

of built-in gain as the section 704(c) property disposed of by the partnership (with appropriate adjustments for any gain recognized on the installment sale). The allocation method for the installment obligation must be consistent with the allocation method chosen for the original property.

(iii) *Contributed contracts.* If a partner contributes to a partnership a contract that is section 704(c) property, and the partnership subsequently acquires property pursuant to that contract in a transaction in which less than all of the gain or loss is recognized, then the acquired property is treated as the section 704(c) property with the same amount of built-in gain or loss as the contract (with appropriate adjustments for any gain or loss recognized on the acquisition). For this purpose, the term contract includes, but is not limited to, options, forward contracts, and futures contracts. The allocation method for the acquired property must be consistent with the allocation method chosen for the contributed contract.

\* \* \* \* \*

(f) *Effective dates.* \* \* \* Paragraph (a)(8)(ii) applies to installment obligations received by a partnership in exchange for section 704(c) property on or after November 24, 2003. Paragraph (a)(8)(iii) applies to property acquired on or after November 24, 2003, by a partnership pursuant to a contract that is section 704(c) property.

■ **Par. 3.** Section 1.704-4 is amended as follows:

- 1. The paragraph heading for (d)(1) is revised.
- 2. The text of paragraph (d)(1) is redesignated as paragraph (d)(1)(i).
- 3. A paragraph heading for newly designated paragraph (d)(1)(i) is added.
- 4. Paragraphs (d)(1)(ii) and (d)(1)(iii) are added.
- 5. Revising paragraph (g).

The revisions and additions read as follows:

**§ 1.704-4 Distribution of contributed property.**

\* \* \* \* \*

(d) *Special rules*—(1) *Nonrecognition transactions, installment obligations and contributed contracts*—(i) *Nonrecognition transactions.* \* \* \*

(ii) *Installment obligations.* An installment obligation received by the partnership in an installment sale (as defined in section 453(b)) of section 704(c) property is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that the installment obligation received is treated as section 704(c) property under § 1.704-3(a)(8). See

§ 1.737-2(d)(3) for a similar rule in the context of section 737.

(iii) *Contributed contracts.* Property acquired by the partnership pursuant to a contract that is section 704(c) property is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section, to the extent that the acquired property is treated as section 704(c) property under § 1.704-3(a)(8). See § 1.737-2(d)(3) for a similar rule in the context of section 737.

\* \* \* \* \*

(g) *Effective dates.* This section applies to distributions by a partnership to a partner on or after January 9, 1995, except that paragraphs (d)(1)(ii) and (iii) apply to distributions by a partnership to a partner on or after November 24, 2003.

■ **Par. 4.** Section 1.737-2 is amended as follows:

- 1. The paragraph heading for (d)(3) is revised.
- 2. The text of paragraph (d)(3) is redesignated (d)(3)(i).
- 3. A paragraph heading for newly designated (d)(3)(i) is added.
- 4. Paragraphs (d)(3)(ii) and (d)(3)(iii) are added.

**§ 1.737-2 Exceptions and special rules.**

\* \* \* \* \*

(d) \* \* \*

(3) *Nonrecognition transactions, installment sales and contributed contracts*—(i) *Nonrecognition transactions.* \* \* \*

(ii) *Installment sales.* An installment obligation received by the partnership in an installment sale (as defined in section 453(b)) of section 704(c) property is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the installment obligation received is treated as section 704(c) property under § 1.704-3(a)(8). See § 1.704-4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

(iii) *Contributed contracts.* Property acquired by a partnership pursuant to a contract that is section 704(c) property is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the acquired property is treated as section 704(c) property under § 1.704-3(a)(8). See § 1.704-4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

\* \* \* \* \*

■ **Par. 5.** Section 1.737-5 is revised to read as follows:

**§ 1.737-5 Effective dates.**

Sections 1.737-1, 1.737-2, 1.737-3, and 1.737-4 apply to distributions by a

partnership to a partner on or after January 9, 1995, except that § 1.737-2(d)(3)(ii) and (iii) apply to distributions by a partnership to a partner on or after November 24, 2003.

**Mark E. Matthews,**

*Deputy Commissioner for Services and Enforcement.*

Approved: March 15, 2005.

**Eric Solomon,**

*Acting Deputy Assistant Secretary of the Treasury (Tax Policy).*

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[TD 9192]

**RIN 1545-BC38; RIN 1545-BC74; RIN 1545-BC95**

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

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations, temporary regulations, and removal of temporary regulations.

**SUMMARY:** This document contains final regulations under section 1502 of the Internal Revenue Code that govern the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income. These final regulations affect corporations filing consolidated returns.

**DATES:** *Effective Date:* These regulations are effective March 21, 2005.

*Applicability Dates:* For dates of applicability, see § 1.1502-11(c)(7), § 1.1502-13(g)(3)(i)(A) and (ii)(C), § 1.1502-19(h)(2)(ii), § 1.1502-21(h)(6), § 1.1502-28(d), and § 1.1502-32(h)(7).

**FOR FURTHER INFORMATION CONTACT:** Concerning § 1.1502-11 of the final regulations, Candace B. Ewell at (202) 622-7530 (not a toll-free number), concerning all other sections of the final regulations, Amber R. Cook at (202) 622-7530 (not a toll-free number).

#### **SUPPLEMENTARY INFORMATION:**

#### **Background and Explanation of Provisions**

This document contains amendments to 26 CFR part 1 under section 1502 of the Internal Revenue Code (Code). On September 4, 2003, temporary regulations (TD 9089) (the first temporary regulations) relating to the

application of section 108 to members of a consolidated group were published in the **Federal Register** (68 FR 52487). A notice of proposed rulemaking (REG-132760-03) cross-referencing the first temporary regulations was published in the **Federal Register** for the same day (68 FR 52542). The first temporary regulations added § 1.1502-28T, which provides guidance regarding the determination of the attributes that are available for reduction when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income (excluded COD income) and the method for reducing those attributes. Section 1.1502-28T reflects a consolidated approach that is intended to reduce all attributes that are available to the debtor member.

Because the first temporary regulations may not have provided for the reduction of all the attributes that are available to the debtor member, on December 11, 2003, the IRS and Treasury Department published in the **Federal Register** (68 FR 69024) temporary regulations (TD 9098) (the second temporary regulations) under section 1502 amending § 1.1502-28T. A notice of proposed rulemaking (REG-153319-03) cross-referencing the second temporary regulations was published in the **Federal Register** for the same day (68 FR 69062). The second temporary regulations clarify that certain attributes that arise (or are treated as arising) in a separate return year are subject to reduction when no SRLY limitation applies to the use of such attributes.

On March 15, 2004, the IRS and Treasury Department published in the **Federal Register** (69 FR 12069) temporary regulations (TD 9117) (the third temporary regulations) under section 1502 amending §§ 1.1502-13 and 1.1502-28T. A notice of proposed rulemaking (REG-167265-03) (the 2004 proposed regulations) cross-referencing the third temporary regulations was published in the **Federal Register** for the same day (69 FR 12091). The third temporary regulations address certain technical issues relating to the application of excluded COD income to reduce attributes under sections 108 and 1017 and § 1.1502-28T.

The 2004 proposed regulations, in addition to cross-referencing the third temporary regulations, proposed amendments to §§ 1.1502-28T and 1.1502-11 to provide a methodology for computing consolidated taxable income and for effecting attribute reduction when there is a disposition of the stock of a member in a year during which any member realizes excluded COD income.

No public hearing was requested or held for any of the regulations described above. Written and electronic comments responding to the notices of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision, and the affected provisions in the corresponding temporary regulations are removed. The more significant revisions are discussed below.

#### *A. Apportionment of Net Operating Losses*

In addition to adding § 1.1502-28T, the first temporary regulations added several provisions to § 1.1502-21T. Sections 1.1502-21 and 1.1502-21T include rules relating to the amount of consolidated net operating losses apportioned to a subsidiary when a subsidiary departs from the group. The provisions added to § 1.1502-21T require a recomputation of the percentage of a consolidated net operating loss attributable to a member when a portion of the loss is carried back to a separate return year or is reduced in respect of excluded COD income, or when a member departs. Questions have arisen regarding the timing of the recomputation of the percentage of a consolidated net operating loss attributable to a member in cases in which a portion of a consolidated net operating loss is carried back to a separate return year or a portion is reduced in respect of excluded COD income. Therefore, these final regulations clarify the timing of the recomputation in these cases.

#### *B. Timing of Asset Basis Reduction*

Section 108(b)(4)(A) requires the reduction of the tax attributes listed in section 108(b)(2), including basis in property, in respect of excluded COD income after the determination of the tax imposed for the taxable year of the discharge. Section 1017(a) provides that when any portion of excluded COD income is to be applied to reduce basis, then such portion is applied to reduce the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. As a result of the reference in section 1017(a) to the property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs, questions have arisen regarding the appropriate time to reduce the basis of property of the taxpayer.

The IRS and Treasury Department believe that the reference in section 1017 to the property held by the taxpayer at the beginning of the taxable

year following the taxable year in which the discharge occurs merely identifies those properties the basis of which are subject to reduction. It does not prescribe that basis of property should not be reduced until the beginning of the taxable year following the taxable year in which the discharge occurs. Accordingly, these regulations clarify that basis of property is subject to reduction pursuant to the rules of sections 108 and 1017 and § 1.1502-28 after the determination of tax for the year during which the member realizes excluded COD income (and any prior years) and coincident with the reduction of other attributes pursuant to section 108 and § 1.1502-28. However, only the basis of property held as of the beginning of the taxable year following the taxable year during which the excluded COD income is realized is available for reduction.

#### *C. Application of Look-Through Rule*

The first temporary regulations 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 reductions must be made to the attributes attributable to the lower-tier member. To effect those corresponding reductions, the lower-tier member is treated as realizing excluded COD income in the amount of the stock basis reduction. Questions have arisen regarding whether the look-through rule applies when there is a reduction in the basis of stock of a corporation that is a member of the group on the last day of the debtor's taxable year during which the excluded COD income is realized, but is not a member of the group on the first day of the debtor's following taxable year. For example, suppose P1 owns all of the stock of S1 and S1 owns all of the stock of S2. P1, S1, and S2 file a consolidated return. In Year 1, P1 realizes excluded COD income. On the last day of Year 1, P1 sells 50 percent of the stock of S1 to P2. P1 reduces its basis in the 50 percent of the S1 stock that it owns on the first day of Year 2 in respect of its excluded COD income. Commentators have questioned whether the look-through rule applies to reduce S1's attributes.

