

son B. B exchanged the X Building for the Y Building in a tax-free exchange, and then gave the Y Building to his wife C. C. in determining the gain from the sale or disposition of the Y Building in 1954, is required to reduce the basis of the building by deductions for depreciation which were successively allowed (but not less than the amount allowable) to A and B upon the X Building and to B upon the Y Building, in addition to the deductions for depreciation allowed (but not less than the amount allowable) to herself during her ownership of the Y Building.

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

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

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

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

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

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

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

(b) *Operating rules*—(1) *Prior tax-attribute reduction.* The amount of excluded COD income applied to reduce basis does not include any COD income applied to reduce tax attributes under sections 108(b)(2) (A) through (D) and, if applicable, section 108(b)(5). For example, if a taxpayer excludes \$100 of COD

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

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

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

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

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

(4) *Transactions to which section 381 applies.* If a taxpayer realizes COD income that is excluded from gross income under section 108(a) 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), the basis of property acquired by the acquiring corporation in the transaction must reflect the reductions required by section

1017 and this section. For this purpose, the basis of property of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the distribution or transfer of assets, will be available for reduction under section 108(b)(2). However, the basis of stock or securities of the acquiring corporation, if any, received by the taxpayer in exchange for the transferred assets shall not be available for reduction under section 108(b)(2). See § 1.108-7. This paragraph (b)(4) applies to discharges of indebtedness occurring on or after May 10, 2004.

(c) *Modification of ordering rules for basis reductions under sections 108(b)(5) and 108(c)*—(1) *In general.* The ordering rules prescribed in paragraph (a) of this section apply, with appropriate modifications, to basis reductions under sections 108(b)(5) and (c). Thus, a taxpayer that elects to reduce basis under section 108(b)(5) may, to the extent that the election applies, reduce only the adjusted basis of property described in paragraphs (a) (1), (2), and (3) of this section and, if an election is made under paragraph (f) of this section, paragraph (a) (4) of this section. Within paragraphs (a) (1), (2), (3) and (4) of this section, such a taxpayer may reduce only the adjusted bases of depreciable property. A taxpayer that elects to apply section 108(c) may reduce only the adjusted basis of property described in paragraphs (a) (1) and (3) of this section and, within paragraphs (a)(1) and (3) of this section, may reduce only the adjusted bases of depreciable real property. Furthermore, for basis reductions under section 108(c), a taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged qualified real property business indebtedness before reducing the adjusted bases of other depreciable real property. The term *qualifying real property* means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3). See paragraphs (f) and (g) of this section for elections relating to section 1221(1) property and partnership interests.

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

(3) *Modification of fresh start rule for prior basis reductions under section 108(b)(5).* After reducing the adjusted bases of depreciable property under section 108(b)(5), a taxpayer must compute the limitation on basis reductions under section 1017(b)(2) using the aggregate of the remaining adjusted bases of property. For example, if, immediately after the discharge of indebtedness in a title 11 case, a taxpayer's adjusted bases of property is \$100 and its undischarged indebtedness is \$70, and if the taxpayer elects to reduce the adjusted bases of depreciable property by \$10 under section 108(b)(5), section 1017(b)(2) limits any further basis reductions under section 108(b)(2)(E) to \$20 ($(\$100 - \$10) - \70).

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

(e) *Depreciable property.* For purposes of this section, the term *depreciable property* means any property of a character subject to the allowance for depreciation or amortization, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor cannot reduce the basis of

leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of such property.

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

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

(g) *Partnerships*—(1) *Partnership COD income.* For purposes of paragraph (a) of this section, a taxpayer must treat a distributive share of a partnership's COD income as attributable to a discharged indebtedness secured by the taxpayer's interest in that partnership.

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

(ii) *Request by partner and consent of partnership*—(A) *In general.* Except as otherwise provided in this paragraph (g)(2)(ii), a taxpayer may choose

whether or not to request that a partnership reduce the inside basis of its depreciable property (or depreciable real property) with respect to the taxpayer, and the partnership may grant or withhold such consent, in its sole discretion. A request by the taxpayer must be made before the due date (including extensions) for filing the taxpayer's Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

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

(C) *Granting of request required.* A partnership must consent to reduce its partners' shares of inside basis with respect to a discharged indebtedness if consent is requested with respect to that indebtedness by partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership or five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. For example, if there is a cancellation of partnership indebtedness that is secured by real property used in a partnership's trade or business, and if partners owning (in the aggregate) 90 percent of the capital and profits interests of the partnership elect to exclude the COD income under section 108(c), the partnership must make the appropriate reductions in those partners' shares of inside basis.

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

taxpayer on or before the due date of the taxpayer's return (including extensions) for the taxable year in which the taxpayer excludes COD income from gross income, a statement that—

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

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

(B) *Taxpayer's requirement.* For taxable years beginning before January 1, 2003, statements described in § 1.1017-1(g)(2)(iii)(A) must be attached to a taxpayer's timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). For taxable years beginning after December 31, 2002, taxpayers must retain the statements and keep them available for inspection in the manner required by § 1.6001-1(e), but are not required to attach the statements to their returns.

(iv) *Partner's share of partnership basis—(A) In general.* For purposes of this paragraph (g), a partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property) is equal to the sum of—

(1) The partner's section 743(b) basis adjustments to items of partnership depreciable property (or depreciable real property); and

(2) The common basis depreciation deductions (but not including remedial allocations of depreciation deductions under § 1.704-3(d)) that, under the terms of the partnership agreement effective for the taxable year in which the discharge of indebtedness occurs, are reasonably expected to be allocated to the partner over the property's remaining useful life. The assumptions made by a partnership in determining the reasonably expected allocation of depreciation deductions must be consistent for each partner. For example, a partnership may not treat the same depreciation deductions as being reasonably expected by more than one partner.

