

11.0 CANCELTATION OF INDEBTEDNESS INCOME

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11.1 THE TAX TREATMENT OF CANCELTATION OF INDEBTEDNESS INCOME (CODI)**11.1.1 Tax Treatment**

In general, California conforms to Internal Revenue Code (IRC) Section 108 as amended, with certain modifications. (Revenue and Taxation Code (R&TC) Section 24307)

If a debt of a solvent taxpayer is canceled, forgiven, or discharged for less than the full amount owed, the debtor generally realizes income in the amount of the debt canceled.

In the case of an S corporation, most of the Cancellation of Debt (COD) rules of IRC Section 108 are applied at the corporate level. (IRC Section 108(d)(7)(A)) Thus, CODI may be excluded from taxable income without regard to the financial condition of the corporation's shareholders.

Under IRC Section 108(d)(6), the CODI exclusion, attribute reduction rules, treatment of qualified real property business indebtedness and the special rules for discharge of qualified farm indebtedness are applied at the partner level. Therefore, insolvent S corporation partners may exclude their share of CODI in whole or in part, while insolvent partners are taxed on their allocable share of CODI unless another exclusion under IRC Section 108 applies.

CODI for noncorporate taxpayers (individuals, partnerships, and trusts) is beyond the scope of this section. Additional law, exclusions, and exceptions may apply to these types of taxpayers.

11.1.2 Exclusions

In general, CODI is taxable and includable in gross income on the tax return for the year the cancellation occurs. (IRC Section 61(a)(12)) However, gross income does not include any amount otherwise includable in gross income by reason of the discharge of debt if it meets any of the following conditions.

1. The CODI occurs in a Title 11 case (bankruptcy) without regard to whether the bankruptcy is filed under Chapter 7, Chapter 11, or Chapter 13. (IRC Section 108(a)(1)(A))
2. The CODI occurs when the taxpayer is insolvent. (IRC Section 108(a)(1)(B))
3. Cancellation of qualified farm indebtedness. (IRC Section 108(a)(1)(C))
4. The indebtedness discharged is qualified real property business indebtedness (QRPBI). This exclusion does not apply to C corporations. (IRC Section 108(a)(1)(D))

The exclusion for Title 11 cases takes precedence. Therefore, exclusions related to insolvency, qualified farm indebtedness and qualified real property business indebtedness do not apply to a discharge which occurs in a Title 11 case. (IRC Section 108(a)(2)(A))

The insolvency exclusion takes precedence over the qualified farm indebtedness and qualified real property business indebtedness. (IRC Section 108(a)(2)(B))

11.1.3 Exceptions

Amounts that meet the requirements for any of the following exceptions are not CODI.

- Amounts of canceled debt that would be deductible if the S corporation as a cash basis taxpayer paid the debt. (IRC Section 108(e)(2))
- A qualified purchase price reduction given by the seller of property to the buyer and the reduction does not occur in a Title 11 case and the buyer is not insolvent. (IRC Section 108(e)(5))

11.1.4 Tax Attributes Reduction

If a debtor excludes canceled debt from gross income, certain tax attributes must be reduced. See Section 11.6 Reduction of Tax Attributes for additional information.

11.1.5 Interest

Under certain situations, interest that has not yet been paid is cancellation of debt income along with principal that has been canceled. These situations arise when a taxpayer is on an accrual method of accounting. Under Revenue Ruling (Rev. Rul.) 67-200 and Rev. Rul. 70-406, the amount of any interest that has been accrued and deducted (but not paid) in prior years by the taxpayer is considered cancellation of debt income under IRC Section 61 and R&TC Section 17071. However, if the taxpayer can show that the prior year deduction resulted in no tax benefit, then under IRC Section 111, Treasury Regulation (Treas. Reg.)

Section 1.111-1, and R&TC Section 17131 (tax benefit rules) it will be excluded from gross income.

