

## § 1.108-6

## 26 CFR Ch. I (4-1-14 Edition)

The election is to be made on a completed Form 982, in accordance with that Form and its instructions.

(c) *Revocability of election.* The election described in this section is revocable with the consent of the Commissioner.

(d) *Effective date.* The rules set forth in this section are effective December 27, 1993.

[T.D. 8688, 61 FR 65322, Dec. 12, 1996. Redesignated by T.D. 8787, 63 FR 56563, Oct. 22, 1998]

### § 1.108-6 Limitations on the exclusion of income from the discharge of qualified real property business indebtedness.

(a) *Indebtedness in excess of value.* With respect to any qualified real property business indebtedness that is discharged, the amount excluded from gross income under section 108(a)(1)(D) (concerning discharges of qualified real property business indebtedness) shall not exceed the excess, if any, of the outstanding principal amount of that indebtedness immediately before the discharge over the net fair market value of the qualifying real property, as defined in § 1.1017-1(c)(1), immediately before the discharge. For purposes of this section, *net fair market value* means the fair market value of the qualifying real property (notwithstanding section 7701(g)), reduced by the outstanding principal amount of any qualified real property business indebtedness (other than the discharged indebtedness) that is secured by such property immediately before and after the discharge. Also, for purposes of section 108(c)(2)(A) and this section, outstanding principal amount means the principal amount of indebtedness together with all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future, except that outstanding principal amount shall not include amounts that are subject to section 108(e)(2) and shall be adjusted to account for unamortized premium and discount consistent with section 108(e)(3).

(b) *Overall limitation.* The amount excluded from gross income under section 108(a)(1)(D) shall not exceed the aggregate adjusted bases of all depreciable

real property held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of the discharge) reduced by the sum of any—

(1) Depreciation claimed for the taxable year the taxpayer excluded discharge of indebtedness from gross income under section 108(a)(1)(D); and

(2) Reductions to the adjusted bases of depreciable real property required under section 108(b) or section 108(g) for the same taxable year.

(c) *Effective date.* This section applies to discharges of qualified real property business indebtedness occurring on or after October 22, 1998.

[T.D. 8787, 63 FR 56563, Oct. 22, 1998]

### § 1.108-7 Reduction of attributes.

(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 sections 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.* If a taxpayer realizes COD income that is excluded from gross income under section 108(a) either during or after a taxable year in which the taxpayer is the distributor or transferor of assets in a transaction described in section 381(a), any tax attributes to which the acquiring corporation succeeds, including the basis of property acquired by the acquiring corporation in the transaction, must reflect the reductions required by section 108(b). For this purpose, all attributes listed in section 108(b)(2) immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the distribution or transfer of assets, including basis of property, will be available for reduction under section 108(b)(2). However, the basis of stock or securities of the acquiring corporation, if any, received by the taxpayer in exchange for the transferred assets shall not be available for reduction under section 108(b)(2).

(d) *Special rules for S corporations—(1) In general.* If an S corporation excludes COD income from gross income under section 108(a)(1)(A), (B), or (C), the amount excluded shall be applied to reduce the S corporation's tax attributes under paragraph (a)(1) of this section. For purposes of paragraph (a)(1)(i) of this section, the aggregate amount of the shareholders' losses or deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1), including disallowed losses or deductions of a shareholder that transfers all of the shareholder's stock in the S corporation during the taxable year of the discharge, is treated as the net operating loss tax attribute (deemed NOL) of the S corporation for the taxable year of the discharge.

(2) *Allocation of excess losses or deductions—(i) In general.* If the amount of an S corporation's deemed NOL exceeds

the amount of the S corporation's COD income that is excluded from gross income under section 108(a)(1)(A), (B), or (C), the excess deemed NOL shall be allocated to the shareholder or shareholders of the S corporation as a loss or deduction that is disallowed under section 1366(d) for the taxable year of the discharge.

(ii) *Multiple shareholders—(A) In general.* If an S corporation has multiple shareholders, to determine the amount of the S corporation's excess deemed NOL to be allocated to each shareholder under paragraph (d)(2)(i) of this section, calculate with respect to each shareholder the shareholder's excess amount. The shareholder's excess amount is the amount (if any) by which the shareholder's losses or deductions disallowed under section 1366(d)(1) (before any reduction under paragraph (a)(1) of this section) exceed the amount of COD income that would have been taken into account by that shareholder under section 1366(a) had the COD income not been excluded under section 108(a).

(B) *Shareholders with a shareholder's excess amount.* Each shareholder that has a shareholder's excess amount, as determined under paragraph (d)(2)(ii)(A) of this section, is allocated an amount equal to the S corporation's excess deemed NOL multiplied by a fraction, the numerator of which is the shareholder's excess amount and the denominator of which is the sum of all shareholders' excess amounts.

(C) *Shareholders with no shareholder's excess amount.* If a shareholder does not have a shareholder's excess amount as determined in paragraph (d)(2)(ii)(A) of this section, none of the S corporation's excess deemed NOL shall be allocated to that shareholder.