The IRS and Treasury Department believe that because S1 and S2 were members of the same group on the last day of the debtor's taxable year during which the excluded COD income was realized, it is appropriate to apply the single entity principles reflected in the look-through rule. The IRS and Treasury Department have also considered whether the look-through rule applies when there is a reduction in the basis

of stock of a corporation that is not a member of the group on the last day of the debtor's taxable year during which the excluded COD income is realized (by reason of the application of the next day rule of § 1.1502-76), but is a member of the group on the first day of the debtor's following taxable year. In these cases too, the IRS and Treasury Department believe that it is appropriate to apply the single entity principles reflected in the look-through rule. Therefore, these regulations provide that, if the basis of stock of a corporation (the lower-tier member) that is owned by another corporation (the higher-tier member) is reduced and both of such corporations are members of the same consolidated group on the last day of the higher-tier member's taxable year that includes the date on which the excluded COD income is realized or the first day of the higher-tier member's taxable year that follows the taxable year that includes the date on which the excluded COD income is realized, the look-through rule will apply to reduce the attributes of the lower-tier member.

#### *D. Attributes Available for Reduction on Departure of Debtor Member*

Questions have arisen regarding the identification of the attributes available for reduction in cases in which the member that realizes the excluded COD income leaves the group (for example, by reason of a stock acquisition) or the assets of the member are acquired by a corporation that is not a member of the group in a transaction to which section 381(a) applies on or prior to the last day of the consolidated return year during which the excluded COD income is realized. At least one commentator has questioned whether the attributes of other members of the group from which the debtor member departs are available for reduction in these cases. These final regulations confirm that, in such cases, the tax attributes that remain after the determination of the tax imposed on the group that belong to members of the group are available for reduction.

#### *E. Intragroup Reorganizations and Group Structure Changes*

Questions have also arisen regarding the application of the attribute reduction rules when a taxpayer that is a member of a consolidated group realizes excluded COD income during the same consolidated return year during which it transfers assets in a transaction to which section 381(a) applies to a corporation that is a member of the group immediately after the transaction. Section 1.108-7 provides that if a taxpayer realizes excluded COD income either during or

after a taxable year in which the taxpayer is the distributor or transferor of assets in a transaction described in section 381(a), any tax attributes to which the acquiring corporation succeeds, including the basis of property acquired by the acquiring corporation in the transaction, must reflect the reductions required by section 108(b). If a member of the group transfers assets in a transaction to which section 381(a) applies to a corporation that is a member of the group immediately after the transaction and, as a result, the taxable year of the transferor member ends prior to the end of the consolidated return year, the basis of the transferred property following the transfer may generate depreciation deductions that are allowed in computing the group's consolidated taxable income for the entire consolidated return year that includes the date of the discharge. Requiring the basis of the transferred property to reflect a reduction in respect of the excluded COD income immediately after the transfer could arguably violate the directive of section 108(b)(4)(A) that attributes (including basis) be reduced only after the determination of tax for the taxable year of the discharge. However, if attributes were reduced after the determination of the group's tax for the taxable year of the discharge, it may be difficult to determine which attributes of the combined entity are attributable to the debtor member and available for reduction. For example, if after the transaction to which section 381(a) applies the acquiring corporation purchases property, it may be difficult to determine whether that property is property of the debtor the basis of which is available for reduction or property of the acquiring corporation the basis of which may not be available for reduction. Similar issues may arise with respect to other attributes of the transferor.

To address this issue, these final regulations provide that, if the taxable year of a member during which such member realizes excluded COD income ends prior to the last day of the consolidated return year and, on the first day of the taxable year of such member that follows the taxable year during which such member realizes excluded COD income, such member has a successor member, the successor member is treated as if it had realized the excluded COD income. Accordingly, all attributes of the successor member listed in section 108(b)(2) (including attributes that were attributable to the successor member prior to the date such member became a successor member)

are subject to reduction prior to the attributes attributable to other members of the group. For this purpose, a successor member means a person to which the member that realizes excluded COD income transfers its assets in a transaction to which section 381(a) applies if such transferee is a member of the group immediately after the transaction. This rule avoids the difficulty of tracing attributes and property of the debtor member once the debtor member has been acquired by another member and recognizes that the direction of a transaction to which section 381(a) applies in a group may not be meaningful. These regulations provide a similar rule for cases in which a member of the group acquires the assets of another member in a transaction to which section 381(a) applies that is also a group structure change.

#### *F. Application of Next Day Rule*

Under § 1.1502-76, a consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. A corporation that leaves a consolidated group during the tax year must generally file a short period separate return (or join in the consolidated return of another group) for the portion of the year not included in the consolidated return. If a corporation ceases to be a member during a consolidated return year, it ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends at the end of that day. Under the next day rule, however, any transaction that occurs on the day the member ceases to be affiliated with the group that is properly allocable to the portion of the subsidiary's day after the event terminating affiliation must be treated as occurring at the beginning of the following day. Commentators have questioned whether the next day rule can be applied when the debt of a subsidiary is discharged in exchange for stock of the subsidiary and, as a result of the issuance of the subsidiary's stock to the creditor, the subsidiary ceases to be a member of the group. As a result of the application of that rule, the excluded COD income would be treated as realized at the beginning of the day following the day the subsidiary ceases to be a member of the group, rather than on the day it ceases to be a member of the group.

The IRS and Treasury Department believe that because the excluded COD income accrued in the group, it is not

appropriate to apply the next day rule in these cases. Therefore, these regulations provide that the next day rule cannot be applied to treat excluded COD income as realized at the beginning of the day following the day on which it is realized.

#### *G. Timing of Investment Adjustments*

Under § 1.1502–32, excluded COD income of a subsidiary results in a positive basis adjustment to the extent it is applied to reduce attributes and the reduction of the subsidiary's attributes (other than credits) in respect of excluded COD income will generally result in a negative basis adjustment. Commentators have requested clarification regarding when these basis adjustments are effective in cases in which a subsidiary ceases to be a member of the group on or prior to the end of the consolidated return year during which a member realizes excluded COD income. Therefore, these regulations clarify that, in those cases, basis adjustments resulting from the realization of excluded COD income and from the reduction of attributes in respect thereof are made immediately after the determination of tax for the group for the consolidated return year during which the excluded COD income is realized (and any prior years) and are effective immediately before the beginning of the day following the day the member departs from the group. Therefore, if the departing member becomes a member of another group (the new group), the adjustments to the basis of the departing member's stock in respect of the excluded COD income will not cause stock basis adjustments in the new group.

#### *H. Elimination of Circular Stock Basis on Disposition of Member Stock*

The 2004 proposed regulations provide a methodology for computing consolidated taxable income and for effecting attribute reduction when there is a disposition of member stock during the same taxable year in which any member realizes excluded COD income. The methodology is intended to prevent the reduction of tax attributes from affecting the basis of the member stock that is sold, which would affect the tax liability of the group for the taxable year of the discharge. Accordingly, the methodology limits the actual reduction of tax attributes to the amount of tax attributes available for reduction following the tentative computation of taxable income (or loss).

Commentators have noted, however, that pursuant to section 108(b)(4)(A), attributes are reduced only after the determination of tax for the taxable year

of the discharge. Computing the limitation on attribute reduction based on the tax attributes remaining after a tentative computation of taxable income (or loss) does not account for the use of credits in the computation of the group's tax liability for the taxable year of the discharge. Therefore, in response to these comments, the final regulations provide for the computation of the limitation on attribute reduction after the computation of the tax imposed by chapter 1 of the Code, rather than after the computation of taxable income (or loss).

#### *I. Transactions Designed to Avoid the Application of the Attribute Reduction Rules*

The preamble to the first temporary regulations stated that 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. The IRS and Treasury Department continue to believe that general principles (including step transaction doctrine) could be applied to disregard certain transactions that have the effect of changing the result of the application of the attribute reduction rules. Therefore, the IRS and Treasury Department have decided not to adopt any additional rules at this time.

#### *J. Elective Retroactive Application of Final Regulation*

The portion of these regulations finalizing the rules contained in § 1.1502–28T apply to discharges of indebtedness that occur after March 21, 2005. Groups, however, may apply those rules in whole, but not in part, to discharges of indebtedness that occur on or before March 21, 2005, and after August 29, 2003.

These regulations also permit further retroactive application of a rule included in the third temporary regulations that prevents the potential duplication of ordinary income recapture under section 1245 that could be caused by reason of the application of both section 1245 and either section 1017(b)(3)(D) (which permits subsidiary stock to be treated as depreciable property to the extent that the subsidiary consents to a corresponding reduction in the basis of its depreciable property) or the look-through rule. This section 1245 rule provides that a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation only to the extent that the amount by which the basis of the

subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced pursuant to the subsidiary's consent under section 1017(b)(3)(D) or as a result of the application of the look-through rule. The third temporary regulations made this special rule effective for discharges of indebtedness that occur after August 29, 2003, the effective date of the look-through rule. The IRS and Treasury Department are aware that the problem addressed by this special rule could have occurred in cases of discharges of indebtedness that occurred before August 29, 2003, if section 1017(b)(3)(D) was applied. Accordingly, these final regulations provide that groups may apply this special rule to discharges of indebtedness that occur on or before August 29, 2003, in cases in which section 1017(b)(3)(D) was applied.

#### **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. Further, it is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file a consolidated return, which tend to be larger businesses. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notices of proposed rulemaking preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### **Drafting Information**

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

#### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

#### **Adoption of 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 entries for §§ 1.1502–13T, 1.1502–19T, and 1.1502–28T and adding the following entry in numerical order to read, in part, as follows:

**Authority:** 26 U.S.C. 7805. \* \* \*  
Section 1.1502–28 also issued under 26 U.S.C. 1502. \* \* \*

■ **Par. 2.** Section 1.1502–11 is amended as follows:

- 1. Paragraph (b)(1) is revised.
- 2. Paragraph (c) is redesignated as paragraph (d).
- 3. New paragraph (c) is added.

The revision and addition read as follows:

**§ 1.1502–11 Consolidated taxable income.**

\* \* \* \* \*

(b) *Elimination of circular stock basis adjustments when there is no excluded COD income—*(1) *In general.* If one member (P) disposes of the stock of another member (S), this paragraph (b) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years. The purpose of the limitation is to prevent P's income or gain from the disposition of S's stock from increasing the absorption of S's deductions and losses, because the increased absorption would reduce P's basis (or increase its excess loss account) in S's stock under § 1.1502–32 and, in turn, increase P's income or gain. See paragraph (b)(3) of this section for the application of these principles to P's deduction or loss from the disposition of S's stock, and paragraph (b)(4) of this section for the application of these principles to multiple stock dispositions. This paragraph (b) applies only when no member realizes discharge of indebtedness income that is excluded from gross income under section 108(a) (excluded COD income) during the taxable year of the disposition. See paragraph (c) of this section for rules that apply when a member realizes excluded COD income during the taxable year of the disposition. See § 1.1502–19(c) for the definition of disposition.

\* \* \* \* \*

(c) *Elimination of circular stock basis adjustments when there is excluded COD income—*(1) *In general.* If one member (P) disposes of the stock of another member (S) in a year during which any member realizes excluded COD income, this paragraph (c) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years, the

amount of the attributes of certain members that can be reduced in respect of excluded COD income of certain other members, and the attributes that can be used to offset an excess loss account taken into account by reason of the application of § 1.1502–19(c)(1)(iii)(B). In addition to the purpose set forth in paragraph (b)(1) of this section, the purpose of these limitations is to prevent the reduction of tax attributes in respect of excluded COD income from affecting P's income, gain, or loss on the disposition of S stock (including a disposition of S stock that results from the application of § 1.1502–19(c)(1)(iii)(B)) and, in turn, affecting the attributes available for reduction pursuant to sections 108 and 1017 and § 1.1502–28. See § 1.1502–19(c) for the definition of disposition.

(2) *Computation of tax liability, reduction of attributes, and computation of limits on absorption and reduction of attributes.* If a member realizes excluded COD income in the taxable year during which P disposes of S stock, the steps used to compute tax liability, to effect the reduction of attributes, and to compute the limitations on the absorption and reduction of attributes are as follows. These steps also apply to determine whether and to what extent an excess loss account must be taken into account as a result of the application of § 1.1502–19(b)(1) and (c)(1)(iii)(B).

(i) *Limitation on deductions and losses to offset income or gain.* First, the determination of the extent to which S's deductions and losses for the tax year of the disposition (and its deductions and losses carried over from prior years) may offset income and gain is made pursuant to paragraphs (b)(2) and (3) of this section.

(ii) *Tentative adjustment of stock basis.* Second, § 1.1502–32 is tentatively applied to adjust the basis of the S stock to reflect the amount of S's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of taxable income or loss for the year of the disposition (and any prior years) that is made pursuant to paragraph (b)(2) of this section, but not to reflect the realization of excluded COD income and the reduction of attributes in respect thereof.

(iii) *Tentative computation of stock gain or loss.* Third, in the case of a disposition of S stock that does not result from the application of § 1.1502–19(c)(1)(iii)(B), P's income, gain, or loss from the disposition of S stock is computed. For this purpose, the result of the computation pursuant to

paragraph (c)(2)(ii) of this section is treated as the basis of such stock.

(iv) *Tentative computation of tax imposed.* Fourth, the tax imposed by chapter 1 of the Internal Revenue Code for the year of disposition (and any prior years) is tentatively computed. For this purpose, in the case of a disposition of S stock that does not result from the application of § 1.1502–19(c)(1)(iii)(B), the tentative computation of tax imposed takes into account P's income, gain, or loss from the disposition of S stock computed pursuant to paragraph (c)(2)(iii) of this section. The tentative computation of tax imposed is made without regard to whether all or a portion of an excess loss account in a share of S stock is required to be taken into account pursuant to § 1.1502–19(b)(1) and (c)(1)(iii)(B).

(v) *Tentative reduction of attributes.* Fifth, the rules of sections 108 and 1017 and § 1.1502–28 are tentatively applied to reduce the attributes remaining after the tentative computation of tax imposed pursuant to paragraph (c)(2)(iv) of this section.

(vi) *Actual adjustment of stock basis.* Sixth, § 1.1502–32 is applied to reflect the amount of S's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of tax imposed for the year of the disposition (and any prior years) made pursuant to paragraph (c)(2)(iv) of this section, and the excluded COD income applied to reduce attributes and the attributes tentatively reduced in respect of the excluded COD income pursuant to paragraph (c)(2)(v) of this section.

(vii) *Actual computation of stock gain or loss.* Seventh, the group's actual gain or loss on the disposition of S stock (including a disposition that results from the application of § 1.1502–19(c)(1)(iii)(B)) is computed. The result of the computation pursuant to paragraph (c)(2)(vi) of this section is treated as the basis of such stock.

(viii) *Actual computation of tax imposed.* Eighth, the tax imposed by chapter 1 of the Internal Revenue Code for the year of the disposition (and any prior years) is computed. The actual tax imposed on the group for the year of the disposition is computed by applying the limitation computed pursuant to paragraph (c)(2)(i) of this section, and by including the gain or loss recognized on the disposition of S stock computed pursuant to paragraph (c)(2)(vii) of this section. However, attributes that were tentatively used in the computation of tax imposed pursuant to paragraph (c)(2)(iv) of this section and attributes that were tentatively reduced pursuant to paragraph (c)(2)(v) of this section

cannot offset any excess loss account taken into account as a result of the application of § 1.1502-19(b)(1) and (c)(1)(iii)(B).

(ix) *Actual reduction of attributes.* Ninth, the rules of sections 108 and 1017 and § 1.1502-28 are actually applied to reduce the attributes remaining after the actual computation of tax imposed pursuant to paragraph (c)(2)(viii) of this section.

(A) *S or a lower-tier corporation realizes excluded COD income.* If S or a lower-tier corporation of S realizes excluded COD income, the aggregate amount of excluded COD income that is applied to reduce attributes attributable to members other than S and any lower-tier corporation of S pursuant to this paragraph (c)(2)(ix) shall not exceed the aggregate amount of excluded COD income that was tentatively applied to reduce attributes attributable to members other than S and any lower-tier corporation of S pursuant to paragraph (c)(2)(v) of this section. The amount of the actual reduction of attributes attributable to S and any lower-tier corporation of S that may be reduced in respect of the excluded COD income of S or a lower-tier corporation of S shall not be so limited.

(B) *A member other than S or a lower-tier corporation realizes excluded COD income.* If a member other than S or a lower-tier corporation of S realizes excluded COD income, the aggregate amount of excluded COD income that is applied to reduce attributes (other than credits) attributable to S and any lower-tier corporation of S pursuant to this paragraph (c)(2)(ix) shall not exceed the aggregate amount of excluded COD income that was tentatively applied to reduce attributes (other than credits) attributable to S and any lower-tier corporation of S pursuant to paragraph (c)(2)(v) of this section. The amount of the actual reduction of attributes attributable to any member other than S and any lower-tier corporation of S that may be reduced in respect of the excluded COD income of S or a lower-tier corporation of S shall not be so limited.

(3) *Special rules.* (i) If the reduction of attributes attributable to a member is prevented as a result of a limitation described in paragraph (c)(2)(ix)(B) of this section, the excluded COD income that would have otherwise been applied to reduce such attributes is applied to reduce the remaining attributes of the same type that are available for reduction under § 1.1502-28(a)(4), on a pro rata basis, prior to reducing attributes of a different type. The reduction of such remaining attributes, however, is subject to any applicable

limitation described in paragraph (c)(2)(ix)(B) of this section.

(ii) To the extent S's deductions and losses in the year of disposition (or those of a lower-tier corporation of S) cannot offset income or gain because of the limitation under paragraph (b) of this section or this paragraph (c) and are not reduced pursuant to sections 108 and 1017 and § 1.1502-28, such items are carried to other years under the applicable provisions of the Internal Revenue Code and regulations as if they were the only items incurred by S (or a lower-tier corporation of S) in the year of disposition. For example, to the extent S incurs an operating loss in the year of disposition that is limited and is not reduced pursuant to section 108 and § 1.1502-28, the loss is treated as a separate net operating loss attributable to S arising in that year.

(4) *Definition of lower-tier corporation.* A corporation is a lower-tier corporation of S if all of its items of income, gain, deduction, and loss (including the absorption of deduction or loss and the reduction of attributes other than credits) would be fully reflected in P's basis in S's stock under § 1.1502-32.

(5) *Examples.* For purposes of the examples in this paragraph (c), unless otherwise stated, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, tax liabilities are disregarded, and no election under section 108(b)(5) is made. The principles of this paragraph (c) are illustrated by the following examples:

*Example 1. Departing member realizes excluded COD income.* (i) *Facts.* P owns all of S's stock with a \$90 basis. For Year 1, P has ordinary income of \$30, and S has an \$80 ordinary loss and \$100 of excluded COD income from the discharge of non-intercompany indebtedness. P sells the S stock for \$20 at the close of Year 1. As of the beginning of Year 2, S has Asset A with a basis of \$0 and a fair market value of \$20.

(ii) *Analysis.* The steps used to compute the tax imposed on the group, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain.* To determine the amount of the limitation under paragraph (c)(2)(i) of this section on S's loss and the effect of the absorption of S's loss on P's basis in S's stock under § 1.1502-32(b), P's gain or loss from the disposition of S's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of \$50 (P's \$30 of income minus S's \$80 loss). Thus, \$30 of S's loss is unlimited and \$50 of S's loss is limited under paragraph (c)(2)(i) of

this section. Under the principles of § 1.1502-21(b)(2)(iv), all of the consolidated net operating loss is attributable to S.

(B) *Tentative adjustment of stock basis.* Then, pursuant to paragraph (c)(2)(ii) of this section, § 1.1502-32 is tentatively applied to adjust the basis of S stock. For this purpose, however, adjustments attributable to the excluded COD income and the reduction of attributes in respect thereof are not taken into account. Under § 1.1502-32(b), the absorption of \$30 of S's loss decreases P's basis in S's stock by \$30 to \$60.

(C) *Tentative computation of stock gain or loss.* Then, P's income, gain, or loss from the sale of S stock is computed pursuant to paragraph (c)(2)(iii) of this section using the basis computed in the previous step. Thus, P is treated as recognizing a \$40 loss from the sale of S stock.

(D) *Tentative computation of tax imposed.* Pursuant to paragraph (c)(2)(iv) of this section, the tax imposed for the year of disposition is then tentatively computed, taking into account P's \$40 loss on the sale of the S stock computed pursuant to paragraph (c)(2)(iii) of this section. The group has a \$50 consolidated net operating loss for Year 1 that, under the principles of § 1.1502-21(b)(2)(iv), is wholly attributable to S and a consolidated capital loss of \$40 that, under the principles of § 1.1502-21(b)(2)(iv), is wholly attributable to P.

(E) *Tentative reduction of attributes.* Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and § 1.1502-28 are tentatively applied to reduce attributes remaining after the tentative computation of the tax imposed. Pursuant to § 1.1502-28(a)(2), the tax attributes attributable to S would first be reduced to take into account its \$100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 would be reduced by \$50, the portion of that consolidated net operating loss attributable to S under the principles of § 1.1502-21(b)(2)(iv), to \$0. Then, pursuant to § 1.1502-28(a)(4), S's remaining \$50 of excluded COD income would reduce the consolidated capital loss attributable to P of \$40 by \$40 to \$0. The remaining \$10 of excluded COD income would have no effect.

(F) *Actual adjustment of stock basis.* Pursuant to paragraph (c)(2)(vi) of this section, § 1.1502-32 is applied to reflect the amount of S's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of the tax imposed for the year of the disposition and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under § 1.1502-32(b), the absorption of \$30 of S's loss, the application of \$90 of S's excluded COD income to reduce attributes of P and S, and the reduction of the \$50 loss attributable to S in respect of the excluded COD income results in a positive adjustment of \$10 to P's basis in the S stock. P's basis in the S stock, therefore, is \$100.

(G) *Actual computation of stock gain or loss.* Pursuant to paragraph (c)(2)(vii) of this section, P's actual gain or loss on the sale of the S stock is computed using the basis

computed in the previous step. Accordingly, P recognizes an \$80 loss on the disposition of the S stock.

(H) *Actual computation of tax imposed.* Pursuant to paragraph (c)(2)(viii) of this section, the tax imposed is computed by taking into account P's \$80 loss from the sale of S stock. Before the application of § 1.1502-28, therefore, the group has a consolidated net operating loss of \$50 that is wholly attributable to S under the principles of § 1.1502-21(b)(2)(iv), and a consolidated capital loss of \$80 that is wholly attributable to P under the principles of § 1.1502-21(b)(2)(iv).

(I) *Actual reduction of attributes.* Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and § 1.1502-28 are then actually applied to reduce attributes remaining after the actual computation of the tax imposed. Pursuant to § 1.1502-28(a)(2), the tax attributes attributable to S must first be reduced to take into account its \$100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 is reduced by \$50, the portion of that consolidated net operating loss attributable to S under the principles of § 1.1502-21(b)(2)(iv), to \$0. Then, pursuant to § 1.1502-28(a)(4), S's remaining \$50 of excluded COD income reduces consolidated tax attributes. In particular, without regard to the limitation imposed by paragraph (c)(2)(ix)(A) of this section, the \$80 consolidated capital loss, which under the principles of § 1.1502-21(b)(2)(iv) is attributable to P, would be reduced by \$50 from \$80 to \$30. However, the limitation imposed by paragraph (c)(2)(ix)(A) of this section prevents the reduction of the consolidated capital loss attributable to P by more than \$40. Therefore, the consolidated capital loss attributable to P is reduced by only \$40 in respect of S's excluded COD income. The remaining \$10 of excluded COD income has no effect.

*Example 2. Member other than departing member realizes excluded COD income.* (i) *Facts.* P owns all of S1's and S2's stock. P's basis in S2's stock is \$600. For Year 1, P has ordinary income of \$30, S1 has a \$100 ordinary loss and \$100 of excluded COD income from the discharge of non-intercompany indebtedness, and S2 has \$200 of ordinary loss. P sells the S2 stock for \$600 at the close of Year 1. As of the beginning of Year 2, S1 has Asset A with a basis of \$0 and a fair market value of \$10.

(ii) *Analysis.* The steps used to compute the tax imposed on the group, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain.* To determine the amount of the limitation under paragraph (c)(2)(i) of this section on S2's loss and the effect of the absorption of S2's loss on P's basis in S2's stock under § 1.1502-32(b), P's gain or loss from the sale of S2's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of \$270 (P's \$30 of income minus S1's \$100 loss and S2's \$200 loss). Consequently, \$20 of S2's loss from Year 1 is unlimited and \$180

of S2's loss from Year 1 is limited under paragraph (c)(2)(i) of this section. Under the principles of § 1.1502-21(b)(2)(iv), \$90 of the consolidated net operating loss is attributable to S1 and \$180 of the consolidated net operating loss is attributable to S2.

(B) *Tentative adjustment of stock basis.* Then, pursuant to paragraph (c)(2)(ii) of this section, § 1.1502-32 is tentatively applied to adjust the basis of S2's stock. For this purpose, however, adjustments to the basis of S2's stock attributable to the reduction of attributes in respect of S1's excluded COD income are not taken into account. Under § 1.1502-32(b), the absorption of \$20 of S2's loss decreases P's basis in S2's stock by \$20 to \$580.

(C) *Tentative computation of stock gain or loss.* Then, P's income, gain, or loss from the disposition of S2 stock is computed pursuant to paragraph (c)(2)(iii) of this section using the basis computed in the previous step. Thus, P is treated as recognizing a \$20 gain from the sale of the S2 stock.

(D) *Tentative computation of tax imposed.* Pursuant to paragraph (c)(2)(iv) of this section, the tax imposed for the year of disposition is then tentatively computed, taking into account P's \$20 gain from the sale of S2 stock computed pursuant to paragraph (c)(2)(iii) of this section. Although S2's limited loss cannot be used to offset P's \$20 gain from the sale of S2's stock under the rules of this section, S1's loss will offset that gain. Therefore, the group is tentatively treated as having a consolidated net operating loss of \$250, \$70 of which is attributable to S1 and \$180 of which is attributable to S2 under the principles of § 1.1502-21(b)(2)(iv).

(E) *Tentative reduction of attributes.* Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and § 1.1502-28 are tentatively applied to reduce attributes remaining after the tentative computation of the tax imposed. Pursuant to § 1.1502-28(a)(2), the tax attributes attributable to S1 would first be reduced to take into account its \$100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 would be reduced by \$70, the portion of that consolidated net operating loss attributable to S1 under the principles of § 1.1502-21(b)(2)(iv), to \$0. Then, pursuant to § 1.1502-28(a)(4), S1's remaining \$30 of excluded COD income would reduce the consolidated net operating loss for Year 1 attributable to S2 of \$180 by \$30 to \$150.

(F) *Actual adjustment of stock basis.* Pursuant to paragraph (c)(2)(vi) of this section, § 1.1502-32 is applied to reflect the amount of S2's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of the tax imposed for the year of the disposition and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under § 1.1502-32(b), the absorption of \$20 of S2's loss to offset a portion of P's income and the application of \$30 of S1's excluded COD income to reduce attributes attributable to S2 results in a negative adjustment of \$50 to P's basis in the S2 stock. P's basis in the S2 stock, therefore, is \$550.

(G) *Actual computation of stock gain or loss.* Pursuant to paragraph (c)(2)(vii) of this section, P's actual gain or loss on the sale of the S2 stock is computed using the basis computed in the previous step. Therefore, P recognizes a \$50 gain on the disposition of the S2 stock.

(H) *Actual computation of tax imposed.* Pursuant to paragraph (c)(2)(viii) of this section, the tax imposed is computed by taking into account P's \$50 gain from the disposition of the S2 stock. Before the application of § 1.1502-28, therefore, the group has a consolidated net operating loss of \$220, \$40 of which is attributable to S1 and \$180 of which is attributable to S2 under the principles of § 1.1502-21(b)(2)(iv).

(I) *Actual reduction of attributes.* Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and § 1.1502-28 are then actually applied to reduce attributes remaining after the actual computation of the tax imposed. Pursuant to § 1.1502-28(a)(2), the tax attributes attributable to S1 must first be reduced to take into account its \$100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 is reduced by \$40, the portion of that consolidated net operating loss attributable to S1 under the principles of § 1.1502-21(b)(2)(iv), to \$0. Then, pursuant to § 1.1502-28(a)(4), without regard to the limitation imposed by paragraph (c)(2)(ix)(B) of this section, S1's remaining \$60 of excluded COD income would reduce S2's net operating loss of \$180 to \$120. However, the limitation imposed by paragraph (c)(2)(ix)(B) of this section prevents the reduction of S2's loss by more than \$30. Therefore, S2's loss of \$180 is reduced by \$30 to \$150 in respect of S1's excluded COD income. The remaining \$30 of excluded COD income has no effect.

*Example 3. Lower-tier corporation of departing member realizes excluded COD income.* (i) *Facts.* P owns all of S1's stock, S2's stock, and S3's stock. S1 owns all of S4's stock. P's basis in S1's stock is \$50 and S1's basis in S4's stock is \$50. For Year 1, P has \$50 of ordinary loss, S1 has \$100 of ordinary loss, S2 has \$150 of ordinary loss, S3 has \$50 of ordinary loss, and S4 has \$50 of ordinary loss and \$80 of excluded COD income from the discharge of non-intercompany indebtedness. P sells the S1 stock for \$100 at the close of Year 1. As of the beginning of Year 2, S4 has Asset A with a fair market value of \$10. After the computation of tax imposed for Year 1 and before the application of sections 108 and 1017 and § 1.1502-28, Asset A has a basis of \$0.

(ii) *Analysis.* The steps used to compute the tax imposed on the group, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain.* To determine the amount of the limitation under paragraph (c)(2)(i) of this section on S1's and S4's losses and the effect of the absorption of S1's and S4's losses on P's basis in S1's stock under § 1.1502-32(b), P's gain or loss from the sale of S1's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of \$400. Consequently,



\$100 of S1's loss and \$50 of S4's loss is limited under paragraph (c)(2)(i) of this section.

(B) *Tentative adjustment of stock basis.* Then, pursuant to paragraph (c)(2)(ii) of this section, § 1.1502–32 is tentatively applied to adjust the basis of S1's stock. For this purpose, adjustments to the basis of S1's stock attributable to S4's realization of excluded COD income and the reduction of attributes in respect of such excluded COD income are not taken into account. There is no adjustment under § 1.1502–32 to the basis of the S1 stock. Therefore, P's basis in the S1 stock for this purpose is \$50.

(C) *Tentative computation of stock gain or loss.* Then, P's income, gain, or loss from the sale of S1 stock is computed pursuant to paragraph (c)(2)(iii) of this section using the basis computed in the previous step. Thus, P is treated as recognizing a \$50 gain from the sale of the S1 stock.

(D) *Tentative computation of tax imposed.* Pursuant to paragraph (c)(2)(iv) of this section, the tax imposed for the year of disposition is then tentatively computed, taking into account P's \$50 gain from the sale of the S1 stock computed pursuant to paragraph (c)(2)(iii) of this section. Although S1's and S4's limited losses cannot be used to offset P's \$50 gain from the sale of S1's stock under the rules of this section, \$10 of P's loss, \$30 of S2's loss, and \$10 of S3's loss will offset that gain. Therefore, the group is tentatively treated as having a consolidated net operating loss of \$350, \$40 of which is attributable to P, \$100 of which is attributable to S1, \$120 of which is attributable to S2, \$40 of which is attributable to S3, and \$50 of which is attributable to S4 under the principles of § 1.1502–21(b)(2)(iv).

(E) *Tentative reduction of attributes.* Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and § 1.1502–28 are tentatively applied to reduce attributes remaining after the tentative computation of the tax imposed. Pursuant to § 1.1502–28(a)(2), the tax attributes attributable to S4 would first be reduced to take into account its \$80 of excluded COD. Accordingly, the consolidated net operating loss for Year 1 would be reduced by \$50, the portion of the consolidated net operating loss attributable to S4 under the principles of § 1.1502–21(b)(2)(iv), to \$300. Then, pursuant to § 1.1502–28(a)(4), S4's remaining \$30 of excluded COD income would reduce the consolidated net operating loss for Year 1 that is attributable to other members. Therefore, the consolidated net operating loss for Year 1 would be reduced by \$30. Of that amount, \$4 is attributable to P, \$10 is attributable to S1, \$12 is attributable to S2, and \$4 is attributable to S3.

(F) *Actual adjustment of stock basis.* Pursuant to paragraph (c)(2)(vi) of this section, § 1.1502–32 is applied to reflect the amount of S1's and S4's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of tax imposed for the year of the disposition and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income

pursuant to the previous step. Under § 1.1502–32(b), the application of \$80 of S4's excluded COD income to reduce attributes, and the reduction of S4's loss in the amount of \$50 and S1's loss in the amount of \$10 in respect of the excluded COD income results in a positive adjustment of \$20 to P's basis in the S1 stock. Accordingly, P's basis in S1 stock is \$70.

(G) *Actual computation of stock gain or loss.* Pursuant to paragraph (c)(2)(vii) of this section, P's actual gain or loss on the sale of the S1 stock is computed using the basis computed in the previous step. Accordingly, P recognizes a \$30 gain on the disposition of the S1 stock.

(H) *Actual computation of tax imposed.* Pursuant to paragraph (c)(2)(viii) of this section, the tax imposed is computed by taking into account P's \$30 gain from the sale of S1 stock. Before the application of § 1.1502–28, therefore, the group has a consolidated net operating loss of \$370, \$44 of which is attributable to P, \$100 of which is attributable to S1, \$132 of which is attributable to S2, \$44 of which is attributable to S3, and \$50 of which is attributable to S4.

(I) *Actual reduction of attributes.* Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and § 1.1502–28 are then actually applied to reduce attributes remaining after the actual computation of the tax imposed. Pursuant to § 1.1502–28(a)(2), the tax attributes attributable to S4 must first be reduced to take into account its \$80 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 is reduced by \$50, the portion of that consolidated net operating loss attributable to S4 under the principles of § 1.1502–21(b)(2)(iv), to \$320. Then, pursuant to § 1.1502–28(a)(4), without regard to the limitation imposed by paragraph (c)(2)(ix)(A) of this section, S4's remaining \$30 of excluded COD income would reduce the consolidated net operating loss for Year 1 by \$30 (\$4.12 of the consolidated net operating loss attributable to P, \$9.38 of the consolidated net operating loss attributable to S1, \$12.38 of the consolidated net operating loss attributable to S2, and \$4.12 of the consolidated net operating loss attributable to S3) to \$290. However, the limitation imposed by paragraph (c)(2)(ix)(A) of this section prevents the reduction of the consolidated net operating loss attributable to P, S2, and S3 by more than \$4, \$12, and \$4 respectively. The \$62 of excluded COD income that would have otherwise reduced the consolidated net operating loss attributable to P, S2, and S3 is applied to reduce the consolidated net operating loss attributable to S1. Therefore, S1 carries forward \$90 of loss.

*Example 4. Excess loss account taken into account.* (i) *Facts.* P is the common parent of a consolidated group. On Day 1 of Year 2, P acquired all of the stock of S1. As of the beginning of Year 2, S1 had a \$30 net operating loss carryover from Year 1, a separate return limitation year. A limitation under § 1.1502–21(c) applies to the use of that loss by the P group. For Years 1 and 2, the P group had no consolidated taxable income or loss. On Day 1 of Year 3, S1 acquired all of the stock of S2 for \$10. In Year

3, P had ordinary income of \$10, S1 had ordinary income of \$25, and S2 had an ordinary loss of \$50. In addition, in Year 3, S2 realized \$20 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S2 had no liabilities. As of the beginning of Year 4, S2 had Asset A with a fair market value of \$10. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and § 1.1502–28, Asset A has a basis of \$0. S2 had no taxable income (or loss) for Year 1 and Year 2.

(ii) *Analysis.* The steps used to compute the tax imposed on the group, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain, tentative basis adjustments, tentative computation of stock gain or loss.* Because it is not initially apparent that there has been a disposition of stock, paragraph (c)(2)(i) of this section does not limit the use of deductions to offset income or gain, no adjustments to the basis are required pursuant to paragraph (c)(2)(ii) of this section, and no stock gain or loss is computed pursuant to paragraph (c)(2)(iii) of this section or taken into account in the tentative computation of tax imposed pursuant to paragraph (c)(2)(iv) of this section.

(B) *Tentative computation of tax imposed.* Pursuant to paragraph (c)(2)(iv) of this section, the tax imposed for Year 3 is tentatively computed. For Year 3, the P group has a consolidated taxable loss of \$15, all of which is attributable to S2 under the principles of § 1.1502–21(b)(2)(iv).

(C) *Tentative reduction of attributes.* Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and § 1.1502–28 are tentatively applied to reduce attributes remaining after the tentative computation of tax imposed. Pursuant to § 1.1502–28(a)(2), the tax attributes attributable to S2 would first be reduced to take into account its \$20 of excluded COD income. Accordingly, the consolidated net operating loss for Year 3 is reduced by \$15, the portion of that consolidated net operating loss attributable to S2 under the principles of § 1.1502–21(b)(2)(iv), to \$0. The remaining \$5 of excluded COD income is not applied to reduce attributes as there are no remaining attributes that are subject to reduction.

(D) *Actual adjustment of stock basis.* Pursuant to paragraph (c)(2)(vi) of this section, § 1.1502–32 is applied to reflect the amount of S2's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of tax imposed for the year of the disposition and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under § 1.1502–32, the absorption of \$35 of S2's loss, the application of \$15 in respect of S2's excluded COD income to reduce attributes, and the reduction of \$15 in respect of the loss attributable to S2 reduced in respect of the excluded COD income results in a negative



adjustment of \$35 to the basis of the S2 stock. Therefore, S1 has an excess loss account of \$25 in the S2 stock.

(E) *Actual computation of stock gain or loss.* Pursuant to paragraph (c)(2)(vii) of this section, S1's actual gain or loss, if any, on the S2 stock is computed. Because S2 realized \$5 of excluded COD income that was not applied to reduce attributes, pursuant to § 1.1502-19(b)(1) and (c)(1)(iii)(B), S1 is attributed to take into account \$5 of its excess loss account in the S2 stock.

(F) *Actual computation of tax imposed.* Pursuant to paragraph (c)(2)(viii) of this section, the tax imposed is computed by taking into account the \$5 of the excess loss account in the S2 stock required to be taken into account. See § 1.1502-28(b)(6) (requiring an excess loss account that is required to be taken into account as a result of the application of § 1.1502-19(c)(1)(iii)(B) to be included in the group's tax return for the year that includes the date of the debt discharge). However, pursuant to paragraph (c)(2)(viii) of this section, such amount may not be offset by any of the consolidated net operating loss attributable to S2. It may, however, subject to applicable limitations, be offset by the separate net operating loss of S1 from Year 1.

(G) *Actual reduction of attributes.* Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and § 1.1502-28 are then actually applied to reduce attributes remaining after the actual computation of the tax imposed. Attributes will be actually reduced in the same way that they were tentatively reduced.

(6) *Additional rules for multiple dispositions.* [Reserved]

(7) *Effective date.* This paragraph (c) applies to dispositions of subsidiary stock that occur after March 22, 2005. Taxpayers may apply § 1.1502-11(c) of REG-167265-03 (2004-15 IRB 730) (see § 601.601(d)(2) of this chapter) in whole, but not in part, to any disposition of subsidiary stock that occurs on or before March 22, 2005, if a member of the group realized excluded COD income after August 29, 2003, in the taxable year that includes the date of the disposition of such subsidiary stock.

\* \* \* \* \*

■ **Par. 3.** Section 1.1502-13 is amended as follows:

■ 1. Three sentences are added at the end of paragraph (g)(3)(i)(A).

■ 2. Paragraph (g)(3)(ii)(B) is revised.

■ 3. Paragraph (g)(3)(ii)(C) is added.

The revision and additions read as follows:

**§ 1.1502-13 Intercompany transactions.**

\* \* \* \* \*

(g) \* \* \*

(3) \* \* \*

(i) \* \* \*

(A) \* \* \* For purposes of the preceding sentence, a reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and

1.1502-28 is not a comparable transaction. Notwithstanding paragraph (l) of this section, the preceding sentence applies to transactions or events occurring during a taxable year the original return for which is due (without regard to extensions) after March 21, 2005. For transactions or events occurring during a taxable year the original return for which is due (without regard to extensions) on or before March 21, 2005, and after March 12, 2004, see § 1.1502-13T(g)(3)(ii)(B)(3) as contained in 26 CFR part 1 revised as of April 1, 2004.

\* \* \* \* \*

(ii) \* \* \*

(B) *Timing and attributes.* For purposes of applying the matching rule and the acceleration rule—

(1) Paragraph (c)(6)(ii) of this section (limitation on treatment of intercompany income or gain as excluded from gross income) does not apply to prevent any intercompany income or gain from being excluded from gross income;

(2) Paragraph (c)(6)(i) of this section (treatment of intercompany items if corresponding items are excluded or nondeductible) will not apply to exclude any amount of income or gain attributable to a reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and § 1.1502-28; and

(3) Any gain or loss from an intercompany obligation is not subject to section 108(a), section 354 or section 1091.

(C) *Effective date.* Notwithstanding paragraph (l) of this section, paragraph (g)(3)(ii)(B) of this section applies to transactions or events occurring during a taxable year the original return for which is due (without regard to extensions) after March 12, 2004. For transactions or events occurring during a taxable year the original return for which is due (without regard to extensions) on or before March 12, 2004, see § 1.1502-13(g)(3)(ii)(B) as contained in 26 CFR part 1 revised as of April 1, 2003.

\* \* \* \* \*

**§ 1.1502-13T [Removed]**

■ **Par. 4.** Section 1.1502-13T is removed.

■ **Par. 5.** Section 1.1502-19 is amended as follows:

■ 1. Paragraph (b)(1) is revised.

■ 2. Paragraph (h)(2)(ii) is revised.

The revisions read as follows:

**§ 1.1502-19 Excess loss accounts.**

\* \* \* \* \*

(b) \* \* \*

(1) *Operating rules—(i) General rule.* Except as provided in paragraph

(b)(1)(ii) of this section, if P is treated under this section 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 paragraph (c)(1)(iii)(B) of this section, 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 § 1.1502-32(b)(3)(ii)(C)(1). 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 paragraph (b)(4) of this section, the disposition is treated as a sale or exchange for purposes of determining the character of the income or gain.

\* \* \* \* \*

(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 paragraph (c)(1)(iii)(B) of this section after August 29, 2003, 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 paragraph (c)(1)(iii)(B) of this section on or before August 29, 2003, 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.

\* \* \* \* \*

**§ 1.1502-19T [Removed]**

■ **Par. 6.** Section 1.1502-19T is removed.

■ **Par. 7.** In § 1.1502-21, paragraphs (b)(1), (b)(2)(ii)(A), (b)(2)(iv), (c)(2)(vii), and (h)(6) are revised to read as follows:

**§ 1.1502-21 Net operating losses.**

\* \* \* \* \*

(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 paragraph (c)(1)(iii) of this section, *Example 2*, for an illustration of pro rata absorption of losses subject to a SRLY limitation. See § 1.1502–21T(b)(3)(v) regarding the treatment of any loss that is treated as expired under § 1.1502–35T(f)(1).

(2) \* \* \*

(ii) *Special rules—(A) Year of departure from group.* If a corporation ceases to be a member during a consolidated return year, net operating loss carryovers attributable to the corporation are first carried to the consolidated return year, and then are subject to reduction under section 108 and § 1.1502–28 in respect of discharge of indebtedness income that is realized by a member of the group and that is excluded from gross income under section 108(a). Only the amount so attributable that is not absorbed by the group in that year or reduced under section 108 and § 1.1502–28 is carried to the corporation's first separate return year. For rules concerning a member departing a subgroup, see paragraph (c)(2)(vii) of this section.

\* \* \* \* \*

(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 rules—(i) Carryback to a separate return year.* 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 immediately after such portion of the CNOL is carried back shall be recomputed pursuant to paragraph (b)(2)(iv)(B)(2)(iv) of this section.

(ii) *Excluded discharge of indebtedness income.* If during a taxable year 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 any member pursuant to section 108 and § 1.1502–28, the percentage of the CNOL attributable to each member as of immediately after the reduction of attributes pursuant to sections 108 and 1017 and § 1.1502–28 shall be recomputed pursuant to paragraph (b)(2)(iv)(B)(2)(iv) of this section.

(iii) *Departing member.* If during a taxable year 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 consolidated return year shall be recomputed pursuant to paragraph (b)(2)(iv)(B)(2)(iv) of this section.

(iv) *Recomputed percentage.* The recomputed percentage of the CNOL attributable to each member shall equal the unabsorbed CNOL attributable to the member at the time of the recomputation divided by the sum of the unabsorbed CNOL attributable to all of the members at the time of the recomputation. For purposes of the preceding sentence, a CNOL that is reduced pursuant to section 108 and § 1.1502–28 or that is otherwise permanently disallowed or eliminated shall be treated as absorbed.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(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 paragraphs (b)(2)(ii)(A) and (b)(2)(iv) of this section.

\* \* \* \* \*

(h) \* \* \*

(6) *Certain prior periods.* Paragraphs (b)(1), (b)(2)(ii)(A), (b)(2)(iv), and (c)(2)(vii) of this section shall apply to taxable years the original return for which the due date (without regard to extensions) is after March 21, 2005. Paragraph (b)(2)(ii)(A) of this section and § 1.1502–21T(b)(1), (b)(2)(iv), and (c)(2)(vii) as contained in 26 CFR part 1 revised as of April 1, 2004, shall apply to taxable years the original return for which the due date (without regard to extensions) is on or before March 21, 2005, and after August 29, 2003. For taxable years the original return for which the due date (without regard to extensions) is on or before August 29, 2003, see paragraphs (b)(1), (b)(2)(ii)(A), (b)(2)(iv), and (c)(2)(vii) of this section and § 1.1502–21T(b)(1) as contained in 26 CFR part 1 revised as of April 1, 2003.

\* \* \* \* \*

■ **Par. 8.** Section 1.1502–21T is amended as follows:

■ 1. Paragraphs (a) through (b)(2)(v) are revised.

■ 2. Paragraphs (c)(1) through (h)(7) are revised.

The revisions read as follows:

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

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

\* \* \* \* \*

(c)(1) through (h)(7) [Reserved]. For further guidance, see § 1.1502–21(c)(1) through (h)(7).

\* \* \* \* \*

■ **Par. 9.** Section 1.1502–28 is added to read as follows:

**§ 1.1502–28 Consolidated section 108.**

(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)(A) and (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 pursuant to paragraph (a)(2) of this section (including when subsidiary stock is treated as depreciable property under section 1017(b)(3)(D) when there is an election under section 108(b)(5)).

(ii) *Consolidated tax attributes attributable to a member.* For purposes of this section, the amount of a consolidated tax attribute (e.g., a consolidated net operating loss) that is attributable to a member shall be determined pursuant to the principles of § 1.1502–21(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 § 1.1502–21(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 corporation (the lower-tier member) that is owned by another corporation (the higher-tier member) is reduced pursuant to sections 108 and 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)), and both of such corporations are members of the same consolidated group on the last day of the higher-tier member's taxable year that includes the date on which the excluded COD income is realized or the first day of the higher-tier member's taxable year that follows the taxable year that includes the date on which the excluded COD income is realized, 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 on the last day of the taxable year of the higher-tier member that includes the date on which the higher-tier member realized the 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 and shall not cause an excess loss account to be taken into account under § 1.1502–19(b)(1) and (c)(1)(iii)(B).

(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, other than consolidated tax attributes to which a SRLY limitation applies, 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 if a SRLY limitation applies to the use of such attribute. In addition, such amount shall be applied to reduce the tax attributes attributable to members that arose in a separate return year or that arose (or are treated as arising) in a separate return limitation year if no SRLY limitation applies to the use of such attribute. The reduction of each tax attribute pursuant to the three preceding sentences shall be made in the order prescribed in section 108(b)(2) and pursuant to the principles of § 1.1502–21(b)(1). Except as otherwise provided in this paragraph (a)(4), a tax attribute that arose in a separate return year or that arose (or is treated as arising) in a separate return limitation year is not subject to reduction pursuant to this paragraph (a)(4). 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 before 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. In applying the rules of paragraph (a)(2) and (3) of this section with respect to the excluded COD income of the higher-tier member, the liabilities that give rise to the excluded COD income of the other such member shall not be treated as discharged for purposes of computing the limitation on basis reduction under section 1017(b)(2). 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 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.

(iv) *Ownership of lower-tier member by multiple higher-tier members.* If stock

of a corporation is held by more than one higher-tier member of the group and more than one such higher-tier member reduces its basis in such stock, then under paragraph (a)(3) of this section the excluded COD income resulting from the stock basis reductions shall be applied on a pro rata basis (based on the amount of excluded COD income caused by each basis reduction) to reduce the attributes of the corporation.

(v) *Ownership of lower-tier member by multiple higher-tier members in multiple groups.* If a corporation is a member of one group (the first group) on the last day of the first group's higher-tier member's taxable year that includes the date on which that higher-tier member realizes excluded COD income and is a member of another group (the second group) on the following day and the first group's higher-tier member and the second group's higher-tier member both reduce their basis in the stock of such corporation pursuant to sections 108 and 1017 and this section, paragraph (a)(3) of this section shall first be applied in respect of the excluded COD income that results from the reduction of the basis of the corporation's stock owned by the first group's higher-tier member and then shall be applied in respect of the excluded COD income that results from the reduction of the basis of the corporation's stock owned by the second group's higher-tier member.

(2) *Election under section 108(b)(5)*—(i) *Availability of election.* The group may make the election described in section 108(b)(5) for any member that realizes excluded COD income. 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). See § 1.108-4 for rules relating to the procedure for making an election under section 108(b)(5).

(ii) *Treatment of shares with an excess loss account.* For purposes of applying section 108(b)(5)(B), the basis of stock of a subsidiary that has an excess loss account shall be treated as zero.

(3) *Application of section 1017*—(i) *Timing of basis reduction.* Basis of property shall be subject to reduction pursuant to the rules of sections 108 and 1017 and this section after the determination of the tax imposed by chapter 1 of the Internal Revenue Code for the taxable year during which the

member realizes excluded COD income and any prior years and coincident with the reduction of other attributes pursuant to section 108 and this section. However, only the basis of property held as of the beginning of the taxable year following the taxable year during which the excluded COD income is realized is subject to reduction pursuant to sections 108 and 1017 and this section.

(ii) *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.

(iii) *Treatment of shares with an excess loss account.* For purposes of applying section 1017(b)(2) and § 1.1017-1, the basis of stock of a subsidiary that has an excess loss account shall be treated as zero.

(4) *Application of section 1245.* Notwithstanding section 1017(d)(1)(B), a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation only to the extent that the amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced pursuant to the subsidiary's consent under section 1017(b)(3)(D) or as a result of the application of paragraph (a)(3)(ii) of this section.

(5) *Reduction of basis of intercompany obligations and former intercompany obligations*—(i) *Intercompany obligations that cease to be intercompany obligations.* If excluded COD income is realized in a consolidated return year in which an intercompany obligation becomes an obligation that is not an intercompany obligation because the debtor or the creditor becomes a nonmember or because the assets of the creditor are acquired by a nonmember in a transaction to which section 381(a) applies, the basis of such intercompany obligation is not available for reduction in respect of such excluded COD income pursuant to sections 108 and 1017 and this section. However, in such cases, the basis of the debt treated as new debt issued under § 1.1502-13(g)(3) is available for reduction in respect of such excluded COD income pursuant to sections 108 and 1017 and this section.

(ii) *Intercompany obligations.* The reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and this section

shall not result in the satisfaction and reissuance of the obligation under § 1.1502-13(g). Therefore, any income or gain (or reduction of loss or deduction) attributable to a reduction of the basis of an intercompany obligation will be taken into account when § 1.1502-13(g)(3) applies to such obligation. Furthermore, § 1.1502-13(c)(6)(i) (regarding the treatment of intercompany items if corresponding items are excluded or nondeductible) will not apply to exclude any amount of income or gain attributable to a reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and this section. See § 1.1502-13(g)(3)(i)(A) and (ii)(B)(2).

(6) *Taking into account excess loss account*—(i) *Determination of inclusion.* The determination of whether any portion of an excess loss account in a share of stock of a subsidiary that realizes excluded COD income is required to be taken into account as a result of the application of § 1.1502-19(c)(1)(iii)(B) is made after the determination of the tax imposed by chapter 1 of the Internal Revenue Code for the year during which the member realizes excluded COD income (without regard to whether any portion of an excess loss account in a share of stock of the subsidiary is required to be taken into account) and any prior years, after the reduction of tax attributes pursuant to sections 108 and 1017 and this section, and after the adjustment of the basis of the share of stock of the subsidiary pursuant to § 1.1502-32 to reflect the amount of the subsidiary's deductions and losses that are absorbed in the computation of taxable income (or loss) for the year of the disposition and any prior years, and the excluded COD income applied to reduce attributes and the attributes reduced in respect thereof. See § 1.1502-11(c) for special rules related to the computation of tax that apply when an excess loss account is required to be taken into account.

(ii) *Timing of inclusion.* To the extent an excess loss account in a share of stock of a subsidiary that realizes excluded COD income is required to be taken into account as a result of the application of § 1.1502-19(c)(1)(iii)(B), such amount shall be included on the group's tax return for the taxable year that includes the date on which the subsidiary realizes such excluded COD income.

(7) *Dispositions of stock.* See § 1.1502-11(c) for limitations on the reduction of tax attributes when a member disposes of stock of another member (including dispositions that result from the application of § 1.1502-

19(c)(1)(iii)(B)) during a taxable year in which any member realizes excluded COD income.

(8) *Departure of member.* If the taxable year of a member (the departing member) during which such member realizes excluded COD income ends on or prior to the last day of the consolidated return year and, on the first day of the taxable year of such member that follows the taxable year during which such member realizes excluded COD income, such member is not a member of the group and does not have a successor member (within the meaning of paragraph (b)(10) of this section), all tax attributes listed in section 108(b)(2) that remain after the determination of the tax imposed that belong to members of the group (including the departing member and subsidiaries of the departing member) shall be subject to reduction as provided in section 108 and the regulations promulgated thereunder (including § 1.108-7(c), if applicable) and this section.

(9) *Intragroup reorganization—(i) In general.* If the taxable year of a member during which such member realizes excluded COD income ends prior to the last day of the consolidated return year and, on the first day that follows the taxable year of such member during which such member realizes excluded COD income, such member has a successor member, for purposes of applying the rules of sections 108 and 1017 and this section, notwithstanding § 1.108-7, the successor member shall be treated as the member that realized the excluded COD income. Thus, all attributes attributable to the successor member listed in section 108(b)(2) (including attributes that were attributable to the successor member prior to the date such member became a successor member) are available for reduction under paragraph (a)(2) of this section.

(ii) *Group structure change.* If a member that realizes excluded COD income acquires the assets of the common parent of the consolidated group in a transaction to which section 381(a) applies and succeeds such common parent under the principles of § 1.1502-75(d)(2) as the common parent of the consolidated group, the member's attributes that remain after the determination of tax for the group for the consolidated return year during which the excluded COD income is realized (and any prior years) (including attributes that were attributable to the former common parent prior to the date of the transaction to which section 381(a) applies) shall be available for

reduction under paragraph (a)(2) of this section.

(10) *Definition of successor member.* A successor member means a person to which the member that realizes excluded COD income (or a successor member) transfers its assets in a transaction to which section 381(a) applies if such transferee is a member of the group immediately after the transaction.

(11) *Non-application of next day rule.* For purposes of applying the rules of sections 108 and 1017 and this section, the next day rule of § 1.1502-76(b)(1)(ii)(B) shall not apply to treat a member's excluded COD income as realized at the beginning of the day following the day on which such member's status as a member changes.

(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 and the taxable year of all consolidated groups is the calendar year. The examples are as follows:

*Example 1. (i) Facts.* P is the common parent of a consolidated group that includes subsidiary S1. P owns 80 percent of the stock of S1. In Year 1, the P group sustained a \$250 consolidated net operating loss. Under the principles of § 1.1502-21(b)(2)(iv), of that amount, \$125 was attributable to P and \$125 was attributable to S1. On Day 1 of Year 2, P acquired 100 percent of the stock of S2, and 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 § 1.1502-21(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. 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 § 1.1502-21(b)(2)(iv). As of the beginning of Year 4, S2 had Asset A with a fair market value of \$10. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and this section, Asset A had a basis of \$40 and S2 had no liabilities.

(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) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S2 under the principles of § 1.1502-21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). 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 § 1.1502-21(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 § 1.1502-21(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. 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 § 1.1502-21(b)(2)(iv). As of the beginning of Year 4, S1's sole asset was the stock of S2, and S2 had Asset A with a \$10 value. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and this section, S1 had an \$80 basis in the S2 stock, Asset A had a basis of \$0, and neither S1 nor S2 had any liabilities.

(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) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S1 under the

principles of § 1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). 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. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S2 under the principles of § 1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). 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. None of P, S1, S2, or S3 had a separate return limitation year prior to Year 1. In Year 1, the P group sustained a \$150 consolidated net operating loss. Under the principles of § 1.1502–21(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 § 1.1502–21(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. 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 § 1.1502–21(b)(2)(iv). At the beginning of Year 4, S1's only asset was the stock of S2, and S2's only asset was the stock of S3 with a value of \$10. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and this section, S1's stock of S2 had a basis of \$120 and S2's stock of S3 had a basis of \$180. In addition, none of S1, S2, and S3 had any liabilities.

(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) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S1 under the principles of § 1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). 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, 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.

(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 \$120, from \$120 to \$0.

(B) *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) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S2 under the principles of § 1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). 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, 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, 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.

(C) *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) and paragraph (a) of this section, therefore, the net operating loss and the net operating loss carryovers attributable to S3 under the principles of § 1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). 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 \$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. None of P, S1, S2, or S3 had a separate return limitation year prior to Year 1. In Year 1, the P group sustained a \$160 consolidated net operating loss. Under the principles of § 1.1502–21(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 § 1.1502–21(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. 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 § 1.1502–21(b)(2)(iv). At the beginning of Year 4, S3 had one asset with a value of \$10. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and this section, S1's basis in its S3 stock was \$60, S2's basis in its S3 stock was \$120, and S3's asset had a basis of \$200. In addition, none of S1, S2, and S3 had any liabilities.

(ii) *Analysis—(A) 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. Then, pursuant to paragraph (a)(3) of this section, the tax attributes attributable to S3 are reduced so as to reflect a reduction of S1's and S2's basis in the stock of S3. Then, paragraph (a)(4) is applied to reduce additional tax attributes.

(1) *Reduction of net operating losses generally.* Pursuant to section 108(b)(2)(A) 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 § 1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B).

(2) *Reduction of net operating losses attributable to S1.* 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, 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.

(3) *Reduction of net operating losses attributable to S2.* The consolidated net operating loss for Year 3 is also reduced by \$20, the portion of the consolidated net operating loss attributable to S2, to \$20. Then, 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, the consolidated net operating loss carryover from Year 2 is reduced by \$70, the portion of that consolidated net operating loss carryover attributable to S2, to \$0.

(4) *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.

(B) *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) and paragraph (a) of this section, therefore, the net operating loss and the net operating loss carryovers attributable to S3 under the principles of § 1.1502-21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). 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.

(C) *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.

*Example 5.* (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 and S2, and S1 owns 100 percent of the stock of S3. None of P, S1, S2, or S3 has a separate return limitation year prior to Year 1. In Year 1, the P group sustained a \$90 consolidated net operating loss. Under the principles of § 1.1502-21(b)(2)(iv), of that amount, \$10 was attributable to P, \$15 was attributable to S1, \$20 was attributable to S2, and \$45 was attributable to S3. On January 1 of Year 2, P realized \$140 of excluded COD income from the discharge of non-intercompany indebtedness. On December 31 of Year 2, S1 issued stock representing 50 percent of the vote and value of its outstanding stock to a person that was not a member of the group. As a result of the issuance of stock, S1 and S3 ceased to be members of the P group. For the consolidated return year of Year 2, the P group sustained a \$60 consolidated net operating loss, of which \$5 was attributable to S1, \$40 was attributable to S2, and \$15 was attributable to S3 under the principles of § 1.1502-21(b)(2)(iv). As of the beginning of Year 3, P's only assets were the stock of S1 and S2, S1's sole asset was the stock of S3, S2 had Asset A with a value of \$10, and S3 had Asset B with a value of \$10. After the computation of tax imposed for Year 2 and before the application of sections 108 and 1017 and this section, P had a \$80 basis in the S1 stock and a \$50 basis in the S2 stock, S1 had a \$80 basis in the S3 stock, and Asset A and B each had a basis of \$10. In addition, none of P, S1, S2, and S3 had any liabilities.

(ii) *Analysis.* Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to P must first be reduced to take into account its excluded COD income in the amount of \$140.

(A) *Reduction of net operating losses.* Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating loss and the net operating loss carryover attributable to P under the principles of § 1.1502-21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss carryover from Year 1 is reduced by \$10, the portion of that consolidated net operating loss carryover attributable to P, to \$80.

(B) *Reduction of basis.* Following the reduction of the net operating loss and the net operating loss carryover attributable to P, P reduces its basis in its assets pursuant to section 1017 and § 1.1017-1. Accordingly, P reduces its basis in the stock of S1 by \$80, from \$80 to \$0, and its basis in the stock of S2 by \$50, from \$50 to \$0.

(C) *Tiering down of stock basis reduction to S1.* Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S1 is treated as realizing \$80 of excluded COD income, despite the fact that it ceases to be a member of the group at the end of the day on December 31 of Year 2. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S1 under the principles of § 1.1502-21(b)(2)(iv) are reduced in the order prescribed by

section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 2 is reduced by \$5, the portion of the consolidated net operating loss for Year 2 attributable to S1, to \$55. Then, the consolidated net operating loss carryover from Year 1 is reduced by an additional \$15, the portion of that consolidated net operating loss carryover attributable to S1, to \$65. Following the reduction of the net operating loss and the net operating loss carryover 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 S3 by \$60, from \$80 to \$20.

(D) *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 \$50 of excluded COD income. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S2 under the principles of § 1.1502-21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 2 is reduced by an additional \$40, the portion of the consolidated net operating loss for Year 2 attributable to S2, to \$15. Then, the consolidated net operating loss carryover from Year 1 is reduced by an additional \$10, a portion of the consolidated net operating loss carryover attributable to S2, to \$55.

(E) *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 \$60 of excluded COD income (by reason of S1's reduction in its basis of its S3 stock). Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S3 under the principles of § 1.1502-21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 2 is reduced by an additional \$15, the portion of the consolidated net operating loss for Year 2 attributable to S3, to \$0. Then, the consolidated net operating loss carryover from Year 1 is reduced by an additional \$45, the portion of that consolidated net operating loss carryover attributable to S3, to \$10.