(B) *Effective date.* This paragraph (g)(2)(iv) applies to elections made

under sections 108(b)(5) and 108(c) on or after December 15, 1999.

(v) *Treatment of basis reduction—(A) Basis adjustment.* The amount of the reduction to the basis of depreciable partnership property constitutes an adjustment to the basis of partnership property with respect to the partner only. No adjustment is made to the common basis of partnership property. Thus, for purposes of income, deduction, gain, loss, and distribution, the partner will have a special basis for those partnership properties the bases of which are adjusted under section 1017 and this section.

(B) *Recovery of adjustments to basis of partnership property.* Adjustments to the basis of partnership property under this section are recovered in the manner described in § 1.743-1.

(C) *Effect of basis reduction.* Adjustments to the basis of partnership property under this section are treated in the same manner and have the same effect as an adjustment to the basis of partnership property under section 743(b). The following example illustrates this paragraph (g)(2)(v):

Example. (i) A, B, and C are equal partners in partnership PRS, which owns (among other things) Asset 1, an item of depreciable property with a basis of \$30,000. A's basis in its partnership interest is \$20,000. Under the terms of the partnership agreement, A's share of the depreciation deductions from Asset 1 over its remaining useful life will be \$10,000. Under section 1017, A requests, and PRS agrees, to decrease the basis of Asset 1 with respect to A by \$10,000.

(ii) In the year following the reduction of basis under section 1017, PRS amends its partnership agreement to provide that items of depreciation and loss from Asset 1 will be allocated equally between B and C. In that year, A's distributive share of the partnership's common basis depreciation deductions from Asset 1 is now \$0. Under § 1.743-1(j)(4)(ii)(B), the amount of the section 1017 basis adjustment that A recovers during the year is \$1,000. A will report \$1,000 of ordinary income because A's distributive share of the partnership's common basis depreciation deductions from Asset 1 (\$0) is insufficient to offset the amount of the section 1017 basis adjustment recovered by A during the year (\$1,000).

(iii) In the following year, PRS sells Asset 1 for \$15,000 and recognizes a \$12,000 loss. This loss is allocated equally between B and C, and A's share of the loss is \$0. Upon the sale of Asset 1, A recovers its entire remaining

section 1017 basis adjustment (\$9,000). A will report \$9,000 of ordinary income.

(D) *Effective date.* This paragraph (g)(2)(v) applies to elections made under sections 108(b)(5) and 108(c) on or after December 15, 1999.

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

(h) *Special allocation rule for cases to which section 1398 applies.* If a bankruptcy estate and a taxpayer to whom section 1398 applies (concerning only individuals under Chapter 7 or 11 of title 11 of the United States Code) hold property subject to basis reduction under section 108(b) (2)(E) or (5) on the first day of the taxable year following the taxable year of discharge, the bankruptcy estate must reduce all of the adjusted bases of its property before the taxpayer is required to reduce any adjusted bases of property.

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

[T.D. 8787, 63 FR 56563, Oct. 22, 1998, as amended by T.D. 8847, 64 FR 69921, Dec. 15, 1999; T.D. 9080, 68 FR 42593, July 18, 2003; T.D. 9100, 68 FR 70705, Dec. 19, 2003; T.D. 9100, 69 FR 5017, Feb. 3, 2004; T.D. 9127, 69 FR 26039, May 11, 2004; T.D. 9300, 71 FR 71042, Dec. 8, 2006]

§ 1.1019-1 Property on which lessee has made improvements.

In any case in which a lessee of real property has erected buildings or made other improvements upon the leased property and the lease is terminated by forfeiture or otherwise resulting in the realization by such lessor of income which, were it not for the provisions of section 109, would be includible in gross income of the lessor, the amount so excluded from gross income shall not be taken into account in determining the basis or the adjusted basis of such property or any portion thereof in the hands of the lessor. If, however, in any taxable year beginning before January 1, 1942, there has been included in the gross income of the lessor an amount representing any part of the value of such property attributable to such buildings or improvements, the basis of each portion of such property shall be

properly adjusted for the amount so included in gross income. For example, A leased in 1930 to B for a period of 25 years unimproved real property and in accordance with the terms of the lease B erected a building on the property. It was estimated that upon expiration of the lease the building would have a depreciated value of \$50,000, which value the lessor elected to report (beginning in 1931) as income over the term of the lease. This method of reporting was used until 1942. In 1952 B forfeits the lease. The amount of \$22,000 reported as income by A during the years 1931 to 1941, inclusive, shall be added to the basis of the property represented by the improvements in the hands of A. If in such case A did not report during the period of the lease any income attributable to the value of the building erected by the lessee and the lease was forfeited in 1940 when the building was worth \$75,000, such amount, having been included in gross income under the law applicable to that year, is added to the basis of the property represented by the improvements in the hands of A. As to treatment of such property for the purposes of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code.

§ 1.1020-1 Election as to amounts allowed in respect of depreciation, etc., before 1952.

(a) *In general.* (1) Any person may elect to have the adjustments to the cost or other basis of property under section 1016(a)(2) determined in accordance with subparagraph (B) of such section by filing a statement of election in accordance with the requirements set forth in paragraph (b) of this section. Any election made after 1952 shall be irrevocable when made. Any election made after 1952 shall apply with respect to all property held by the person making the election at any time on or before December 31, 1952, and shall apply to all periods since February 28, 1913, and before January 1, 1952, during which such person held such property or for which adjustments must be made under section 1016(b). For rules with respect to an election made on or before December 31, 1952, see paragraph (c) of this section.