum of the taxpayer’s tax attributes, the excess is disregarded such that it does not result in income or have other tax consequences. See H.R. Rep. No. 96-833, at 11 (1980).

Instead of reducing tax attributes in the order set forth in section 108(b)(2), a taxpayer may elect under section 108(b)(5) to reduce first the adjusted bases of depreciable property to the extent of the excluded COD income. The amount to which the election applies is limited to the aggregate adjusted basis of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs. If the adjusted bases of depreciable property are insufficient to offset the entire amount of excluded COD income, the taxpayer must then reduce any remaining tax attributes in the order set forth in section 108(b)(2). Congress intended the election under section 108(b)(5) to allow debtors, including debtors in bankruptcy, to account for a debt discharge amount in a manner most favorable to their tax situations. See S. Rep. No. 96-1035, at 10 (1980); H.R. Rep. No. 96-833, at 9 (1980).

Section 1017(a) provides that when any portion of COD income excluded from gross income under section 108(a) is to be applied to reduce basis, then such portion shall be applied to reduce the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. Section 1017(b)(1) provides that the amount of reduction under section 1017(a), and the particular properties the bases of which are to be reduced, shall be determined under regulations.

The Reorganization Rules

Section 368(a)(1) defines a reorganization to include certain types of asset acquisitions. Under section 361, a corporation that is a party to a reorganization recognizes neither gain nor loss when it exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization. If the corporation receives in the exchange not only

stock or securities permitted to be received without the recognition of gain, but also other property or money, then the corporation may be required to recognize gain. Under section 362(b), if property is acquired by a corporation in connection with a reorganization, then the basis is the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor on such transfer.

Section 332(a) provides that a corporation recognizes no gain or loss on the receipt of property distributed in complete liquidation of another corporation. Section 337(a) provides that a liquidating corporation recognizes no gain or loss on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies. Under section 334(b)(1), if property is received by a corporate distributee in a distribution in a complete liquidation to which section 332 applies, the basis of such property in the hands of such distributee is the same as it would be in the hands of the transferor. However, in any case in which gain or loss is recognized by the liquidating corporation with respect to such property, the basis of such property in the hands of such distributee is the fair market value of the property at the time of the distribution.

Section 381 provides that a corporation that acquires the assets of another corporation in a distribution to which section 332 applies or in a transfer to which section 361 applies (but only if the transfer is in connection with certain reorganizations described in sections 368(a)(1)(A), (C), (D), (F), or (G)) shall succeed to, and take into account, as of the close of the day of distribution or transfer, the items described in section 381(c) of the distributor or transferor corporation, subject to certain conditions and limitations. Among those items described in section 381(c) are net operating loss carryovers, capital loss carryovers, general business credits, and minimum tax credits. With respect to

net operating loss carryovers and capital loss carryovers, the regulations under section 381 reflect that the acquiring corporation succeeds to only those carryovers that remain after the application of sections 172 and 1212 and their carryforward and carryback provisions. See §§1.381(c)(1)-1; 1.381(c)(3)-1. Furthermore, those regulations provide that the acquiring corporation succeeds to only those general business credits that remain unused by the transferor corporation after computing its taxable income for the year of the transfer. See §1.381(c)(23)-1. Section 381(b)(1) provides that, except in the case of an acquisition in connection with a reorganization described in section 368(a)(1)(F), the taxable year of the distributor or transferor corporation ends on the date of distribution or transfer.

Interaction Between Debt Discharge and Reorganization Rules

Questions have arisen regarding the application of the attribute reduction rules of sections 108 and 1017 when a transaction described in section 381(a) ends a taxable year in which the transferor excludes COD income from gross income. If section 108(b)(4)(A) and section 1017 were interpreted to require attribute reduction to occur after the close of the taxable year of discharge and after the transfer of assets and carryover of items described in section 381(c), then arguably no attributes described in section 108(b)(2) would be available for reduction.