11.1.6 Business Debt Reacquisitions (IRC Section 108(i))

California has not updated its federal conformity statute (R&TC Section 24307) and so it does not conform to IRC Section 108(i), as added by the American Recovery and Reinvestment Act of 2009 (ARRA) (P. L. 111-5), that gives taxpayers an election to have debt discharge income from the reacquisition of an applicable debt instrument at a discount in 2009 and 2010, included in gross income ratably over five tax years beginning with discharges in tax years ending after December 31, 2008, for reacquisitions after December 31, 2008, and before January 1, 2011. (IRC Section 108(i), as amended by P.L. 111-5, Section 1231(a))

11.2 DISCHARGE THAT OCCURS IN A TITLE 11 CASE OR WHEN A TAXPAYER IS INSOLVENT

In general, Title 11 (related to bankruptcy) and insolvency are the main exceptions to the taxability of cancellation of debt income.

When CODI is excluded from gross income because of bankruptcy or insolvency, certain tax attributes must be reduced in a specific order unless an election is made to reduce the basis of depreciable property first. It is the reduction of these attributes that result in the recognition of the income at a later date, but only to the extent there are attributes to reduce. See Section 11.6 Tax Attribute Reduction for additional information.

11.2.1 Bankruptcy Code

Gross income does not include discharge of indebtedness income if the discharge occurs in a Title 11 case. (IRC Section 108(a)(1)(A)) California conforms to federal law by reference under R&TC Section 24307. Under IRC Section 108(d)(2), the term "Title 11 case" means a case under the Bankruptcy Code if: (1) the taxpayer is under the jurisdiction of the court and, (2) the discharge of indebtedness is granted by the court or pursuant to a plan approved by the court (IRC Section 108(d)(2)).

11.2.2 Insolvency

Insolvency is the excess of liabilities over the fair market value of assets. This determination is based on assets and liabilities held immediately before the discharge and may be referred to as the balance sheet insolvency test. (IRC Section 108(d)(3))

Gross income does not include amounts otherwise includible in income because of the discharge of indebtedness if the discharge occurs when the taxpayer is insolvent. IRC Section 108(a)(1)(B)

The insolvency provision does not apply to a discharge that occurs in a bankruptcy case since the bankruptcy exclusion takes precedence. (IRC Section 108(a)(2)(A))

Under IRC Section 108(a)(3), the amount excluded from gross income by reason of the insolvency cannot exceed the amount by which the taxpayer is insolvent.

The statutory language of IRC Section 108(d)(3) does not specify which assets and which liabilities are taken into consideration for determining "insolvency." Further guidance may be found in the California Code of Civil Procedure (Code Civ. Proc.) Sections 487.010(a) and 488.300.

11.2.3 Bankruptcy Exemptions

Property not within the reach of creditor claims is provided in Code Civ. Proc. Section 487.020. Except as provided elsewhere, the following property is exempt from attachment:

- All property exempt from enforcement of a money judgment.
- Compensation payable by an employer to an employee (Code Civ. Proc. Section 706.011(a)).
- All property not subject to attachment pursuant to Code Civ. Proc. Section 487.010.

11.2.4 Additional Considerations

Outside of a bankruptcy proceeding, California law does not provide taxpayers the protection offered to those who make such a filing because exempt assets may not be excluded from the taxpayer's net worth. Therefore, in making an insolvency determination where the discharge occurs outside of a bankruptcy proceeding, the auditor need only obtain the FMV of all (material) assets of the taxpayer.

In addition, where a debtor has property subject to nonrecourse debt in excess of the value of the property, the excess of the amount of the nonrecourse debt over the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, the debtor is insolvent only to the extent that the excess debt is discharged. The reason for this is that the excess nonrecourse debt that is not discharged does not affect the debtor's solvency. Thus, even though the cancelation of nonrecourse debt in excess of the value of the property is treated as taxable income, the remaining portion of the nonrecourse debt that is not canceled is not taken into account in determining solvency. (Rev. Rul. 92-53, Situation 1, 1992-2 CB 48)

Also, note that when a debtor engages in two (or more) exchanges as part of one plan for discharge of debt, for purposes of determining solvency, the debtor is treated as engaging in both exchanges simultaneously. (Rev. Rul. 92-53, Situation 3, 1992-2 CB 48) In these cases, it will be necessary to compute the taxpayer's state of solvency for each debt discharge date and then give the taxpayer the outcome that offers the most tax relief.