(iii) *Terminating shareholder.* Any amount of the S corporation's excess deemed NOL allocated under paragraph (d)(2) of this section to a shareholder that had transferred all of the shareholder's stock in the corporation during the taxable year of the discharge is permanently disallowed under § 1.1366-2(a)(5), unless the transfer of stock is described in section 1041(a). If the transfer of stock is described in section 1041(a), the amount of the S corporation's excess deemed NOL allocated to

the transferor under paragraph (d)(2) of this section shall be treated as a loss or deduction incurred by the corporation in the succeeding taxable year with respect to the transferee. See section 1366(d)(2)(B).

(3) *Character of excess losses or deductions allocated to a shareholder.* The character of an S corporation's excess deemed NOL that is allocated to a shareholder under paragraph (d)(2) of this section consists of a proportionate amount of each item of the shareholder's loss or deduction that is disallowed for the taxable year of the discharge under section 1366(d)(1).

(4) *Information requirements.* If an S corporation excludes COD income from gross income under section 108(a) for a taxable year, each shareholder of the S corporation during the taxable year of the discharge must report to the S corporation the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1), even if that amount is zero. If a shareholder fails to report the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1) to the S corporation, or if the S corporation knows that the amount reported by the shareholder is inaccurate, or if the information, as reported, appears to be incomplete or incorrect, the S corporation may rely on its own books and records, as well as other information available to the S corporation, to determine the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1), provided that the S corporation knows or reasonably believes that its information presents an accurate reflection of the shareholder's disallowed losses and deductions under section 1366(d)(1). The S corporation must report to each shareholder the amount of the S corporation's excess deemed NOL that is allocated to that shareholder under paragraph (d)(2) of this section, even if that amount is zero, in accordance with applicable forms and instructions.

(e) *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 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.

*Example 5.* (i) *Facts.* During the entire calendar year 2009, A, B, and C each own equal shares of stock in X, a calendar year S corporation. As of December 31, 2009, A, B, and C each have a zero stock basis and X does not have any indebtedness to A, B, or C. For the 2009 taxable year, X excludes from gross income \$45,000 of COD income under section 108(a)(1)(A). The COD income (had it not been excluded) would have been allocated \$15,000 to A, \$15,000 to B, and \$15,000 to C under sec-

tion 1366(a). For the 2009 taxable year, X has \$30,000 of losses and deductions that X passes through pro rata to A, B, and C in the amount of \$10,000 each. The losses and deductions that pass through to A, B, and C are disallowed under section 1366(d)(1). In addition, B has \$10,000 of section 1366(d) losses from prior years and C has \$20,000 of section 1366(d) losses from prior years. A's (\$10,000), B's (\$20,000) and C's (\$30,000) combined \$60,000 of disallowed losses and deductions for the taxable year of the discharge are treated as a current year net operating loss tax attribute of X under section 108(d)(7)(B) (deemed NOL) for purposes of the section 108(b) reduction of tax attributes.

(ii) *Allocation.* Under section 108(b)(2)(A), X's \$45,000 of excluded COD income reduces the \$60,000 deemed NOL to \$15,000. Therefore, X has a \$15,000 excess net operating loss (excess deemed NOL) to allocate to its shareholders. Under paragraph (d)(2)(ii)(C) of this section, none of the \$15,000 excess deemed NOL is allocated to A because A's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction (\$10,000) do not exceed A's share of the excluded COD income for 2008 (\$15,000). Thus, A has no shareholder's excess amount. Each of B's and C's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of B's and C's respective shares of the excluded COD income for 2008. B's excess amount is \$5,000 (\$20,000 - \$15,000) and C's excess amount is \$15,000 (\$30,000 - \$15,000). Therefore, the total of all shareholders' excess amounts is \$20,000. Under paragraph (d)(2) of this section, X will allocate \$3,750 of the \$15,000 excess deemed NOL to B ( $\$15,000 \times \$5,000/\$20,000$ ) and \$11,250 of the \$15,000 excess deemed NOL to C ( $\$15,000 \times \$15,000/\$20,000$ ). These amounts are treated as losses and deductions disallowed under section 1366(d)(1) for the taxable year of the discharge. Accordingly, at the beginning of 2010, A has no section 1366(d)(2) carryovers, B has \$3,750 of carryovers, and C has \$11,250 of carryovers.

(iii) *Character.* Immediately prior to the section 108(b)(2)(A) reduction, B's \$20,000 of section 1366(d) losses and deductions consisted of \$8,000 of long-term capital losses, \$7,000 of section 1231 losses, and \$5,000 of ordinary losses. After the section 108(b)(2)(A) tax attribute reduction, X will allocate \$3,750 of the excess deemed NOL to B. Under paragraph (d)(3) of this section, the \$3,750 excess deemed NOL allocated to B consists of \$1,500 of long-term capital losses ( $(\$8,000/\$20,000) \times \$3,750$ ), \$1,312.50 of section 1231 losses ( $(\$7,000/\$20,000) \times \$3,750$ ), and \$937.50 of ordinary losses ( $(\$5,000/\$20,000) \times \$3,750$ ). As a result, at the beginning of 2010, B's \$3,750 of section 1366(d)(2) carryovers consist of \$1,500 of long-term capital losses, \$1,312.50 of section 1231 losses, and \$937.50 of ordinary losses.