Explanation of Provisions

The IRS and Treasury Department believe that the rule of section 108(b)(4)(A) prescribes an ordering of calculations. First, section 108(b)(4)(A) requires a determination of the taxpayer's tax for the taxable year of discharge in order to identify the amounts, if any, of the tax attributes described in section 108(b)(2) that remain available for reduction. Second, section 108(b)(4)(A) requires the reduction of those attributes. This ordering rule affords the taxpayer the use of certain of its tax

attributes described in section 108(b)(2), including any losses carried forward to the taxable year of discharge, for purposes of determining its tax for the taxable year of discharge, before subjecting those attributes to reduction.

Similarly, the IRS and Treasury believe that the rule of section 1017 prescribes an ordering of calculations. The Bankruptcy Tax Act of 1980 reflects that Congress enacted the rule of section 1017 "to avoid interaction between basis reduction and reduction of other attributes." S. Rep. No. 96-1035, at 14 (1980); H. Rep. No. 96-833, at 11 (1980). Without this rule, a circular calculation could be required. The taxpayer's net operating loss for the year of the discharge of indebtedness might be based in part on the amount of cost recovery deductions allowed to the taxpayer. The amount of cost recovery deductions, however, would depend on the taxpayer's basis in its depreciable or amortizable property at the end of the year. Because net operating losses are reduced by excluded COD income prior to the reduction of asset basis absent an election under section 108(b)(5), the amount of basis required to be reduced would depend on the amount of net operating losses. Reducing the basis of property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs avoids this circularity.

The position that sections 108 and 1017 require the reduction of attributes, including the basis of transferred assets, in cases where the debtor's taxable year ends with a transfer of assets in a transaction described in section 381 is consistent with the policies underlying sections 108 and 1017 and the corporate reorganization provisions, including "deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge." S. Rep. No. 96-1035, at 10 (1980). For example, assume that a debt of corporation X is discharged in a title 11 case. X's attributes described

in section 108(b)(2) consist solely of basis in property. As part of a plan of reorganization, X transfers all of its assets to a newly formed corporation, Y. Under section 368(a)(3)(C), even though the transaction also qualifies as a reorganization under section 368(a)(1)(F), the transaction is treated as qualifying as a reorganization only under section 368(a)(1)(G). If sections 108 and 1017 were interpreted to not require a reduction of the bases of the property transferred, X would permanently exclude from gross income the COD income, notwithstanding that X underwent nothing more than a mere change in identity, form, or place of organization. Accordingly, consistent with the legislative history of the Bankruptcy Tax Act of 1980, the IRS and Treasury Department believe that the basis reduction rules of sections 108 and 1017 apply to property of a debtor transferred in a transaction described in section 381(a).

The legislative history of the Bankruptcy Tax Act of 1980 reflects that Congress specifically anticipated that amounts that carry over in a transaction described in section 381, including the basis of transferred property, are to be adjusted under the rules of sections 108 and 1017 to account for excluded COD income. See H.R. Rep. No. 96-833, at 32-34 (1980). The legislative history states:

Assume that Corporation A is in a bankruptcy case commenced after October 1, 1979. Immediately prior to a transfer under a plan of reorganization, A's assets have an adjusted basis of \$75,000 and a fair market value of \$100,000. A has a net operating loss carryover of \$200,000. A has outstanding bonds of \$100,000 (on which there is no accrued but unpaid interest) and trade debts of \$100,000.

Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for \$100,000 of B stock. Corporation A will distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A's shareholders will receive nothing.

The transaction would qualify as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for

continuity of interest purposes. Thus, A would recognize no gain or loss on the transfer of its assets to B (sec. 361). B's basis in the assets would be \$75,000 (sec. 362), and B would succeed to A's net operating loss carryover (sec. 381).

Under the bill, . . . [o]n the distribution of B stock to A's trade creditors, A excludes from gross income the debt discharge amount of \$50,000 -- i.e., the difference between the \$100,000 debt held by non-security creditors and the \$50,000 worth of stock given for such debt. A may elect to reduce the basis of its depreciable assets transferred to B by all or part of the \$50,000 debt discharge amount; to the extent the election is not made, the debt discharge amount reduces A's net operating loss carryover by the remainder of the debt discharge amount.

H.R. Rep. No. 96-833, at 34 (1980). The treatment of the net operating loss and basis in the legislative history demonstrates that, in a transaction described in section 381, the transferor's attributes, including the basis of transferred property, that carry over to the transferee are reduced.

Accordingly, these temporary regulations clarify that, in the case of a transaction described in section 381(a) that ends a year in which the distributor or transferor corporation excludes COD income from gross income under section 108(a), any tax attributes to which the acquiring corporation succeeds and the basis of property acquired by the acquiring corporation in the transaction shall reflect the reductions required by sections 108 and 1017. For this purpose, all attributes listed in section 108(b)(2) of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), including the basis of property, but after the determination of tax for the year of the discharge, are available for reduction under section 108(b)(2).

These temporary regulations also clarify that the tax attributes subject to reduction under section 108(b)(2) that are carryovers to the taxable year of the discharge, or that may be carried back to taxable years preceding the year of the discharge, are first taken into account by the taxpayer for the taxable year of the discharge or the preceding years, as the case may be, before such attributes are

reduced pursuant to section 108(b)(2).

These temporary regulations apply to discharges of indebtedness occurring after July 17, 2003.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these temporary regulations, and, because no preceding notice of proposed rulemaking is required for these temporary regulations, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Theresa M. Kolish, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding the following entry in

numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.108-7T also issued under 26 U.S.C. 108. * * *

Par. 2. Section 1.108-7T is added to read as follows:

§1.108-7T Reduction of attributes (temporary).

(a) In general. (1) If a taxpayer excludes discharge of indebtedness income (COD income) from gross income under section 108(a)(1)(A), (B), or (C), then the amount excluded shall be applied to reduce the following tax attributes of the taxpayer in the following order:

- (i) Net operating losses.
- (ii) General business credits.
- (iii) Minimum tax credits.
- (iv) Capital loss carryovers.
- (v) Basis of property.
- (vi) Passive activity loss and credit carryovers.
- (vii) Foreign tax credit carryovers.

(2) The taxpayer may elect under section 108(b)(5), however, to apply any portion of the excluded COD income to reduce first the basis of depreciable property to the extent the excluded COD income is not so applied, the taxpayer must then reduce any remaining tax attributes in the order specified in section 108(b)(2). If the excluded COD income exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income. For rules relating to basis reductions required by sections 108(b)(2)(E) and 108(b)(5), see section 1017 and §1.1017-1.

For rules relating to the time and manner for making an election under section 108(b)(5), see §1.108-4.

(b) Carryovers and carrybacks. The tax attributes subject to reduction under section 108(b)(2) and paragraph (a)(1) of this section that are carryovers to the taxable year of the discharge, or that may be carried back to taxable years preceding the year of the discharge, are taken into account by the taxpayer for the taxable year of the discharge or the preceding years, as the case may be, before such attributes are reduced pursuant to section 108(b)(2) and paragraph (a)(1) of this section.

(c) Transactions to which section 381 applies. In the case of a transaction described in section 381(a) that ends a taxable year in which the distributor or transferor corporation excludes COD income under section 108(a), any tax attributes to which the acquiring corporation succeeds and the basis of property acquired by the acquiring corporation in the transaction shall reflect the reductions required by section 108(b). For this purpose, all attributes listed in section 108(b)(2) of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the discharge, including basis of property, shall be available for reduction under section 108(b)(2).

(d) Examples. The following examples illustrate the application of this section:

Example 1. (i) Facts. In Year 4, X, a corporation in a title 11 case, is entitled under section 108(a)(1)(A) to exclude from gross income \$100,000 of COD income. For Year 4, X has gross income in the amount of \$50,000. In each of Years 1 and 2, X had no taxable income or loss. In Year 3, X had a net operating loss of \$100,000, the use of which when carried over to Year 4 is not subject to any restrictions other than those of section 172.

(ii) Analysis. Pursuant to paragraph (b) of this section, X takes into account the net operating loss carryover from Year 3 in computing its taxable income for Year 4 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes. Thus, the amount of the net operating loss carryover that is reduced under section 108(b)(2) and paragraph (a) of this section is \$50,000.