*Example 6.* (i) *Facts.* P1 is the common parent of a consolidated group that includes subsidiaries S1, S2, and S3. P1 owns 100 percent of the stock of S1 and S2. S1 owns 100 percent of the stock of S3. None of P1, S1, S2, or S3 has a separate return limitation year prior to Year 1. In Year 1, the P1 group sustained a \$120 consolidated net operating loss. Under the principles of § 1.1502-21(b)(2)(iv), of that amount, \$40 was attributable to P1, \$35 was attributable to S1, \$30 was attributable to S2, and \$15 was attributable to S3. On January 1 of Year 2, S3 realized \$65 of excluded COD income from the discharge of non-intercompany indebtedness. On June 30 of Year 2, S3 issued stock representing 80 percent of the vote and value of its outstanding stock to P2, the common parent of another group. As a result of the issuance of stock, S3 ceased to



be a member of the P1 group and became a member of the P2 group. For the consolidated return year of Year 2, the P1 group sustained a \$50 consolidated net operating loss, of which \$5 was attributable to S1, \$40 was attributable to S2, and \$5 was attributable to S3 under the principles of § 1.1502-21(b)(2)(iv). As of the beginning of its taxable year beginning on July 1 of Year 2, S3's sole asset was Asset A with a \$10 value. After the computation of tax imposed for Year 2 on the P1 group and before the application of sections 108 and 1017 and this section and the computation of tax imposed for Year 2 on the P2 group, Asset A had a basis of \$0. In addition, S3 had no liabilities. On January 1 of Year 3, P1 sold all of its stock of S1.

(ii) *Analysis*—(A) *Reduction of tax attributes attributable to debtor.* Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S3 must first be reduced to take into account its excluded COD income in the amount of \$65. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating loss and the net operating loss carryover attributable to S3 under the principles of § 1.1502-21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 2 is reduced by \$5, the portion of the consolidated net operating loss for Year 2 attributable to S3, to \$45. Then, the consolidated net operating loss carryover from Year 1 is reduced by \$15, the portion of that consolidated net operating loss carryover attributable to S3, to \$105.

(B) *Reduction of remaining consolidated tax attributes.* Pursuant to paragraphs (a)(4) and (b)(8) of this section, S3's remaining \$45 of excluded COD income reduces the remaining consolidated tax attributes in the P1 group. In particular, the remaining \$45 consolidated net operating loss for Year 2 is reduced by an additional \$45 to \$0.

(C) *Basis Adjustments.* For purposes of computing P1's gain or loss on the sale of the S1 stock in Year 3, P1's basis in its S1 stock will reflect a net positive adjustment of \$40, which is the excess of the amount of S3's excluded COD income that is applied to reduce attributes (\$65) over the reduction of S1's and S3's attributes in respect of such excluded COD income (\$25).

*Example 7.* (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 prior to Year 1. In Year 1, the P group sustained a \$50 consolidated net operating loss. Under the principles of § 1.1502-21(b)(2)(iv), of that amount, \$10 was attributable to P, \$20 was attributable to S1, and \$20 was attributable to S2. On January 1 of Year 2, S1 realized \$55 of excluded COD income from the discharge of non-intercompany indebtedness. On June 30 of Year 2, P transferred all of its assets to S1 in a transaction to which section 381(a) applied. As a result of that transaction, pursuant to § 1.1502-75(d)(2)(ii), S1 succeeded P as the common parent of the group. Pursuant to § 1.1502-75(d)(2)(iii), S1's taxable year closed on the date of the acquisition. However, P's taxable year did

not close. On the consolidated return for Year 2, the group sustained a \$50 consolidated net operating loss. Under the principles of § 1.1502-21(b)(2)(iv), of that amount, \$10 was attributable to S1 for its taxable year that ended on June 30, \$15 was attributable to S1 as the successor of P, and \$25 was attributable to S2.

(ii) *Analysis.* 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 \$55. For this purpose, S1's attributes that remain after the determination of tax for the group for Year 2 are subject to reduction. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating loss and the net operating loss carryover attributable to S1 under the principles of § 1.1502-21(b)(2)(iv) are reduced. Accordingly, the consolidated net operating loss for Year 2 is reduced by \$25, the portion of the consolidated net operating loss for Year 2 attributable to S1, to \$25. Then, the consolidated net operating loss carryover from Year 1 is reduced by \$30, the portion of that consolidated net operating loss carryover attributable to S1 (which includes the portion attributable to P), to \$20.

(d) *Effective dates.* This section applies to discharges of indebtedness that occur after March 21, 2005. Groups, however, may apply this section in whole, but not in part, to discharges of indebtedness that occur on or before March 21, 2005, and after August 29, 2003. For discharges of indebtedness occurring on or before March 21, 2005, and after August 29, 2003, with respect to which a group chooses not to apply this section, see § 1.1502-28T as contained in 26 CFR part 1 revised as of April 1, 2004. Furthermore, groups may apply paragraph (b)(4) of this section to discharges of indebtedness that occur on or before August 29, 2003, in cases in which section 1017(b)(3)(D) was applied.

#### § 1.1502-28T [Removed]

■ **Par. 10.** Section 1.1502-28T is removed.

■ **Par. 11.** Section 1.1502-32 is amended as follows:

■ 1. Paragraph (b)(1)(ii) is redesignated as paragraph (b)(1)(iii).

■ 2. New paragraph (b)(1)(ii) is added.

■ 3. Paragraphs (b)(3)(ii)(C)(1) and (b)(3)(iii)(A) are revised.

■ 4. Paragraph (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c) are revised.

■ 5. Paragraph (h)(7) is revised.

The addition and revisions read as follows:

#### § 1.1502-32 Investment adjustments.

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(ii) *Special rule for discharge of indebtedness income.* Adjustments

under this section resulting from the realization of discharge of indebtedness income of a member that is excluded from gross income under section 108(a) (excluded COD income) and from the reduction of attributes in respect thereof pursuant to sections 108 and 1017 and § 1.1502-28 (including reductions in the basis of property) when a member (the departing member) ceases to be a member of the group on or prior to the last day of the consolidated return year that includes the date the excluded COD income is realized are made immediately after the determination of tax for the group for the taxable year during which the excluded COD income is realized (and any prior years) and are effective immediately before the beginning of the taxable year of the departing member following the taxable year during which the excluded COD income is realized. Such adjustments when a corporation (the new member) is not a member of the group on the last day of the consolidated return year that includes the date the excluded COD income is realized but is a member of the group at the beginning of the following consolidated return year are also made immediately after the determination of tax for the group for the taxable year during which the excluded COD income is realized (and any prior years) and are effective immediately before the beginning of the taxable year of the new member following the taxable year during which the excluded COD income is realized. If the new member was a member of another group immediately before it became a member of the group, such adjustments are treated as occurring immediately after it ceases to be a member of the prior group.

\* \* \* \* \*

(3) \* \* \*

(ii) \* \* \*

(C) \* \* \*

(1) *In general.* Excluded COD income 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 § 1.1502-28. However, if S is treated as realizing excluded COD income pursuant to § 1.1502-28(a)(3), S shall not be treated as realizing excluded COD income for purposes of the preceding sentence.

\* \* \* \* \*

(iii) \* \* \*

(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 § 1.1502-28, 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 § 1.1502-28(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.

\* \* \* \* \*

- (5) \* \* \*  
(ii) \* \* \*

**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 § 1.1502-21(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 § 1.1502-28, the consolidated net operating loss is reduced to \$0.

(b) *Analysis.* Under paragraph (b)(3)(iii)(A) of this section, 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 § 1.1502-28. 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 § 1.1502-28, the consolidated net operating loss is reduced by \$100 to \$0 after the determination of tax for Year 1. Under

paragraph (b)(3)(iii)(A) of this section, 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 of indebtedness income excluded from gross income under section 108(a) has no effect on P's basis in S's stock.

\* \* \* \* \*

- (h) \* \* \*

(7) *Rules related to discharge of indebtedness income excluded from gross income.* Paragraphs (b)(1)(ii), (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 regard to extensions) after March 21, 2005. However, groups may apply those provisions 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 regard to extensions) on or before March 21, 2005, and after August 29, 2003.

For determinations of the basis of the stock of a subsidiary in consolidated return years the original return for which is due (without regard to extensions) on or before March 21, 2005, and after August 29, 2003, with respect to which a group chooses not to apply paragraphs (b)(1)(ii), (b)(3)(ii)(C)(1), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c) of this section, see § 1.1502-32T(b)(3)(ii)(C)(1), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c) as contained in 26 CFR part 1 revised as of April 1, 2004.

■ **Par. 12.** Section 1.1502-32T is amended as follows:

■ 1. Paragraph (a)(3) is added and paragraphs (b) through (b)(3)(iii)(B) are revised.

■ 2. Paragraphs (b)(5)(i) through (h)(5)(ii) are revised.

■ 3. Paragraph (h)(7) is revised.

The revisions read as follows:

**§ 1.1502-32T Investment adjustments (temporary).**

\* \* \* \* \*

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

\* \* \* \* \*

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

\* \* \* \* \*

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

■ **Par. 13.** In § 1.1502-76, paragraph (b)(1)(ii)(B)(3) is revised to read as follows:

**§ 1.1502-76 Taxable year of members of group.**

\* \* \* \* \*

- (b) \* \* \*

- (1) \* \* \*

- (ii) \* \* \*

- (B) \* \* \*

(3) Whether the allocation is inconsistent with other requirements under the Internal Revenue Code and regulations promulgated thereunder (e.g., if a section 338(g) election is made in connection with a group's acquisition of S, the deemed asset sale must take place before S becomes a member and S's gain or loss with respect to its assets must be taken into account by S as a nonmember (but see § 1.338-1(d)), or if S realizes discharge of indebtedness income that is excluded from gross income under section 108(a) on the day it becomes a nonmember, the discharge of indebtedness income must be treated as realized by S as a member (see § 1.1502-28(b)(11))); and

\* \* \* \* \*

■ **Par. 14.** In § 1.1502-80, the second sentence of paragraph (c) is revised to read as follows:

**§ 1.1502-80 Applicability of other provisions of law.**

\* \* \* \* \*

(c) \* \* \* See §§ 1.1502-11(d) and 1.1502-35T for additional rules relating to stock loss. \* \* \*

\* \* \* \* \*

■ **Par. 15.** In § 1.1502-80T, the third sentence of paragraph (c) is revised to read as follows:

**§ 1.1502-80T Applicability of other provisions of law (temporary).**

\* \* \* \* \*

(c) \* \* \* See §§ 1.1502-11(d) and 1.1502-35T for additional rules relating to stock loss. \* \* \*

\* \* \* \* \*

**Mark E. Matthews,**

*Deputy Commissioner for Services and Enforcement.*

Approved: March 10, 2005.

**Eric Solomon,**

*Acting Deputy Assistant Secretary of the Treasury.*

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