

Section 1502.—Regulations

26 CFR 1.1502–19: Excess loss accounts.

T.D. 9089

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations under section 1502 that govern the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income. These temporary regulations affect corporations filing consolidated returns. The text of the temporary regulations also serves as the text of the proposed regulations (REG–132760–03) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective August 29, 2003.

FOR FURTHER INFORMATION CONTACT: Amber Renee Cook or Marie C. Milnes-Vasquez at (202) 622–7530 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 61(a)(12) of the Internal Revenue Code provides that gross income includes income from the discharge of indebtedness, except as provided by law. Section 108(a) provides that gross income of a C corporation does not include any amount that would otherwise be includible in gross income by reason of the discharge,

in whole or in part, of indebtedness of the taxpayer if the discharge occurs in a title 11 case (section 108(a)(1)(A)), the discharge occurs when the taxpayer is insolvent, but only to the extent of the insolvency (section 108(a)(1)(B)), or the indebtedness discharged is qualified farm indebtedness (section 108(a)(1)(C)).

Although section 108 does not require certain taxpayers to include discharge of indebtedness income in gross income, it does require the reduction of tax attributes. Section 108(b)(1) provides that if a taxpayer excludes an amount from gross income under section 108(a)(1)(A), (B), or (C), the taxpayer must reduce its tax attributes by the amount excluded. Absent an election under section 108(b)(5) (described below), pursuant to section 108(b)(2), tax attributes are reduced in the following order: net operating losses and net operating loss carryovers, general business credits under section 38, minimum tax credits under section 53(b), net capital losses and capital loss carryovers, asset basis, passive activity loss and credit carryovers under section 469(b), and foreign tax credits and foreign tax credit carryovers. Section 108(b)(5) provides that the taxpayer may elect to apply any portion of excluded discharge of indebtedness income to first reduce basis in depreciable assets under the rules of section 1017. Any amount of debt discharge that remains after attribute reduction is not includible in income. See H.R. Rep. 96–833 at 11 (1980); S. Rep. No. 96–1035 at 12 (1980).

These provisions are designed to “preserve the debtor’s ‘fresh start’ after bankruptcy.” H.R. Rep. 96–833 at 9 (1980); see S. Rep. No. 96–1035 at 10 (1980). In addition, they are intended to “carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.” H.R. Rep. 96–833 at 9 (1980); see S. Rep. No. 96–1035 at 10 (1980). By making attributes unavailable to offset income in later years, the provisions offer the debtor a temporary, rather than a permanent, deferral of tax.

Questions have arisen regarding the application of section 108 when the taxpayer with discharge of indebtedness income that is excluded from gross income is a member of a consolidated group. In particular, questions have arisen regarding

the determination of the attributes that are available for reduction in a consolidated group and the method for reducing those attributes. These regulations provide guidance regarding those questions.

Explanation of Provisions

A. Application of Section 108(a)(1)(B)

As described above, pursuant to section 108(a)(1)(B), gross income of an insolvent C corporation does not include any amount that would otherwise be includible in gross income by reason of the discharge, in whole or in part, of indebtedness of the taxpayer, but only to the extent of the insolvency. The IRS and Treasury believe that computing the amount of the insolvency for purposes of section 108(a)(1)(B) with respect to only the debtor member reflects that, without an agreement that provides otherwise, the assets of members other than the debtor member will not be available to satisfy claims of the creditors of the debtor member. Therefore, these temporary regulations provide that the amount of discharge of indebtedness income excluded from gross income in the case in which the debtor is insolvent is determined based on the assets and liabilities of only the member with discharge of indebtedness income.

B. Application of Section 108(b)

1. Consolidated approach

The IRS and Treasury Department have considered a separate entity approach and various consolidated approaches to the application of the attribute reduction rules of section 108(b) in the consolidated group context. As explained below, these regulations adopt a consolidated approach that reduces all attributes that are available to the debtor.

The IRS and Treasury Department have rejected a separate entity approach. Such an approach would reduce only the attributes attributable to the member with excluded discharge of indebtedness income. The IRS and Treasury Department have rejected this approach because it fails to take into account the fact that consolidated attributes that are attributable to other members will be available to offset income of the debtor member as long as the debtor

is a member of the group. A separate entity approach could result in the permanent exclusion of discharge of indebtedness income when there are other attributes available to the debtor member.

In the view of the IRS and Treasury Department, the policies underlying section 108 require a consolidated approach that reduces all attributes that are available to the debtor. An approach that does not reduce all of such attributes is inconsistent with Congressional intent that income realized from debt discharge generally be deferred and not permanently eliminated. Furthermore, reducing all of the consolidated attributes available to the debtor member reflects the principle enunciated by the Supreme Court in *United Dominion Indus., Inc. v. United States*, 532 U.S. 822 (2001), that, in general, the only net operating loss of a consolidated group or its members for a consolidated return year is the consolidated net operating loss. Consistent with *United Dominion*, the tax attributes subject to reduction under section 108(b) when the debtor is a member of a consolidated group include the group's consolidated attributes in their entirety. Therefore, these temporary regulations provide for the reduction of consolidated net operating losses and all other consolidated tax attributes, including consolidated tax attributes that are attributable to members other than the debtor member.

When the debtor is a member of a consolidated group, consolidated tax attributes attributable to other members may be used to offset income of the debtor member. That ability may enable the debtor member to offset future income with the consolidated attributes attributable to other members. As a result, unless such other attributes are reduced, discharge of indebtedness income that is excluded from gross income may never result in taxable income.

Unlike consolidated attributes, the basis of assets held by members other than the debtor member is not directly available to offset income of the debtor member. In fact, the basis of assets held by members other than the debtor member may never give rise to an attribute that could be directly available to offset income of a member of the group for a consolidated return year. Therefore, as explained below, these

temporary regulations provide for a reduction of basis of assets of members other than the debtor member only in limited circumstances.

2. Ordering rule

Under these temporary regulations, the attributes attributable to the debtor member are first subject to reduction. For this purpose, attributes attributable to the debtor member include (1) consolidated attributes attributable to the debtor member, (2) attributes that arose in separate return limitation years of the debtor member, and (3) the basis of property of the debtor member. The amount of a consolidated attribute attributable to the debtor member is determined pursuant to the principles of §1.1502-21(b). To the extent that the excluded discharge of indebtedness income exceeds the attributes attributable to the debtor member, these temporary regulations require the reduction of consolidated attributes attributable to other members and attributes attributable to members other than the debtor member that arose (or are treated as arising) in a separate return limitation year to the extent that the debtor member is a member of the separate return limitation year subgroup with respect to such attribute.