Example 2. (i) Facts. The facts are the same as in Example 1, except that in Year 4 X sustains a net operating loss in the amount of \$100,000. In addition, in each of Years 2 and 3, X reported taxable income in the amount of \$25,000.

(ii) Analysis. Pursuant to paragraph (b) of this section and section 172, the net operating loss sustained in Year 4 is carried back to Years 2 and 3 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes. Thus, the amount of the net operating loss that is reduced under section 108(b)(2) and paragraph (a) of this section is \$50,000.

Example 3. (i) Facts. In Year 2, X, a corporation in a title 11 case, has outstanding debts of \$200,000 and a depreciable asset that has an adjusted basis of \$75,000 and a fair market value of \$100,000. X has no other assets or liabilities. X has a net operating loss of \$80,000 that is carried over to Year 2 but has no general business credit, minimum tax credit, or capital loss carryovers. Under a plan of reorganization, X transfers its asset to Corporation Y in exchange for Y stock with a value of \$100,000. X distributes the Y stock to its trade creditors in exchange for release of their claims against X. X's shareholders receive nothing in the transaction. The transaction qualifies as a reorganization under section 368(a)(1)(G) that satisfies the requirements of section 354(b)(1)(A) and (B). For Year 2, X has gross income of \$10,000 (without regard to any income from the discharge of indebtedness) and is allowed a depreciation deduction of \$10,000 in respect of the asset. In addition, it generates no general business credits.

(ii) Analysis. On the distribution of Y stock to X's creditors, under section 108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of \$100,000. (Under section 108(e)(8), X is treated as satisfying \$100,000 of the debt owed the creditors for \$100,000, the fair market value of the Y stock transferred to those creditors.) In Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is reduced by \$10,000 to \$65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). Pursuant to paragraph (a) of this section, X's net operating loss carryover in the amount of \$80,000 is reduced by \$80,000 of the COD income excluded under section 108(a)(1). In addition, X's basis in the asset is reduced by \$20,000, the extent to which the COD income excluded under section 108(a)(1) did not reduce the net operating loss. Accordingly, as a result of the reorganization, there is no net operating loss to which Y succeeds under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is \$45,000.

Example 4. (i) Facts. The facts are the same as in Example 3, except that X elects under section 108(b)(5) to reduce first the basis of its depreciable asset.

(ii) Analysis. As in Example 3, on the distribution of Y stock to X's creditors, under section

108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of \$100,000. In addition, in Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is reduced by \$10,000 to \$65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). As a result of the election under section 108(b)(5), X's basis in the asset is reduced by \$65,000 to \$0. In addition, X's net operating loss is reduced by \$35,000, the extent to which the amount excluded from income under section 108(a)(1)(A) does not reduce X's asset basis. Accordingly, as a result of the reorganization, Y succeeds to X's net operating loss in the amount of \$45,000 under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is \$0.

(e) Effective date. This section applies to discharges of indebtedness occurring after July 17, 2003.

Par. 3. Section 1.1017-1 is amended by adding paragraph (b)(4) to read as follows:

§1.1017-1 Basis reductions following a discharge of indebtedness.

* * * * *

(b) * * *

(4) For further guidance, see §1.1017-1T(b)(4).

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Par. 4. Section 1.1017-1T is added to read as follows:

§1.1017-1T Basis reductions following a discharge of indebtedness (temporary).

(a) through (b)(3) [Reserved]. For further guidance, see §1.1017-1(a) through (b)(3).

(4) Transactions to which section 381 applies. In the case of a transaction described in section 381(a) that ends a taxable year in which the distributor or transferor corporation excludes COD income from gross income under section 108(a), the basis of property acquired by the acquiring corporation in

the transaction shall reflect the reductions required by section 1017 and this section. For this purpose, the basis of property of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the discharge, shall be available for reduction under section 108(b)(2). See §1.108-7T. This paragraph (b)(4) applies to discharges of indebtedness occurring after July 17, 2003.

(c) through (i) [Reserved]. For further guidance, see §1.1017-1(c) through (i).

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

Approved: July 9, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.