

of that consolidated net operating loss carryover attributable to S3, to \$10. Following the reduction of the net operating loss and the net operating loss carryover attributable to S3, S3 reduces its basis in its asset pursuant to section 1017 and § 1.1017-1. Accordingly, S3 reduces its basis in its asset by \$60, from \$200 to \$140.

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

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

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

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

The revisions and additions read as follows:

§ 1.1502-32 Investment adjustments.

* * * * *

(b) * * *

(3) * * *

(ii) * * *

(C) * * *

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

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(iii) * * *

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

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(4) * * *

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

(5) * * *

(ii) * * *

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

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(h) * * *

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

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

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

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

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

■ 4. Paragraph (h)(7) is added.

The revisions and addition read as follows:

§ 1.1502-32T Investment adjustments (temporary).

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

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

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

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

prevent the disallowance from being permanent.

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

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

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

Example 4. Discharge of indebtedness. (a) *Facts.* P forms S on January 1 of Year 1 and S borrows \$200. During Year 1, S's assets decline in value and the P group has a \$100 consolidated net operating loss. Of that amount, \$10 is attributable to P and \$90 is attributable to S under the principles of § 1.1502-21T(b)(2)(iv). None of the loss is absorbed by the group in Year 1, and S is discharged from \$100 of indebtedness at the close of Year 1. P has a \$0 basis in the S stock. P and S have no attributes other than the consolidated net operating loss. Under section 108(a), S's \$100 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b) and § 1.1502-28T, the consolidated net operating loss is reduced to \$0.

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

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

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

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(h)(7) *Rules related to discharges of indebtedness excluded from gross income.* Paragraphs (b)(3)(ii)(C)(1), (b)(3)(iii)(A), and