The availability of tax attributes attributable to other members of a consolidated group to reduce the future income of the debtor member creates the possibility of shifting the location of tax attributes and future tax liability. Preserving the location of tax items within the group is a fundamental policy underlying the consolidated return regulations which is reflected in a number of such regulations. See, e.g., §1.1502-13 (regarding intercompany transactions); §1.1502-21 (regarding the use of attributes that arise in separate return limitation years). Location is particularly important when a member leaves the group and no longer shares the attributes attributable to it with, or uses the attributes attributable to, the other members. This sharing of tax attributes can shift the location of items within the group, affecting the amount of consolidated tax attributes that a member takes with it when it leaves the group.

The IRS and Treasury Department did not adopt an alternative consolidated approach that would require the reduction of consolidated attributes attributable to other members prior to the reduction of all of the attributes attributable to the debtor member. Such an approach would not preserve the location of income in the debtor member resulting from the reduction of attributes as effectively as the approach adopted in these temporary regulations. For example, a reduction of the consolidated attributes attributable to each member before the reduction of all of the attributes attributable to the debtor member could cause a shifting of the tax burden if the debtor member subsequently leaves the group. In that case, the debtor member may take with it a larger portion of the consolidated attributes than it otherwise would, while a portion of the consolidated attributes attributable to other members would be reduced. The larger portion of the consolidated attributes that the debtor member would take with it would be available to offset future income of the debtor member, while the remaining members of the group would bear a higher tax burden as a result of the unavailability of those consolidated attributes.

These temporary regulations achieve the dual objectives of subjecting the entire amount of consolidated attributes to reduction *and* preserving the location of future income that is deferred by first reducing attributes attributable to the debtor member, including consolidated attributes, in the order prescribed in section 108(b) and then reducing the remaining amount of consolidated attributes. This ordering rule reduces the potential to shift the location of attributes within the group.

3. Look-through rule

The adopted approach include a look-through rule that applies if the attribute of the debtor member reduced is the basis of stock of another member of the group. In these cases, corresponding adjustments must be made to the attributes attributable to the lower-tier member. To effect those corresponding adjustments, these temporary regulations treat the lower-tier member as a debtor member that has discharge of indebtedness income that is excluded from gross income in the amount of the stock basis reduction

for purposes of the rules relating to the reduction of the attributes attributable to a debtor member. For this purpose, the consolidated attributes attributable to the lower-tier member (determined pursuant to the principles of §1.1502–21(b)) as well as the lower-tier member’s separate attributes (including attributes that arose in separate return limitation years and asset basis) are available for reduction. The look-through rule is consistent with the treatment of a group as a single taxpayer under a number of the consolidated return regulations, including the provisions allowing the consolidated tax attributes attributable to one member of a group to offset income of other members of the group and the investment adjustment rules that adjust the basis of subsidiary stock to reflect the income and absorbed losses of the subsidiary.

C. Corresponding Amendments

Included in these temporary regulations are amendments to certain provisions of the consolidated return regulations that reflect the attribute reduction rules that apply when the debtor is a member of a consolidated group. The following paragraphs describe these amendments.

1. The investment adjustment rules

Under §1.1502–32(b)(3)(ii)(C), discharge of indebtedness income of a subsidiary that is excluded from gross income is treated as tax-exempt income for purposes of the investment adjustment rules only to the extent it is applied to reduce attributes. For this purpose, a discharge of indebtedness is treated as applied to reduce tax attributes only to the extent the attribute reduction is taken into account as a noncapital, nondeductible expense under §1.1502–32. The investment adjustment rules of §1.1502–32 do not apply to affect the basis of the stock of the common parent of a group. Therefore, to the extent that discharge of indebtedness income reduces consolidated attributes that are attributable to the common parent, no positive basis adjustment is made to the stock of the subsidiary. Furthermore, because the reduction of a tax credit is not a noncapital, nondeductible expense, to the extent that the discharge of indebtedness income reduces a tax credit, no positive

basis adjustment is made to the stock of the subsidiary.

The IRS and Treasury Department believe that a positive basis adjustment should be made to the basis of the stock of a debtor subsidiary even if the discharge of indebtedness income reduces an attribute that is attributable to the common parent. This position is consistent with the approach of §1.1502–32 that income of a subsidiary that is offset by net operating losses generated by the common parent results in an increase in the basis of the subsidiary stock. In addition, the IRS and Treasury Department believe that a positive basis adjustment should be made to the basis of the stock of a debtor subsidiary even if the discharge of indebtedness income reduces a credit of any member. Accordingly, these temporary regulations treat as tax-exempt income discharge of indebtedness income that is excluded from gross income to the extent that such excluded income reduces tax attributes, including tax attributes attributable to the common parent and any other attribute the reduction of which is not treated as a noncapital, nondeductible expense, such as a credit.

2. The excess loss account rules

Under §1.1502–19, an excess loss account attributable to subsidiary stock must be included in income when an indebtedness of that subsidiary is discharged and any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under §1.1502–32. This rule may require inclusion of an excess loss account in income in an amount that is substantially greater than the amount discharged that is not treated as tax-exempt income.

The IRS and Treasury Department believe that requiring the inclusion of the excess loss account in income only to the extent of the amount discharged that is not treated as tax-exempt income is consistent with the policies underlying section 108 and the consolidated return regulations. Accordingly, these temporary regulations modify the rules of §1.1502–19 to provide that the excess loss account must be included in income only to the extent that any amount discharged that is excluded from gross income is not treated as tax-exempt income.

3. Rules governing apportionment of net operating losses

The temporary regulations also include modifications to the rules of §1.1502–21 relating to the amount of consolidated net operating losses apportioned to a subsidiary when a consolidated net operating loss is absorbed and when a subsidiary departs from the group. These modifications take into account the reduction of the net operating losses attributable to that member that occurs as a result of discharge of indebtedness.

D. Request for Comments

The IRS and Treasury Department are considering adopting rules under section 1502 (and possibly other Code sections) to address the effect of transitory transactions and other transactions designed to avoid the application of the rules concerning attribute reduction. Comments are requested regarding whether such a rule should be adopted and the appropriate scope of such a rule. Even in the absence of such a rule, such transactions may be challenged under existing law. If the IRS and Treasury Department determine such a rule is necessary to protect the policies underlying section 108 and the consolidated return regulations, the IRS and Treasury Department are prepared to promulgate such a rule with retroactive effect to discharges of indebtedness that occur after August 29, 2003.

Effective Dates

The temporary regulations related to the application of section 108(b) when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income apply to discharges of indebtedness that occur after August 29, 2003. The amendments to the investment adjustment rules apply with respect to determinations of stock basis in consolidated return years the original return for which is due (without extensions) after August 29, 2003. The amendments to the excess loss account rules apply to dispositions of subsidiary stock after August 29, 2003. However, taxpayers may apply the amendments to the investment adjustment rules and the excess loss account rules retroactively. Finally, the amendments to the net operating loss rules apply only to taxable years the original return for

which the due date (without extensions) is after August 29, 2003.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. These temporary regulations are necessary to provide taxpayers with immediate guidance regarding the application of section 108 when a member of a consolidated group has discharge of indebtedness income that is excluded from gross income. Current circumstances have made the application of section 108 in the consolidated group context an issue that needs to be addressed at this time. In addition, consolidated groups may be taking positions that are inconsistent with the policies underlying section 108 and the principle enunciated by the Supreme Court in *United Dominion Indus., Inc. v. United States*, 532 U.S. 822 (2001). Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the Bulletin. 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 their impact on small business.

Drafting Information

Various personnel from the IRS and Treasury Department participated in the development of the regulations.

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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 removing the two entries for §1.1502–32T and adding the following entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.1502–19T also issued under 26 U.S.C. 1502. * * *
Section 1.1502–28T also issued under 26 U.S.C. 1502. * * *
Section 1.1502–32T also issued under 26 U.S.C. 1502. * * *
Par. 2. Section 1.1502–19 is amended as follows:

1. Paragraph (b)(1) is revised.
2. The headings for paragraphs (h)(2) and (h)(2)(i) are revised.
3. Paragraph (h)(2)(ii) is redesignated as paragraph (h)(2)(iii).
4. New paragraph (h)(2)(ii) is added.

The revisions and addition read as follows:

§1.1502–19 Excess loss accounts.

* * * * *

(b) * * * (1) [Reserved]. For further guidance, see §1.1502–19T(b)(1).

* * * * *

(h) * * *

(2) *Dispositions of stock*—(i) *Dispositions of stock before effective date.* * * *

(ii) *Application of special limitation.* [Reserved]. For further guidance, see §1.1502–19T(h)(2)(ii).

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Par. 3. Section 1.1502–19T is added to read as follows:

§1.1502–19T Excess loss accounts (temporary).

(a) [Reserved]. For further guidance, see §1.1502–19(a).

(b) *Excess loss account taken into account as income or gain*—(1) *Operating rules*—(i) *General rule.* Except as provided in paragraph (b)(1)(ii) of this section, if P is treated under §1.1502–19 as disposing of a share of S's stock, P takes into account its excess loss account in the share as income or gain from the disposition.

(ii) *Special limitation on amount taken into account.* Notwithstanding paragraph (b)(1)(i) of this section, if P is treated as disposing of a share of S's stock as a result of the application of §1.1502–19(c)(1)(iii)(B), the aggregate amount of its excess loss account in the shares of S's stock that P takes into account as income or gain from the disposition shall not exceed the amount

of S's indebtedness that is discharged that is neither included in gross income nor treated as tax-exempt income under §1.1502–32T(b)(3)(ii)(C)(I). If more than one share of S's stock has an excess loss account, such excess loss accounts shall be taken into account pursuant to the preceding sentence, to the extent possible, in a manner that equalizes the excess loss accounts in S's shares that have an excess loss account.

(iii) *Treatment of disposition.* Except as provided in §1.1502–19(b)(4), the disposition is treated as a sale or exchange for purposes of determining the character of the income or gain.

(b)(2) through (h)(2)(i) [Reserved]. For further guidance, see §1.1502–19(b)(2) through (h)(2)(i).

(h)(2)(ii) *Application of special limitation.* If P was treated as disposing of stock of S because S was treated as worthless as a result of the application of §1.1502–19(c)(1)(iii)(B) after August 29, 2003, and in a consolidated return year beginning on or after January 1, 1995, the amount of P's income, gain, deduction, or loss, and the stock basis reflected in that amount, are determined or redetermined with regard to paragraph (b)(1)(ii) of this section. If P was treated as disposing of stock of S because S was treated as worthless as a result of the application of §1.1502–19(c)(1)(iii)(B) on or before August 29, 2003, and in a consolidated return year beginning on or after January 1, 1995, the group may determine or redetermine the amount of P's income, gain, deduction, or loss, and the stock basis reflected in that amount with regard to paragraph (b)(1)(ii) of this section.

(h)(2)(iii) through (h)(3) [Reserved]. For further guidance, see §1.1502–19(h)(2)(iii) through (h)(3).

Par. 4. Section 1.1502–21 is amended as follows:

1. Paragraphs (b)(2)(iv) and (c)(2)(vii) are revised.

2. Paragraphs (h)(6) and (h)(7) are redesignated as paragraphs (h)(7) and (h)(8), respectively.

3. New paragraph (h)(6) is added.

4. Newly designated paragraph (h)(8) is revised.

The revision and additions read as follows:

§1.1502–21 Net operating losses.

* * * * *

(b) * * *

(2) * * *

(iv) [Reserved]. For further guidance, see §1.1502–21T(b)(2)(iv).

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(c) * * *

(2) * * *

(vii) [Reserved]. For further guidance, see §1.1502–21T(c)(2)(vii).

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(h) * * *

(6) [Reserved]. For further guidance, see §1.1502–21T(h)(6).

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(8) [Reserved]. For further guidance, see §1.1502–21T(h)(8).

Par. 5. Section 1.1502–21T is amended as follows:

1. Paragraphs (b)(1) through (b)(3)(ii)(B) are revised.

2. Paragraphs (c) through (h)(7) are revised.

3. Paragraph (h)(8) is added.

The revisions and addition read as follows:

§1.1502–21T Net operating losses (temporary).

* * * * *

(b) * * *

(1) *Carryovers and carrybacks generally.* The net operating loss carryovers and carrybacks to a taxable year are determined under the principles of section 172 and this section. Thus, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset consolidated taxable income for the year, generally are absorbed on a *pro rata* basis. In addition, the amount of any CNOL absorbed by the group in any year is apportioned among members based on the percentage of the CNOL attributable to each member as of the beginning of the year. The percentage of the CNOL attributable to a member is determined pursuant to paragraph (b)(2)(iv)(B) of this section. Additional rules provided under the Internal Revenue Code or regulations also apply. See, e.g., section 382(l)(2)(B) (if

losses are carried from the same taxable year, losses subject to limitation under section 382 are absorbed before losses that are not subject to limitation under section 382). See §1.1502–21(c)(1)(iii), *Example 2*, for an illustration of *pro rata* absorption of losses subject to a SRLY limitation. See paragraph (b)(3)(v) of this section regarding the treatment of any loss that is treated as expired under §1.1502–35T(f)(1).

(2)(i) through (iii) [Reserved]. For further guidance, see §1.1502–21(b)(2)(i) through (iii).

(iv) *Operating rules—(A) Amount of CNOL attributable to a member.* The amount of a CNOL that is attributable to a member shall equal the product of the CNOL and the percentage of the CNOL attributable to such member.

(B) *Percentage of CNOL attributable to a member—(1) In general.* Except as provided in paragraph (b)(2)(iv)(B)(2) of this section, the percentage of the CNOL attributable to a member shall equal the separate net operating loss of the member for the year of the loss divided by the sum of the separate net operating losses for that year of all members having such losses. For this purpose, the separate net operating loss of a member is determined by computing the CNOL by reference to only the member's items of income, gain, deduction, and loss, including the member's losses and deductions actually absorbed by the group in the taxable year (whether or not absorbed by the member).

(2) *Special rule.* If during a taxable year either a member realizes discharge of indebtedness income that is excluded from gross income under section 108(a) and such amount reduces any portion of the CNOL attributable to such member pursuant to section 108 and §1.1502–28T, or a member that had a separate net operating loss for the year of the CNOL ceases to be a member, the percentage of the CNOL attributable to each member as of the first day of the following taxable year shall be recomputed. In addition, if a portion of the CNOL attributable to a member for a taxable year is carried back to a separate return year, the percentage of the CNOL attributable to each member as of the first day of the taxable year following the taxable year of the CNOL shall be recomputed. In each case, such recomputed percentage shall equal the unabsorbed CNOL attributable to the member on the first day

of the following taxable year divided by the sum of the unabsorbed CNOL attributable to all of the members on the first day of the following taxable year. For purposes of the preceding sentence, a CNOL that is reduced pursuant to section 108 and §1.1502–28T or that is otherwise permanently disallowed or eliminated shall be treated as absorbed.

(b)(2)(v) through (b)(3)(ii)(B) [Reserved]. For further guidance, see §1.1502–21(b)(2)(v) through (b)(3)(ii)(B).

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(c)(1) through (c)(2)(vi) [Reserved]. For further guidance, see §1.1502–21(c)(1) through (c)(2)(vi).

(vii) *Corporations that leave a SRLY subgroup.* If a loss member ceases to be affiliated with a SRLY subgroup, the amount of the member's remaining SRLY loss from a specific year is determined pursuant to the principles of §1.1502–21(b)(2)(ii)(A) and §1.1502–21T(b)(2)(iv).

(c)(2)(viii) through (h)(5) [Reserved]. For further guidance, see §1.1502–21(c)(2)(viii) through (h)(5).

(6) *Certain prior periods.* Paragraphs (b)(1), (b)(2)(iv), and (c)(2)(vii) of this section shall only apply to taxable years the original return for which the due date (without extensions) is after August 29, 2003. For taxable years the original return for which the due date (without extensions) is on or before August 29, 2003, see paragraphs (b)(1), (b)(2)(iv), and (c)(2)(vii) of §1.1502–21 and paragraph (b)(1) of §1.1502–21T as contained in 26 CFR part 1 revised April 1, 2003.

(7) [Reserved]. For further guidance, see §1.1502–21(h)(7).

(8) *Losses treated as expired under §1.1502–35T(f)(1).* Paragraph (b)(3)(v) of this section is effective for losses treated as expired under §1.1502–35T(f)(1) on and after March 7, 2002, and no later than March 11, 2006.

Par. 6. Section 1.1502–28T is added to read as follows:

§1.1502–28T Consolidated section 108 (temporary).

(a) *In general.* This section sets forth rules for the application of section 108(a) and the reduction of tax attributes pursuant to section 108(b) when a member of the group realizes discharge of indebtedness

income that is excluded from gross income under section 108(a) (excluded COD income).

(1) *Application of section 108(a)*. Section 108(a)(1)(B) is applied separately to each member that realizes excluded COD income. Therefore, the limitation of section 108(a)(3) on the amount of discharge of indebtedness income that is treated as excluded COD income is determined based on the assets (including stock and securities of other members) and liabilities (including liabilities to other members) of only the member that realizes excluded COD income.

(2) *Reduction of tax attributes attributable to the debtor*—(i) *In general*. With respect to a member that realizes excluded COD income in a taxable year, the tax attributes attributable to that member (and its direct and indirect subsidiaries to the extent required by section 1017(b)(3)(D) and paragraph (a)(3) of this section), including basis of assets and losses and credits arising in separate return limitation years, shall be reduced as provided in sections 108 and 1017 and this section. Basis of subsidiary stock, however, shall not be reduced below zero.

(ii) *Consolidated tax attributes attributable to a member*. For purposes of this section, the amount of a consolidated tax attribute that is attributable to a member shall be determined pursuant to the principles of §1.1502-21T(b)(2)(iv). In addition, if the member is a member of a separate return limitation year subgroup, the amount of a tax attribute that arose in a separate return limitation year that is attributable to that member shall also be determined pursuant to the principles of §1.1502-21T(b)(2)(iv).

(3) *Look-through rules*—(i) *Priority of section 1017(b)(3)(D)*. If a member treats stock of a subsidiary as depreciable property pursuant to section 1017(b)(3)(D), the basis of the depreciable property of such subsidiary shall be reduced pursuant to section 1017(b)(3)(D) prior to the application of paragraph (a)(3)(ii) of this section.

(ii) *Application of additional look-through rule*. If the basis of stock of a member (the lower-tier member) that is owned by another member is reduced pursuant to section 108, section 1017, and paragraph (a)(2) of this section (but not as a result of treating subsidiary stock as depreciable property pursuant to section 1017(b)(3)(D)), solely for purposes of

sections 108 and 1017 and this section other than paragraphs (a)(4) and (b)(1) of this section, the lower-tier member shall be treated as realizing excluded COD income. The amount of such excluded COD income shall be the amount of such basis reduction. Accordingly, the tax attributes attributable to such lower-tier member shall be reduced as provided in sections 108 and 1017 and this section. To the extent that the excluded COD income realized by the lower-tier member pursuant to this paragraph (a)(3) does not reduce a tax attribute attributable to the lower-tier member, such excluded COD income shall not be applied to reduce tax attributes attributable to any member under paragraph (a)(4) of this section.

(4) *Reduction of certain tax attributes attributable to other members*. To the extent that, pursuant to paragraph (a)(2) of this section, the excluded COD income is not applied to reduce the tax attributes attributable to the member that realizes the excluded COD income, after the application of paragraph (a)(3) of this section, such amount shall be applied to reduce the remaining consolidated tax attributes of the group as provided in section 108 and this section. Such amount also shall be applied to reduce the tax attributes attributable to members that arose (or are treated as arising) in a separate return limitation year to the extent that the member that realizes excluded COD income is a member of the separate return limitation year subgroup with respect to such attribute. The reduction of each tax attribute pursuant to the two preceding sentences shall be made in the order prescribed in section 108 and pursuant to §1.1502-21T(b)(1). Except to the extent that the member that realizes excluded COD income is a member of the separate return limitation year subgroup with respect to a tax attribute that arose (or is treated as arising) in a separate return limitation year, such attribute is not subject to reduction pursuant to this paragraph (a)(4). In addition, basis in assets is not subject to reduction pursuant to this paragraph (a)(4). Finally, to the extent that the realization of excluded COD income by a member pursuant to paragraph (a)(3) does not reduce a tax attribute attributable to such lower-tier member, such excess shall not be applied to reduce tax attributes attributable to any member pursuant to this paragraph (a)(4).

(b) *Special rules*—(1) *Multiple debtor members*—(i) *Reduction of tax attributes attributable to debtor members prior to reduction of consolidated tax attributes*. If in a single taxable year multiple members realize excluded COD income, paragraphs (a)(2) and (3) of this section shall apply with respect to the excluded COD income of each such member prior to the application of paragraph (a)(4) of this section.

(ii) *Reduction of higher-tier debtor's tax attributes*. If in a single taxable year multiple members realize excluded COD income and one such member is a higher-tier member of another such member, paragraphs (a)(2) and (3) of this section shall be applied with respect to the excluded COD income of the higher-tier member before such paragraphs are applied to the excluded COD income of the other such member. A member (the first member) is a higher-tier member of another member (the second member) if the first member is the common parent or investment adjustments under §1.1502-32 or §1.1502-32T with respect to the stock of the second member would affect investment adjustments with respect to the stock of the first member.

(iii) *Reduction of additional tax attributes*. If more than one member realizes excluded COD income that has not been applied to reduce a tax attribute attributable to such member (the remaining COD amount) and the remaining tax attributes available for reduction under paragraph (a)(4) of this section are less than the aggregate of the remaining COD amounts, after the application of paragraph (a)(2) of this section, each such member's remaining COD amount shall be applied on a *pro rata* basis (based on the relative remaining COD amounts), pursuant to paragraph (a)(4) of this section, to reduce such remaining available tax attributes.

(2) *Election under section 108(b)(5)*. Any member that realizes excluded COD income may make the election described in section 108(b)(5). The election is made separately for each member. Therefore, an election may be made for one member that realizes excluded COD income (either actually or pursuant to paragraph (a)(3) of this section) while another election, or no election, may be made for another member that realizes excluded COD income (either actually or pursuant to paragraph (a)(3) of this section).

this section). See §1.108-4 for rules relating to the procedure for making an election under section 108(b)(5).

(3) *Limitation of section 1017(b)(2)*. The limitation of section 1017(b)(2) on the reduction in basis of property shall be applied by reference to the aggregate of the basis of the property held by the member that realizes excluded COD income, not the aggregate of the basis of the property held by all of the members of the group, and the liabilities of such member, not the aggregate liabilities of all of the members of the group.

(c) *Examples*. The principles of paragraphs (a) and (b) of this section are illustrated by the following examples. Unless otherwise indicated, no election under section 108(b)(5) has been made. The examples are as follows:

Example 1. (i) *Facts*. P is the common parent of a consolidated group that includes subsidiaries S1 and S2. P owns 80 percent of the stock of S1 and 100 percent of the stock of S2. In Year 1, the P group sustained a \$250 consolidated net operating loss. Under the principles of §1.1502-21T(b)(2)(iv), of that amount, \$125 was attributable to P and \$125 was attributable to S1. On Day 1 of Year 2, S2 joined the P group. As of the beginning of Year 2, S2 had a \$50 net operating loss carryover from Year 1, a separate return limitation year. In Year 2, the P group sustained a \$200 consolidated net operating loss. Under the principles of §1.1502-21T(b)(2)(iv), of that amount, \$90 was attributable to P, \$70 was attributable to S1, and \$40 was attributable to S2. In Year 3, S2 realized \$200 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S2 had no liabilities. In that same year, the P group sustained a \$50 consolidated net operating loss, of which \$40 was attributable to S1 and \$10 was attributable to S2 under the principles of §1.1502-21T(b)(2)(iv). As of the beginning of Year 4, S2 had Asset A with a basis of \$40 and a fair market value of \$10.

(ii) *Analysis—(A) Reduction of tax attributes attributable to debtor*. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S2 must first be reduced to take into account its excluded COD income in the amount of \$200.

(1) *Reduction of net operating losses*. Pursuant to section 108(b)(2)(A), the net operating loss and the net operating loss carryovers of S2 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S2 under the principles of §1.1502-21T(b)(2)(iv) are reduced first. Accordingly, the consolidated net operating loss for Year 3 is reduced by \$10, the portion of the consolidated net operating loss attributable to S2, to \$40. Then, again pursuant to section 108(b)(4)(B), S2's net operating loss carryover of \$50 from its separate return limitation year is reduced to \$0. Finally, the consolidated net operating loss carryover from Year 2 is reduced by \$40, the portion of that consolidated net operating loss carryover attributable to S2, to \$160.

(2) *Reduction of basis*. Following the reduction of the net operating loss and the net operating loss carryovers attributable to S2, S2 reduces its basis in its assets pursuant to section 1017 and §1.1017-1. Accordingly, S2 reduces its basis in Asset A by \$40, from \$40 to \$0.

(B) *Reduction of remaining consolidated tax attributes*. The remaining \$60 of excluded COD income then reduces consolidated tax attributes pursuant to paragraph (a)(4) of this section. In particular, the remaining \$40 consolidated net operating loss for Year 3 is reduced to \$0. Then, the consolidated net operating loss carryover from Year 1 is reduced by \$20 from \$250 to \$230. Pursuant to paragraph (a)(4) of this section, a *pro rata* amount of the consolidated net operating loss carryover from Year 1 that is attributable to each of P and S1 is treated as reduced. Therefore, \$10 of the consolidated net operating loss carryover from Year 1 that is attributable to each of P and S1 is treated as reduced.

Example 2. (i) *Facts*. P is the common parent of a consolidated group that includes subsidiaries S1 and S2. P owns 100 percent of the stock of S1 and S1 owns 100 percent of the stock of S2. None of P, S1, or S2 has a separate return limitation year. In Year 1, the P group sustained a \$50 consolidated net operating loss. Under the principles of §1.1502-21T(b)(2)(iv), of that amount, \$10 was attributable to P, \$20 was attributable to S1, and \$20 was attributable to S2. In Year 2, the P group sustained a \$70 consolidated net operating loss. Under the principles of §1.1502-21T(b)(2)(iv), of that amount, \$30 was attributable to P, \$30 was attributable to S1, and \$10 was attributable to S2. In Year 3, S1 realized \$170 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S1 and S2 had no liabilities. In that same year, the P group sustained a \$50 consolidated net operating loss, of which \$10 was attributable to S1 and \$40 was attributable to S2 under the principles of §1.1502-21T(b)(2)(iv). As of the beginning of Year 4, S1's sole asset was the stock of S2, and S1 had a \$80 basis in the S2 stock. In addition, at the beginning of Year 4, S2 had an asset with a \$0 basis and a \$10 value.

(ii) *Analysis—(A) Reduction of tax attributes attributable to debtor*. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S1 must first be reduced to take into account its excluded COD income in the amount of \$170.

(1) *Reduction of net operating losses*. Pursuant to section 108(b)(2)(A), the net operating loss and the net operating loss carryovers of S1 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S1 under the principles of §1.1502-21T(b)(2)(iv) are reduced first. Accordingly, the consolidated net operating loss for Year 3 is reduced by \$10, the portion of the consolidated net operating loss for Year 3 attributable to S1, to \$40. Then, the consolidated net operating loss carryover from Year 1 is reduced by \$20, the portion of that consolidated net operating loss carryover attributable to S1, to \$30, and the consolidated net operating loss carryover from Year 2 is reduced by \$30, the portion of that consolidated net operating loss carryover attributable to S1, to \$40.

(2) *Reduction of basis*. Following the reduction of the net operating loss and the net operating loss

carryovers attributable to S1, S1 reduces its basis in its assets pursuant to section 1017 and §1.1017-1. Accordingly, S1 reduces its basis in the stock of S2 by \$80, from \$80 to \$0.

(3) *Tiering down of stock basis reduction*. Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S2 is treated as realizing \$80 of excluded COD income. Accordingly, the consolidated net operating loss for Year 3 is reduced by an additional \$40, the portion of the consolidated net operating loss for Year 3 attributable to S2, to \$0. Then, the consolidated net operating loss carryover from Year 1 is reduced by \$20, the portion of that consolidated net operating loss carryover attributable to S2, to \$10. Then, the consolidated net operating loss carryover from Year 2 is reduced by \$10, the portion of that consolidated net operating loss carryover attributable to S2, to \$30. S2's remaining \$10 of excluded COD income does not reduce consolidated tax attributes attributable to P or S1 under paragraph (a)(4) of this section.

(B) *Reduction of remaining consolidated tax attributes*. Finally, pursuant to paragraph (a)(4) of this section, S1's remaining \$30 of excluded COD income reduces the remaining consolidated tax attributes. In particular, the remaining \$10 consolidated net operating loss carryover from Year 1 is reduced by \$10 to \$0, and the remaining \$30 consolidated net operating loss carryover from Year 2 is reduced by \$20 to \$10.

Example 3. (i) *Facts*. P is the common parent of a consolidated group that includes subsidiaries S1, S2, and S3. P owns 100 percent of the stock of S1, S1 owns 100 percent of the stock of S2, and S2 owns 100 percent of the stock of S3. In Year 1, the P group sustained a \$150 consolidated net operating loss. Under the principles of §1.1502-21T(b)(2)(iv), of that amount, \$50 was attributable to S2, and \$100 was attributable to S3. In Year 2, the P group sustained a \$50 consolidated net operating loss. Under the principles of §1.1502-21T(b)(2)(iv), of that amount, \$40 was attributable to S1 and \$10 was attributable to S2. In Year 3, S1 realized \$170 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S1, S2, and S3 had no liabilities. In that same year, the P group sustained a \$50 consolidated net operating loss, of which \$10 was attributable to S1, \$20 was attributable to S2, and \$20 was attributable to S3 under the principles of §1.1502-21T(b)(2)(iv). At the beginning of Year 4, S1's only asset was the stock of S2, with a basis of \$120, and S2's only asset was the stock of S3 with a basis of \$180 and a value of \$10. None of P, S1, or S2 had a separate return limitation year.

(ii) *Analysis—Reduction of tax attributes attributable to debtor*. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S1 must first be reduced to take into account its excluded COD income in the amount of \$170.

(A) *Reduction of net operating losses*. Pursuant to section 108(b)(2)(A), the net operating loss and the net operating loss carryovers of S1 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S1 under the principles of §1.1502-21T(b)(2)(iv) are reduced first. Pursuant to section 108(b)(4)(B), S1's net operating loss for the taxable year of the discharge is reduced first. Accordingly, the consolidated net operating loss for Year

3 is reduced by \$10, the portion of the consolidated net operating loss attributable to S1, to \$40. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 2 is reduced by \$40, the portion of that consolidated net operating loss carryover attributable to S1, to \$10.

(B) *Reduction of basis.* Following the reduction of the net operating loss and the net operating loss carryovers attributable to S1, S1 reduces its basis in its assets pursuant to section 1017 and §1.1017-1. Accordingly, S1 reduces its basis in the stock of S2 by \$120, to \$0.

(C) *Tiering down of stock basis reduction to S2.* Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S2 is treated as realizing \$120 of excluded COD income. Pursuant to section 108(b)(2)(A), therefore, the net operating loss and net operating loss carryovers of S2 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S2 under the principles of §1.1502-21T(b)(2)(iv) are reduced. Pursuant to section 108(b)(4)(B), S2's net operating loss for the taxable year of the discharge is reduced. Accordingly, the consolidated net operating loss for Year 3 is further reduced by \$20, the portion of the consolidated net operating loss attributable to S2, to \$20. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 1 is reduced by \$50, the portion of that consolidated net operating loss carryover attributable to S2, to \$100. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 2 is further reduced by \$10, the portion of that consolidated net operating loss carryover attributable to S2, to \$0. Following the reduction of the net operating loss and the net operating loss carryovers attributable to S2, S2 reduces its basis in its assets pursuant to section 1017 and §1.1017-1. Accordingly, S2 reduces its basis in its S3 stock by \$40 to \$140.

(D) *Tiering down of stock basis reduction to S3.* Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S3 is treated as realizing \$40 of excluded COD income. Pursuant to section 108(b)(2)(A), therefore, the net operating loss and the net operating loss carryovers of S3 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S3 under the principles of §1.1502-21T(b)(2)(iv) are reduced. Pursuant to section 108(b)(4)(B), S3's net operating loss for the taxable year of the discharge is reduced. Accordingly, the consolidated net operating loss for Year 3 is further reduced by \$20, the portion of the consolidated net operating loss attributable to S3, to \$0. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 1 is reduced by \$20, the lesser of the portion of that consolidated net operating loss carryover attributable to S3 and the remaining excluded COD income, to \$80.

Example 4. (i) *Facts.* P is the common parent of a consolidated group that includes subsidiaries S1, S2, and S3. P owns 100 percent of the stock of each of S1 and S2. Each of S1 and S2 owns stock of S3 that represents 50 percent of the value of the stock of S3. In Year 1, the P group sustained a \$160 consolidated net operating loss. Under the

principles of §1.1502-21T(b)(2)(iv), of that amount, \$10 was attributable to P, \$50 was attributable to S2, and \$100 was attributable to S3. In Year 2, the P group sustained a \$110 consolidated net operating loss. Under the principles of §1.1502-21T(b)(2)(iv), of that amount, \$40 was attributable to S1 and \$70 was attributable to S2. In Year 3, S1 realized \$200 of excluded COD income from the discharge of non-intercompany indebtedness, and S2 realized \$270 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S1, S2, and S3 had no liabilities. In that same year, the P group sustained a \$50 consolidated net operating loss, of which \$10 was attributable to S1, \$20 was attributable to S2, and \$20 was attributable to S3 under the principles of §1.1502-21T(b)(2)(iv). At the beginning of Year 4, S1's basis in its S3 stock was \$60, S2's basis in its S3 stock was \$120, and S3 had one asset with a basis of \$200 and a value of \$10. None of P, S1, S2, or S3 had a separate return limitation year.

(ii) *Analysis—Reduction of tax attributes attributable to debtors.* Pursuant to paragraph (b)(1)(i) of this section, the tax attributes attributable to each of S1 and S2 are reduced pursuant to paragraph (a)(2) of this section, and the tax attributes attributable to S3 are reduced pursuant to paragraph (a)(3) of this section so as to reflect a reduction of S1's and S2's basis in the stock of S3 prior to the application of paragraph (a)(4) to reduce additional tax attributes. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S1 and S2 must be reduced to take into account their excluded COD income.

(A) *Reduction of net operating losses generally.* Pursuant to section 108(b)(2)(A), the net operating losses and the net operating loss carryovers of S1 and S2 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating losses and the net operating loss carryovers attributable to S1 and S2 under the principles of §1.1502-21T(b)(2)(iv) are reduced first.

(B) *Reduction of net operating losses attributable to S1.* Pursuant to section 108(b)(4)(B), S1's net operating loss for the taxable year of the discharge is reduced. Accordingly, the consolidated net operating loss for Year 3 is reduced by \$10, the portion of the consolidated net operating loss attributable to S1, to \$40. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 2 is reduced by \$40, the portion of that consolidated net operating loss carryover attributable to S1, to \$70.

(C) *Reduction of net operating losses attributable to S2.* Pursuant to section 108(b)(4)(B), S2's net operating loss for the taxable year of the discharge is reduced. Accordingly, the consolidated net operating loss for Year 3 is further reduced by \$20, the portion of the consolidated net operating loss attributable to S2, to \$20. Then, pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 1 is reduced by \$50, the portion of that consolidated net operating loss carryover attributable to S2, to \$110. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 2 is further reduced by \$70, the portion of that consolidated net operating loss carryover attributable to S2, to \$0.

(D) *Reduction of basis.* Following the reduction of the net operating losses and the net operating loss

carryovers attributable to S1 and S2, S1 and S2 must reduce their basis in their assets pursuant to section 1017 and §1.1017-1. Accordingly, S1 reduces its basis in the stock of S3 by \$60, from \$60 to \$0, and S2 reduces its basis in the stock of S3 by \$120, from \$120 to \$0.

(E) *Tiering down of basis reduction.* Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S3 is treated as realizing \$180 of excluded COD income. Pursuant to section 108(b)(2)(A), therefore, the net operating loss and the net operating loss carryovers of S3 are reduced, in the order indicated by section 108(b)(4)(B). Pursuant to paragraph (a)(2) of this section the consolidated net operating loss and any consolidated net operating loss carryovers that are attributable to S3 under the principles of §1.1502-21T(b)(2)(iv) are reduced. Accordingly, the consolidated net operating loss for Year 3 is further reduced by \$20, the portion of the consolidated net operating loss attributable to S3, to \$0. Then, the consolidated net operating loss carryover from Year 1 is reduced by \$100, the portion of that consolidated net operating loss carryover attributable to S3, to \$10. Following the reduction of the net operating loss and the net operating loss carryover attributable to S3, S3 reduces its basis in its asset pursuant to section 1017 and §1.1017-1. Accordingly, S3 reduces its basis in its asset by \$60, from \$200 to \$140.

(F) *Reduction of remaining consolidated tax attributes.* Finally, pursuant to paragraph (a)(4) of this section, the remaining \$90 of S1's excluded COD income and the remaining \$10 of S2's excluded COD income reduce the remaining consolidated tax attributes. In particular, the remaining \$10 consolidated net operating loss carryover from Year 1 is reduced by \$10 to \$0. Because that amount is less than the aggregate amount of remaining excluded COD income, such income is applied on a *pro rata* basis to reduce the remaining consolidated tax attributes. Accordingly, \$9 of S1's remaining excluded COD income and \$1 of S2's remaining excluded COD income is applied to reduce the remaining consolidated net operating loss carryover from Year 1. Consequently, of S1's excluded COD income of \$200, only \$119 is applied to reduce tax attributes, and, of S2's excluded COD income of \$270, only \$261 is applied to reduce tax attributes.

(d) *Effective date.* This section applies to discharges of indebtedness that occur after August 29, 2003.

Par. 7. Section 1.1502-32 is amended as follows:

1. Paragraphs (b)(3)(ii)(C)(I) and (b)(3)(iii)(A) are revised.
2. Paragraph (b)(4)(vii) is added.
3. Paragraph (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c), are revised.
4. Paragraph (h)(7) is added.

The revisions and additions read as follows:

§1.1502-32 Investment adjustments.

* * * * *

(b) * * * *

(3) * * *

(ii) * * *

(C) * * *

(I) [Reserved]. For further guidance, see §1.1502-32T(b)(3)(ii)(C)(1).

* * * * *

(iii) * * *

(A) [Reserved]. For further guidance, see §1.1502-32T(b)(3)(iii)(A).

* * * * *

(4) * * *

(vii) [Reserved]. For further guidance, see §1.1502-32T(b)(4)(vii).

(5) * * *

(ii) * * *

Example 4(a), (b), and (c) [Reserved]. For further guidance, see §1.1502-32T(b)(5)(ii), *Example 4(a), (b), and (c)*.

* * * * *

(h) * * *

(7) [Reserved]. For further guidance, see §1.1502-32T(h)(7).

Par. 8. Section 1.1502-32T is amended as follows:

1. Paragraphs (b) through (b)(3)(iii)(B) are revised.

2. Add and reserve paragraph (b)(3)(iv) and revise paragraphs (b)(4) through (b)(4)(iv).

3. Add and reserve paragraph (b)(5) and revise paragraphs (c) through (h)(5)(ii).

4. Paragraph (h)(7) is added.

The revisions and addition read as follows:

§1.1502-32T Investment adjustments (temporary).

* * * * *

(b) through (b)(3)(ii)(B) [Reserved]. For further guidance, see §1.1502-32(b) through (b)(3)(ii)(B).

(C) *Discharge of indebtedness income—(1) In general.* Discharge of indebtedness income of S that is excluded from gross income under section 108 is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes attributable to any member of the group under section 108, section 1017, or §1.1502-28T. If S is treated as realizing discharge of indebtedness income that is excluded from gross income pursuant to §1.1502-28T(a)(3), S shall not be treated

as realizing excluded COD income for purposes of the preceding sentence.

(b)(3)(ii)(C)(2) through (b)(3)(ii)(D) [Reserved]. For further guidance, see §1.1502-32(b)(3)(ii)(C)(2) through (b)(3)(ii)(D).

(iii) *Noncapital, nondeductible expenses—(A) In general.* S's noncapital, nondeductible expenses are its deductions and losses that are taken into account but permanently disallowed or eliminated under applicable law in determining its taxable income or loss, and that decrease, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's Federal taxes described in section 275 and loss not recognized under section 311(a) are noncapital, nondeductible expenses. Similarly, if a loss carryover (*e.g.*, under section 172 or 1212) attributable to S expires or is reduced under section 108(b) and §1.1502-28T, it becomes a noncapital, nondeductible expense at the close of the last tax year to which it may be carried. However, when a tax attribute attributable to S is reduced as required pursuant to §1.1502-28T(a)(3), the reduction of the tax attribute is not treated as a noncapital, nondeductible expense of S. Finally, if S sells and repurchases a security subject to section 1091, the disallowed loss is not a noncapital, nondeductible expense because the corresponding basis adjustments under section 1091(d) prevent the disallowance from being permanent.

(b)(3)(iii)(B) [Reserved]. For further guidance, see §1.1502-32(b)(3)(iii)(B).

* * * * *

(b)(3)(iv) through (b)(4)(iv) [Reserved]. For further guidance, see §1.1502-32(b)(3)(iv) through (b)(4)(iv).

* * * * *

(b)(5)(i) through (b)(5)(ii), *Example 3* [Reserved]. For further guidance, see §1.1502-32(b)(5)(i) through (b)(5)(ii), *Example 3*.

Example 4. Discharge of indebtedness. (a) *Facts.* P forms S on January 1 of Year 1 and S borrows \$200. During Year 1, S's assets decline in value and the P group has a \$100 consolidated net operating loss. Of that amount, \$10 is attributable to P and \$90 is attributable to S under the principles of §1.1502-21T(b)(2)(iv). None of the loss is absorbed by the group in Year 1, and S is discharged from \$100 of indebtedness at the close of Year 1. P has a \$0 basis in the S stock. P and S have no attributes other than the consolidated net operating loss. Under section 108(a), S's \$100 of discharge of indebtedness income is excluded from gross income because of insolvency.

Under section 108(b) and §1.1502-28T, the consolidated net operating loss is reduced to \$0.

(b) *Analysis.* Under §1.1502-32(b)(3)(iii)(B), the reduction of \$90 of the consolidated net operating loss attributable to S is treated as a noncapital, nondeductible expense in Year 1 because that loss is permanently disallowed by section 108(b) and §1.1502-28T. Under paragraph (b)(3)(ii)(C)(1) of this section, all \$100 of S's discharge of indebtedness income is treated as tax-exempt income in Year 1 because the discharge results in a \$100 reduction to the consolidated net operating loss. Consequently, the loss and the cancellation of the indebtedness result in a net positive \$10 adjustment to P's basis in its S stock.

(c) *Insufficient attributes.* The facts are the same as in paragraph (a) of this *Example 4*, except that S is discharged from \$120 of indebtedness at the close of Year 1. Under section 108(a), S's \$120 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b) and §1.1502-28T, the consolidated net operating loss is reduced to \$0 at the close of Year 1. Under §1.1502-32(b)(3)(iii)(B), the reduction of \$90 of the consolidated net operating loss attributable to S is treated as a noncapital, nondeductible expense. Under paragraph (b)(3)(ii)(C)(1) of this section, only \$100 of the discharge is treated as tax-exempt income because only that amount is applied to reduce tax attributes. The remaining \$20 of discharge income excluded under section 108(a) has no effect on P's basis in S's stock.

(b)(5)(ii), *Example 4(d)* through (h)(5)(ii) [Reserved]. For further guidance, see §1.1502-32(b)(5)(ii), *Example 4(d)* through (h)(5)(ii).

* * * * *

(h)(7) *Rules related to discharges of indebtedness excluded from gross income.* Paragraphs (b)(3)(ii)(C)(1), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c), of this section apply with respect to determinations of the basis of the stock of a subsidiary in consolidated return years the original return for which is due (without extensions) after August 29, 2003. For determinations in consolidated return years the original return for which is due (without extensions) on or before August 29, 2003, groups may apply paragraphs (b)(3)(ii)(C)(1), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c), of this section without regard to the references to §1.1502-28T or, alternatively, apply paragraphs (b)(3)(ii)(C)(1), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c), of §1.1502-32 as contained in 26 CFR part 1 edition revised as of April 1, 2003.

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

Approved August 28, 2003.

Gregory F. Jenner,
Deputy Assistant Secretary of the Treasury.

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