

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

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SUPPLEMENTARY INFORMATION:

Background

Section 61(a)(12) of the Internal Revenue Code provides that gross income includes income from the discharge of indebtedness, except as provided by law. Section 108(a) provides that gross income of a C corporation does not include any amount that would otherwise be includible in gross income by reason of the discharge, in whole or in part, of indebtedness of the taxpayer if the discharge occurs in a title 11 case (section 108(a)(1)(A)), the discharge occurs when the taxpayer is insolvent, but only to the extent of the insolvency (section 108(a)(1)(B)), or the indebtedness discharged is qualified farm indebtedness (section 108(a)(1)(C)).

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

These provisions are designed to “preserve the debtor’s ‘fresh start’ after bankruptcy.” H.R. Rep. 96-833 at 9 (1980); *see* S. Rep. No. 96-1035 at 10 (1980). In addition, they are intended to “carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt

discharge.” H.R. Rep. 96-833 at 9 (1980); *see* S. Rep. No. 96-1035 at 10 (1980). By making attributes unavailable to offset income in later years, the provisions offer the debtor a temporary, rather than a permanent, deferral of tax.

Questions have arisen regarding the application of section 108 when the taxpayer with discharge of indebtedness income that is excluded from gross income is a member of a consolidated group. In particular, questions have arisen regarding the determination of the attributes that are available for reduction in a consolidated group and the method for reducing those attributes. These regulations provide guidance regarding those questions.

Explanation of Provisions

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

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

B. Application of Section 108(b)

1. Consolidated Approach

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

The IRS and Treasury Department have rejected a separate entity approach. Such an approach would reduce only the attributes attributable to the member with excluded discharge of indebtedness income. The IRS and Treasury Department have rejected this approach because it fails to take into account the fact that consolidated

attributes that are attributable to other members will be available to offset income of the debtor member as long as the debtor is a member of the group. A separate entity approach could result in the permanent exclusion of discharge of indebtedness income when there are other attributes available to the debtor member.

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

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

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