*Example 6.* (i) A and B each own 50 percent of the shares of stock in X, a calendar year S corporation. On March 1, 2009, X realizes \$12,000 of COD income and excludes this amount from gross income under section 108(a)(1)(A) for X's 2009 taxable year. On June 30, 2009, A sells all of her shares of stock in X to C in a transfer not described in section 1041(a). X does not make a terminating election under section 1377(a)(2). The COD income (had it not been excluded) would have been allocated \$3,000 to A, \$6,000 to B, and \$3,000 to C under section 1366(a). Prior to the section 108(b)(2)(A) reduction, for the taxable year of the discharge the shareholders have disallowed losses and deductions under section 1366(d) (including disallowed losses carried over to the current year under section 1366(d)(2)) in the following amounts: A—\$5,000, B—\$13,000, and C—\$2,000. The combined \$20,000 of disallowed losses and deductions for the taxable year of the discharge are treated as a current year net operating loss tax attribute of X under section 108(d)(7)(B) (deemed NOL).

(ii) Under section 108(b)(2)(A), X's \$12,000 of excluded COD income reduces the \$20,000 deemed NOL to \$8,000. Therefore, X has an \$8,000 excess net operating loss (excess deemed NOL) to allocate to its shareholders. Under paragraph (d)(2)(ii)(C) of this section, none of the \$8,000 excess deemed NOL is allocated to C because C's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction (\$2,000) do not exceed C's share of the excluded COD income for 2008 (\$3,000). However, each of A's and B's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of A's and B's respective shares of the excluded COD income for 2009. A's excess amount is \$2,000 (\$5,000—\$3,000) and B's excess amount is \$7,000 (\$13,000—\$6,000). Therefore, the total of all shareholders' excess amounts is \$9,000. Under paragraph (d)(2) of this section, X will allocate \$1,777.78 of the \$8,000 excess deemed NOL to A (\$8,000 × \$2,000/\$9,000) and \$6,222.22 of the \$8,000 excess deemed NOL to B (\$8,000 × \$7,000/\$9,000). However, because A transferred all of her shares of stock in X in a transaction not described in section 1041(a), A's \$1,777.78 of section 1366(d) losses and deductions are permanently disallowed under paragraph (d)(2)(iii) of this section. Accordingly, at the beginning of 2010, B has \$6,222.22 of section 1366(d)(2) carryovers and C has no section 1366(d)(2) carryovers.

*Example 7.* The facts are the same as in *Example 6*, except that X, with the consent of A and C, makes a terminating election under section 1377(a)(2) upon A's sale of her stock in X to C. Therefore, the COD income (had it not been excluded) would have been allocated \$6,000 to A, \$6,000 to B, and \$0 to C. Under paragraph (d)(2)(ii)(C) of this section, none of the \$8,000 excess deemed NOL is allo-

cated to A because A's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction (\$5,000) do not exceed A's share of the excluded COD income for 2009 (\$6,000). However, each of B's and C's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of B's and C's respective shares of the excluded COD income for 2009. B's excess amount is \$7,000 (\$13,000—\$6,000), C's excess amount is \$2,000 (\$2,000—\$0). Therefore, the total of all shareholders' excess amounts is \$9,000. Under paragraph (d)(2) of this section, X will allocate \$6,222.22 of the \$8,000 excess deemed NOL to B (\$8,000 × \$7,000/\$9,000) and \$1,777.78 of the \$8,000 excess deemed NOL to C. Accordingly, at the beginning of 2010, B has \$6,222.22 of section 1366(d)(2) carryovers and C has \$1,777.78 of section 1366(d)(2) carryovers.

(f) *Effective/applicability date*—(1) Paragraphs (a), (b), (c), and *Examples 1, 2, 3, and 4* of paragraph (e) of this section apply to discharges of indebtedness occurring on or after May 10, 2004.

(2) Paragraph (d) and *Examples 5, 6, and 7* of paragraph (e) of this section apply to discharges of indebtedness occurring on or after October 30, 2009.

[T.D. 9080, 68 FR 42592, July 18, 2003; 68 FR 56556, Oct. 1, 2003. Redesignated and amended by T.D. 9127, 69 FR 26039, May 11, 2004; T.D. 9469, 74 FR 56111, Oct. 30, 2009]

#### § 1.108-8 Indebtedness satisfied by partnership interest.

(a) *In general.* For purposes of determining income of a debtor from discharge of indebtedness (COD income), if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness (a debt-for-equity exchange), the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the partnership interest.

(b) *Determination of fair market value*—

(1) *In general.* All the facts and circumstances are considered in determining the fair market value of a partnership interest transferred by a debtor partnership to a creditor in satisfaction of the debtor partnership's indebtedness (debt-for-equity interest) for purposes of paragraph (a) of this section. If the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax law