

Section 108.—Income From Discharge of Indebtedness

26 CFR 1.108-4: Election to reduce basis of depreciable property under section 108(b)(5) of the Internal Revenue Code.

T.D. 8787

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301, and 602

Basis Reduction Due to Discharge of Indebtedness

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that provide ordering rules for the reduction of bases of property under sections 108 and 1017 of the Internal Revenue Code of 1986. The regulations will affect taxpayers that exclude discharge of indebtedness income from gross income under section 108.

DATES: *Effective Date:* These regulations are effective, October 22, 1998.

Applicability Date: These regulations apply to discharges of indebtedness occurring on or after, October 22, 1998 and to elections under section 108(b)(5) concerning discharges of indebtedness occurring on or after, October 22, 1998.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations generally, Sharon L. Hall or Christopher F. Kane of the Office of Assistant Chief Counsel (Income Tax & Accounting) at (202) 622-4930; concerning partnership adjustments under section 1017, Matthew Lay of the Office of Assistant Chief Counsel (Passthroughs & Special Industries) at (202) 622-3050.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this final regulation have been reviewed and approved by the Office of

Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1539. Responses to these collections of information are required to obtain a benefit.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent is 1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This final regulation contains amendments to the income tax regulations (26 CFR Parts 1 and 301) under sections 108 and 1017 of the Internal Revenue Code of 1986 (Code). The amendments conform the regulations to amendments to sections 108 and 1017 made by the Bankruptcy Tax Act of 1980, Public Law 96-589, §§2, 94 (Stat. 3389 (1980)); 1980-2 C.B. 607 (Bankruptcy Tax Act); the Technical Corrections Act of 1982, Public Law 97-448, §102(h)(1), 96 (Stat. 2365, 2372 (1983)); 1983-1 C.B. 451; the Deficit Reduction Act of 1984, Public Law 98-369, sections 474(r)(5) and 721(b)(2), 98 (Stat. 494, 839, 966 (1984)); 1984-3 C.B. (Vol. 1) 1; the Tax Reform Act of 1986, Public Law 99-514, sections 104(b)(2), 231(d)(3)(D), 822, and 1171(b)(4), 100 (Stat. 2085, 2105, 2179, 2373, 2513 (1986)); 1986-3 C.B. (Vol. 1) 2; and the Omnibus Budget Reconciliation Act of 1993, Public Law 103-66, section 13150, 107 (Stat. 312, 446 (1993)); 1993-3 C.B. 1.

On January 7, 1997, proposed regulations (REG-208172-91), were published in the **Federal Register** (62 F.R. 955). Written comments were received in response to the notice of proposed rulemaking. One speaker provided testimony at a public hearing held on May 29, 1997.

After consideration of all the comments, the proposed regulations under sections 108 and 1017 are adopted, as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

1. *Basis Reduction Limited to Fair Market Value*

One commentator requested that basis reduction be limited to fair market value as provided by §1.1016-7(a) (as removed by this regulation). The final regulations do not adopt this recommendation. Section 1017, as enacted by the Bankruptcy Tax Act, fundamentally changed the rules relating to basis reduction where discharge of indebtedness income (cancellation of debt (COD) income) is excluded from gross income. The revised statute, in section 1017(b)(2), provides only one limitation on basis reduction for insolvent and bankrupt taxpayers who do not make an election under section 108(b)(5). Under that rule, the basis reduction may not exceed the excess of the aggregate of the bases of the property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge. The fair market value limitation found in the regulations removed by this Treasury decision is not reflected in section 1017. Accordingly, the IRS and Treasury Department do not believe that a rule limiting basis reduction to fair market value would be appropriate.

2. *Section 108(c)(2)(A) Limitation*

Section 1.108-5(a) of the proposed regulations described the limitation under section 108(c)(2)(A) and provided that the amount excluded under section 108(a)(1)(D) (concerning discharges of qualified real property business indebtedness) could not exceed the excess of the outstanding principal amount of that indebtedness immediately before the dis-

charge over the net fair market value of the qualifying real property (as defined under §1.1017-1(c)(1)) immediately before the discharge. Two commentators requested that the regulations clarify that any outstanding accrued and unpaid interest is included in determining the outstanding principal amount of the indebtedness for purposes of this limitation. Given the purpose of this limitation, which is to prevent taxpayers from using the section 108(a)(1)(D) exclusion to the extent that debt cancellation would create equity in property (H.R. Rep. 103-111, 103d Cong., 1st Sess., 622-23 (1993)), the IRS and Treasury Department believe that it is inappropriate to strictly limit the exclusion by reference to the amount stated as principal in the debt instrument. Accordingly, the final regulations provide that, for purposes of section 108(c)(2)(A) and §1.108-6 only, outstanding principal amount means the principal amount of an indebtedness and 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. Amounts that are subject to section 108(e)(2) are excepted from the definition of principal amount. In addition, principal amount must be adjusted to account for unamortized premium and discount consistent with section 108(e)(3).

3. Allocation of Basis Reduction of Multiple Properties Within the Same Class

The proposed regulations incorporated the limitation described in section 1017(b)(2) which provides that the basis reduction for bankrupt and insolvent taxpayers may not exceed the excess of the aggregate of the bases of the property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge. A commentator suggested that this limitation be applied on a class by class basis, so that when a basis reduction applied within a single class of properties described in §1.1017-1(a) exceeds the amount of basis over the debt secured by the properties in that class, the basis reduction in excess of that amount should default to the next class.

The final regulations do not adopt this comment.

The overall limitation on basis reduction is determined by reference to the adjusted basis of property and the amount of money held by the taxpayer over the liabilities of the taxpayer “immediately after the discharge.” By contrast, under the basis reduction rules applicable for purposes of section 108(b)(2)(E), the taxpayer must reduce the adjusted basis of property “held by the taxpayer at the beginning of the taxable year following the year in which the discharge occurs.” Section 1017(a). Given the difference in the relevant time for applying the basis limitation and the basis reduction rules, and the relative complexity of the calculations necessary to implement the proposal, the IRS and Treasury Department believe that the suggested limitation is not workable. Accordingly, the final regulations continue to apply the limitation based on the aggregate bases and liabilities of the taxpayer consistent with section 1017(b)(2).

The proposed regulations also provided that a taxpayer must treat a distributive share of a partnership’s COD income as attributable to a discharged indebtedness secured by the taxpayer’s interest in that partnership. The rule in the proposed regulations for allocating basis reduction among multiple properties under section 108(b)(2)(E) contained parenthetical language cross-referencing the partnership provision for the property classes that included secured real and personal property used in a trade or business or held for investment. This parenthetical language was intended to remind taxpayers that partnership indebtedness is treated as indebtedness secured by the taxpayer’s interest in the partnership.

One commentator stated that the cross-reference with respect to secured real property was confusing since a partnership interest presumably should be treated as personal property in reducing basis under section 108(b)(2)(E). This is contrasted with the modified basis reduction rules under sections 108(b)(5) and 108(c) which, assuming the appropriate requests are made and consents are granted, apply a look-through rule to reduce the inside basis of depreciable property or depreciable real property held by a partnership.

In order to eliminate this confusion, the parenthetical language is not included in the final regulations. However, as under the proposed regulations, the final regula-

tions continue to treat a distributive share of a partnership’s COD income as attributable to a discharged indebtedness secured by the taxpayer’s partnership interest. Accordingly, the elimination of the parenthetical language is not intended to change the substantive results obtained in allocating a basis reduction among multiple properties.

4. Meaning of “In Connection With” In Section 108(c)(3)

A commentator requested that the final regulations provide that the phrase “in connection with” in section 108(c)(3) does not require that the proceeds of debt incurred or assumed before January 1, 1993 be traced to real property used in a trade or business, but only requires that the debt be secured by real property used in a trade or business as of January 1, 1993. The final regulations do not adopt this comment. Section 108(c)(3)(A) defines *qualified real property business indebtedness* as indebtedness which “was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property”. The IRS and Treasury Department do not believe that this sentence should be interpreted to mean only that the debt must be secured by real property used in a trade or business as of January 1, 1993.

5. Basis Reduction With Respect to a Residence

A commentator requested that when the basis of a taxpayer’s residence is reduced under section 1017 and is disposed of in a transaction subject to section 1034 (which provided for the deferral of gain on the sale of a personal residence), the potential recapture income arising under section 1245 should be carried into the replacement property. This comment is not adopted in the final regulations. Section 1034 was repealed by the Taxpayer Relief Act of 1997. New section 121, enacted by the Taxpayer Relief Act of 1997, exempts certain gain on the sale of a residence, but does not provide that the potential gain will be transferred to a replacement residence. Therefore, under the new law, there is no mechanism to preserve the potential recapture income with respect to a new residence, and the

potential recapture income must be recognized on the sale of the residence under section 1245.

6. *Mandatory Request and Consent*

The proposed regulations provided that a partner may treat a partnership interest as depreciable property under section 108(b)(5) (or as depreciable real property under section 108(c)) only if the partnership consents to make corresponding adjustments to the basis of the partnership's depreciable property (or depreciable real property). The IRS and Treasury Department generally believe, in this context, that whether or not a partnership consents to make the corresponding adjustments to the basis of its property should be a matter of agreement between the partner and the partnership. Therefore, the proposed regulations generally provided that a partner is free to choose whether or not to request that a partnership reduce the basis of partnership property and that the partnership is free to grant or withhold its consent.

The ability to freely choose whether or not to request or grant consent, however, provides opportunities to avoid the general ordering rules of the proposed regulations through the use of a partnership. Therefore, the proposed regulations provided that, in a limited number of situations; (i) a partner is required to request the partnership's consent, and (ii) the partnership is required to grant that consent. Specifically, the proposed regulations provided that a partner is required to request consent if the partner owns (directly or indirectly) more than 50 percent of the capital and profits interests of the partnership, or if the partner receives a distributive share of COD income from the partnership. In addition, the partnership is required to grant consent if requests are made by partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership.

One commentator requested revisions to the mandatory request and consent rules contained in the proposed regulations. This commentator argued that the proposed regulations, as written, could unduly burden certain large partnerships in situations where the partnership's refusal to consent was not motivated by tax avoidance. The commentator requested

that the mandatory consent rule be revised to require a partnership to consent only if the partnership receives requests from five or fewer partners who own, in the aggregate, more than 50 percent of the capital and profits of the partnership.

To ensure that partnerships are not unduly burdened by the mandatory request and consent rules, the commentator's proposal has been adopted, in part, in the final regulations. However, to preserve the general ordering rules of the regulations, the IRS and Treasury Department believe that it is appropriate to require a partnership to consent to reduce the basis of its depreciable property (or depreciable real property) where a substantial majority of its partners elect to exclude the COD income under sections 108(b)(5) or 108(c). Therefore, the final regulations provide that a partnership must consent to reduce its partners' shares of the partnership's depreciable basis in depreciable property (or depreciable real property) if consent is requested by: (i) partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership, or (ii) five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership.

As in the proposed regulations, the final regulations do not require a partnership to reduce the basis of its depreciable property (or depreciable real property) in all situations where the partnership is the source of the COD income. However, where a partnership is the source of the COD income and partners elect to exclude such income, such partners are required to request that the partnership reduce its basis in such property. Accordingly, if partners meeting the requirements in (i) or (ii) above elect to exclude such income, the partnership must consent to reduce the basis of its depreciable property (or depreciable real property).

Commentators also requested that the final regulations clarify that a partnership's consent is not required for basis adjustments under section 108(b)(2)(E). The final regulations make it clear that a partnership's consent to reduce the basis of the partnership's depreciable property (or depreciable real property) is neither required nor relevant where a partner

reduces the basis in its partnership interest under section 108(b)(2)(E).

7. *Treatment of the Adjustment to the Basis of Partnership Property Under Subchapter K*

One commentator requested that the final regulations address a number of issues concerning the treatment of the partnership's adjustments to the basis of partnership property under subchapter K. The final regulations do not address these issues. Instead, the IRS and Treasury Department have addressed these issues in the proposed regulations recently promulgated under sections 743 and 755.

8. *Timing and Reporting*

The proposed regulations provided that a partner requesting a reduction in inside basis must make the request and receive consent before the due date (including extensions) for filing the partner's Federal income tax return for the taxable year in which the partner has COD income. The proposed regulations also provided that a partnership that consents to a basis reduction must include a consent statement with its Form 1065, U.S. Partnership Return of Income, and provide a copy of that statement to the affected partner on or before the date the Form 1065 is filed. One commentator stated that the final regulations should provide that; (i) partners should not be required to request consent, and (ii) neither the partner nor the partnership should be required to attach statements to their returns, until the filing date of their respective returns for the taxable year following the year that the partner excludes COD income.

The IRS and Treasury Department continue to believe that a partner electing under sections 108(b)(5) or 108(c) must receive the consent of the partnership before the partner excludes the COD income. Therefore, the final regulations provide that the partner must request and receive the consent of the partnership prior to the due date (including extensions) for filing the partner's Federal income tax return for the taxable year in which the partner has COD income. The final regulations do, however, adopt the commentator's suggestion that the partnership is not required to attach a statement to its return until the filing date of its

Federal income tax return for the taxable year following the year that ends with or within the taxable year that the partner excludes the COD income.

The commentator also stated that the final regulations should provide that when a partnership recognizes any COD income from qualified real property business indebtedness it should attach a statement to its partners' Forms K-1 stating that the COD income is from qualified real property business indebtedness and the date the cancellation occurred. The final regulations do not adopt this proposal. The IRS and Treasury Department believe that §1.703-1(a)(1) currently requires partnerships to separately state qualified real property business indebtedness and identify it as such.

The IRS and Treasury Department recognize that a partner might not always have sufficient information with which to decide to request a basis reduction until on, or shortly before, the due date (including extensions) for filing the partner's Federal income tax return. Therefore, comments were requested as to whether additional rules (such as requiring a partnership to inform partners of COD income prior to the date the Form 1065 is filed) are necessary to ensure that information is exchanged between the partnership and its partners in a timely fashion. The final regulations do not require partnerships to inform their partners of COD income prior to the date the Form 1065 is filed. Instead, the IRS and Treasury Department believe that any additional administrative burdens imposed on partnerships should be the result of an understanding between the partners and the partnership.

9. *Methods Used Prior to Issuance of Final Regulations*

A commentator requested that, for cancellation of debt events occurring prior to the issuance of final regulations, taxpayers be allowed to use any reasonable method that conforms with existing regulations or the proposed regulations in determining which properties are subject to the basis adjustments under sections 108 and 1017. This suggestion to provide for retroactive application of these regulations has not been adopted.

Special Analyses

It has been determined that this final regulation is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has been determined that a final regulatory flexibility analysis is required for the collection of information in this Treasury decision under 5 U.S.C. 604. A summary of the analysis is set forth below under the heading "Summary of Final Regulatory Flexibility Act Analysis." Pursuant to section 7805(f) of the Internal Revenue Code, this final regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Summary of Final Regulatory Flexibility Act Analysis

This analysis is required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). In certain circumstances, the final regulations will require a partnership to include a statement with its Form 1065, U.S. Partnership Return of Income, for the taxable year following the year that ends with or within the taxable year the taxpayer excludes COD income from gross income, and provide a statement to the taxpayer on or before the due date of the requesting partner's return (including extensions) for the taxable year in which the COD income is excluded under section 108(a), stating the amount of the partner's share of the reduction in the partnership's adjusted bases of depreciable real or personal property (inside basis). This requirement will ensure that the partner knows it is entitled to reduce the adjusted basis of the partnership interest and that the affected partnership knows it must reduce the partner's interest in inside basis. The legal basis for this requirement is contained in sections 1017(b), 6001, and 7805(a).

Though the final regulations might affect any partnership owning depreciable property, the IRS and Treasury Department believe that partnerships owning depreciable real property are the most likely to be affected. Approximately 1,560,000 partnership returns were filed for 1993. Approximately 620,000 of these were for

partnerships owning real property. It is unlikely, however, that many of these partnerships or partners in these partnerships will have COD income in any given year, so it is anticipated that only a small number of these partnerships will be affected by the final regulations in a particular year.

After a partner conveys information concerning the amount of COD income excluded from gross income under section 108(a) to the affected partnership, the partnership must reduce the partner's interest in inside basis. Accordingly, the partnership must prepare and maintain special entries on its books because this basis reduction will reduce the partner's share of the partnership's depreciation deductions, and ultimate gain or loss on the sale of the property, in subsequent years. In many cases, partnership returns are prepared using computer software that can prepare and maintain these special entries after the initial year.

The IRS and Treasury Department are not aware of any federal rules that may duplicate, overlap, or conflict with the rule in the final regulation.

As an alternative to the disclosure described above, the IRS and Treasury Department considered, but rejected as too burdensome, a rule that would have required an affected partnership to disclose the reductions of adjusted basis on a property-by-property basis. There are no known alternative rules that are less burdensome to small entities but that accomplish the purpose of the statute.

Drafting Information

The principal authors of these regulations are Sharon L. Hall, Office of Assistant Chief Counsel (Income Tax and Accounting) and Brian Blum, Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

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

Section 1.108-4 also issued under 26 U.S.C. 108.

Section 1.108-5 also issued under 26 U.S.C. 108. * * *

Section 1.1017-1 also issued under 26 U.S.C. 1017. * * *

Par. 2. Section 1.108-4 is added to read as follows.

§1.108-4 Election to reduce basis of depreciable property under section 108(b)(5) of the Internal Revenue Code .

(a) *Description.* An election under section 108(b)(5) is available whenever a taxpayer excludes discharge of indebtedness income (COD income) from gross income under sections 108(a)(1)(A), (B), or (C) (concerning title 11 cases, insolvency, and qualified farm indebtedness, respectively). See sections 108(d)(2) and (3) for the definitions of *title 11 case* and *insolvent*. See section 108(g)(2) for the definition of *qualified farm indebtedness*.

(b) *Time and manner.* To make an election under section 108(b)(5), a taxpayer must enter the appropriate information on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, and attach the form to the timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). An election under this section may be revoked only with the consent of the Commissioner.

(c) *Effective date.* This section applies to elections concerning discharges of indebtedness occurring on or after October 22, 1998.

§1.108(c)-1 [Redesignated as §1.108-5]

Par. 3. Section 1.108(c)-1 is redesignated as §1.108-5.

Par. 4. Section 1.108-6 is added to read as follows:

§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 prop-

erty 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.

§1.108(a)-1 [Removed]

Par. 5. Section 1.108(a)-1 is removed.

§1.108(a)-2 [Removed]

Par. 6. Section 108(a)-2 is removed.

§1.108(b)-1 [Removed]

Par. 7. Section 1.108-(b)-1 is removed.

§1.1016-7 [Removed]

Par. 8. Section 1.1016-7 is removed.

§1.1016-8 [Removed]

Par. 9. Section 1.1016-8 is removed.

Par. 10. Section 1.1017-1 is revised to read as follows:

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

(a) *General rule for section 108(b)(2)(E).* This paragraph (a) applies to basis reductions under section 108(b)(2)(E) that are required by section 108(a)(1)(A) or (B) because the taxpayer excluded discharge of indebtedness (COD income) from gross income. A taxpayer must reduce in the following order, to the extent of the excluded COD income (but not below zero), the adjusted bases of property held on the first day of the taxable year following the taxable year that the taxpayer excluded COD income from gross income (in proportion to adjusted basis)—

(1) Real property used in a trade or business or held for investment, other than real property described in section 1221(1), that secured the discharged indebtedness immediately before the discharge;

(2) Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the discharged indebtedness immediately before the discharge;

(3) Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in section 1221(1);

(4) Inventory, accounts receivable, notes receivable, and real property described in section 1221(1); and

(5) Property not used in a trade or business nor held for investment.

(b) *Operating rules—(1) Prior tax-attribute reduction.* The amount of excluded COD income applied to reduce basis does not include any COD income applied to reduce tax attributes under sec-

tions 108(b)(2)(A) through (D) and, if applicable, section 108(b)(5). For example, if a taxpayer excludes \$100 of COD income from gross income under section 108(a) and reduces tax attributes by \$40 under sections 108(b)(2)(A) through (D), the taxpayer is required to reduce the adjusted bases of property by \$60 ($\$100 - \40) under section 108(b)(2)(E).

(2) *Multiple discharged indebtednesses.* If a taxpayer has COD income attributable to more than one discharged indebtedness resulting in the reduction of tax attributes under sections 108(b)(2)(A) through (D) and, if applicable, section 108(b)(5), paragraph (b)(1) of this section must be applied by allocating the tax-attribute reductions among the indebtednesses in proportion to the amount of COD income attributable to each discharged indebtedness. For example, if a taxpayer excludes \$20 of COD income attributable to secured indebtedness A and excludes \$80 of COD income attributable to unsecured indebtedness B (a total exclusion of \$100), and if the taxpayer reduces tax attributes by \$40 under sections 108(b)(2)(A) through (D), the taxpayer must reduce the amount of COD income attributable to secured indebtedness A to \$12 ($\$20 - (\$20 / \$100 \times \$40)$) and must reduce the amount of COD income attributable to unsecured indebtedness B to \$48 ($\$80 - (\$80 / \$100 \times \$40)$).

(3) *Limitation on basis reductions under section 108(b)(2)(E) in bankruptcy or insolvency.* If COD income arises from a discharge of indebtedness in a title 11 case or while the taxpayer is insolvent, the amount of any basis reduction under section 108(b)(2)(E) shall not exceed the excess of—

(i) The aggregate of the adjusted bases of property and the amount of money held by the taxpayer immediately after the discharge; over

(ii) The aggregate of the liabilities of the taxpayer immediately after the discharge.

(c) *Modification of ordering rules for basis reductions under sections 108(b)(5) and 108(c)—(1) In general.* The ordering rules prescribed in paragraph (a) of this section apply, with appropriate modifications, to basis reductions under sections 108(b)(5) and (c). Thus, a taxpayer that elects to reduce basis under section 108(b)(5) may, to the extent that the elec-

tion applies, reduce only the adjusted basis of property described in paragraphs (a)(1), (2), and (3) of this section and, if an election is made under paragraph (f) of this section, paragraph (a)(4) of this section. Within paragraphs (a)(1), (2), (3) and (4) of this section, such a taxpayer may reduce only the adjusted bases of depreciable property. A taxpayer that elects to apply section 108(c) may reduce only the adjusted basis of property described in paragraphs (a)(1) and (3) of this section and, within paragraphs (a)(1) and (3) of this section, may reduce only the adjusted bases of depreciable real property. Furthermore, for basis reductions under section 108(c), a taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged qualified real property business indebtedness before reducing the adjusted bases of other depreciable real property. The term *qualifying real property* means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3). See paragraphs (f) and (g) of this section for elections relating to section 1221(1) property and partnership interests.

(2) *Partial basis reductions under section 108(b)(5).* If the amount of basis reductions under section 108(b)(5) is less than the amount of the COD income excluded from gross income under section 108(a), the taxpayer must reduce the balance of its tax attributes, including any remaining adjusted bases of depreciable and other property, by following the ordering rules under section 108(b)(2). For example, if a taxpayer excludes \$100 of COD income from gross income under section 108(a) and elects to reduce the adjusted bases of depreciable property by \$10 under section 108(b)(5), the taxpayer must reduce its remaining tax attributes by \$90, starting with net operating losses under section 108(b)(2).

(3) *Modification of fresh start rule for prior basis reductions under section 108(b)(5).* After reducing the adjusted bases of depreciable property under section 108(b)(5), a taxpayer must compute the limitation on basis reductions under section 1017(b)(2) using the aggregate of the remaining adjusted bases of property. For example, if, immediately after the discharge of indebtedness in a title 11 case, a taxpayer's adjusted bases of property is

\$100 and its undischarged indebtedness is \$70, and if the taxpayer elects to reduce the adjusted bases of depreciable property by \$10 under section 108(b)(5), section 1017(b)(2) limits any further basis reductions under section 108(b)(2)(E) to \$20 ($(\$100 - \$10) - \70).

(d) *Changes in security.* If any property is added or eliminated as security for an indebtedness during the one-year period preceding the discharge of that indebtedness, such addition or elimination shall be disregarded where a principal purpose of the change is to affect the taxpayer's basis reductions under section 1017.

(e) *Depreciable property.* For purposes of this section, the term *depreciable property* means any property of a character subject to the allowance for depreciation or amortization, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor cannot reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of such property.

(f) *Election to treat section 1221(1) real property as depreciable—(1) In general.* For basis reductions under section 108(b)(5) and basis reductions relating to qualified farm indebtedness, a taxpayer may elect under sections 1017(b)(3)(E) and (4)(C), respectively, to treat real property described in section 1221(1) as depreciable property. This election is not available, however, for basis reductions under section 108(c).

(2) *Time and manner.* To make an election under section 1017(b)(3)(E) or (4)(C), a taxpayer must enter the appropriate information on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, and attach the form to a timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). An election under this paragraph (f) may be revoked only with the consent of the Commissioner.

(g) *Partnerships—(1) Partnership COD income.* For purposes of paragraph

(a) of this section, a taxpayer must treat a distributive share of a partnership's COD income as attributable to a discharged indebtedness secured by the taxpayer's interest in that partnership.

(2) *Partnership interest treated as depreciable property*—(i) *In general.* For purposes of making basis reductions, if a taxpayer makes an election under section 108(b)(5) (or 108(c)), the taxpayer must treat a partnership interest as depreciable property (or depreciable real property) to the extent of the partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property), provided that the partnership consents to a corresponding reduction in the partnership's basis (inside basis) in depreciable property (or depreciable real property) with respect to such partner.

(ii) *Request by partner and consent of partnership*—(A) *In general.* Except as otherwise provided in this paragraph (g)(2)(ii), a taxpayer may choose whether or not to request that a partnership reduce the inside basis of its depreciable property (or depreciable real property) with respect to the taxpayer, and the partnership may grant or withhold such consent, in its sole discretion. A request by the taxpayer must be made before the due date (including extensions) for filing the taxpayer's Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

(B) *Request for consent required.* A taxpayer must request a partnership's consent to reduce inside basis if, at the time of the discharge, the taxpayer owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership, or if reductions to the basis of the taxpayer's depreciable property (or depreciable real property) are being made with respect to the taxpayer's distributive share of COD income of the partnership.

(C) *Granting of request required.* A partnership must consent to reduce its partners' shares of inside basis with respect to a discharged indebtedness if consent is requested with respect to that indebtedness by partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership or five or fewer

partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. For example, if there is a cancellation of partnership indebtedness that is secured by real property used in a partnership's trade or business, and if partners owning (in the aggregate) 90 percent of the capital and profits interests of the partnership elect to exclude the COD income under section 108(c), the partnership must make the appropriate reductions in those partners' shares of inside basis.

(iii) *Partnership consent statement*—(A) *Partnership requirement.* A consenting partnership must include with the Form 1065, U.S. Partnership Return of Income, for the taxable year following the year that ends with or within the taxable year the taxpayer excludes COD income from gross income under section 108(a), and must provide to the taxpayer on or before the due date of the taxpayer's return (including extensions) for the taxable year in which the taxpayer excludes COD income from gross income, a statement that—

(1) Contains the name, address, and taxpayer identification number of the partnership; and

(2) States the amount of the reduction of the partner's proportionate interest in the adjusted bases of the partnership's depreciable property or depreciable real property, whichever is applicable.

(B) *Taxpayer's requirement.* Statements described in paragraph (g)(2)(iii)-(A) of this section must be attached to a taxpayer's timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

(iv) *Partner's share of partnership's adjusted basis.* [Reserved]

(3) *Partnership basis reduction.* The rules of this section (including this paragraph (g)) apply in determining the properties to which the partnership's basis reductions must be made.

(h) *Special allocation rule for cases to which section 1398 applies.* If a bankruptcy estate and a taxpayer to whom section 1398 applies (concerning only individuals under Chapter 7 or 11 of title 11 of the United States Code) hold property subject to basis reduction under section

108(b)(2)(E) or (5) on the first day of the taxable year following the taxable year of discharge, the bankruptcy estate must reduce all of the adjusted bases of its property before the taxpayer is required to reduce any adjusted bases of property.

(i) *Effective date.* This section applies to discharges of indebtedness occurring on or after October 22, 1998.

§1.1017-2 [Removed]

Par. 11. Section 1.1017-2 is removed.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 12. The authority citation for part 301 continues to read as follows:

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

§301.9100-13T [Removed]

Par. 13. Section 301.9100-13T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 14. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 15. Section 602.101(c) is amended by:

1. Adding the following entries in numerical order to the table:

§602.101 OMB Control numbers.

* * * * *	
(c) * * *	
CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.108-4	1545-1539
1.108-5	1545-1421
* * * * *	
1.1017-1	1 545-1539
* * * * *	

2. Removing the following entries in numerical order from the table:

* * * * *

CFR part or section where identified and described	Current OMB control No.
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* * * * *

1.108(a)-1	1545-0046
1.108(a)-2	1545-0046
1.108(c)-1	1545-1421

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1.1017-2	1545-0028
	1545-0046

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301.9100-13T	1545-0046
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Michael P. Dolan,
*Commissioner of
Internal Revenue.*

Approved September 14, 1998.

Donald C. Lubick,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on October 21, 1998, at 8:45 a.m., and published in the issue of the Federal Register for October 22, 1998, 63 F.R. 56559)