11.3 SPECIAL RULES FOR DISCHARGE OF QUALIFIED FARM INDEBTEDNESS

The qualified farm indebtedness exclusion applies only to the discharge of qualified farm indebtedness by a qualified person. The amount excluded from gross income cannot exceed the sum of the adjusted tax attributes of the taxpayer and the aggregate adjusted basis of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs. (IRC Section 108(a)(1)(C) and IRC Section 108(g))

As with other exceptions under IRC Section 108, the qualified farm indebtedness exception applies at the corporate level in the case of an S corporation.

The qualified farm debt exclusion applies only if the taxpayer was solvent when the debt was canceled. If the taxpayer was insolvent, then the exclusion applies only to the extent the canceled debt is more than the amount by which the taxpayer is insolvent. The adjusted basis of the qualified property and the amount of the adjusted tax attributes is determined after any reduction of tax attributes by reason of amounts excluded from gross income because of insolvency. (IRC Section 108(g)(3)(D))

11.3.1 Qualified Person

A qualified person under IRC Sections 108(g)(1) and 49(a)(1)(D)(iv) **includes**:

- Lenders who are unrelated to the debtor or to the seller of the property.
- Any federal, state, or local government or agency or instrumentality of a government.

A qualified person **does not** include:

- A related person with respect to the S corporation,
- A person from which the S corporation acquired the property (or a related person to such person), or
- A person who receives a fee with respect to the S corporation's investment in the property (or a related person to such person).

11.3.2 Qualified Farm Indebtedness

The debt is considered qualified farm indebtedness under IRC Section 108(g)(2) if:

1. Such indebtedness was incurred directly in connection with the taxpayer's trade or business of farming, and
2. 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

11.3.3 Limitation on Amount Excluded

The amount excluded from gross income cannot exceed the sum of:

1. The adjusted tax attributes of the taxpayer and
2. The aggregated adjusted basis of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs. (IRC Section 108(g)(3)(A)) Qualified property is any property which is used or is held in a trade or business or for the production of income. (IRC Section 108(g)(3)(C))

11.3.4 Adjusted Tax Attributes

Adjusted tax attributes means the sum of:

1. Any net operating loss (NOL) for the taxable year of the discharge and any NOL carryover to such taxable year.
2. Tax credits. Any carryover to or from the taxable year of the discharge. (IRC Section 108(b)(2)(B), modified by R&TC Section 24307)
3. Capital Loss Carryovers. Any capital loss for the taxable year of the discharge and any capital loss carryover to such taxable year.
4. Passive activity loss and credit carryovers. Any passive activity loss or credit carryover of the taxpayer under IRC section 469(b) from the taxable year of the discharge. (IRC Section 108(g)(3)(B))

11.3.5 Tax Credits and Adjusted Tax Attributes

When computing the S corporation's adjusted tax attributes, the S corporation must make adjustments for California tax credits for California purposes.

R&TC Section 24307(b) modifies IRC Section 108(b)(2)(B), which relates to reducing the general business tax credit, substituting the term "this part" (Part 11 of Division 2 of the California Revenue and Taxation Code), for the term "Section 38", thus providing for the reduction of credits that are applicable for California corporate franchise tax purposes.

R&TC Section 24307(e) modifies IRC Section 108(g)(3)(B) by substituting \$9 in lieu of \$3. Since S corporations are limited to 1/3 of a credit, this part is further limited to \$3. (R&TC Section 23802(a))

For federal purposes, adjusted tax attributes include foreign tax credit carryovers. There is no foreign tax credit for California corporate franchise tax purposes. R&TC Section 24307(c) acts to remove a nullity.

In the case where more than one credit is allowable, the credit is reduced on a pro rata basis. (R&TC Section 24307(d))

11.3.6 Reduction of Tax Attributes

If debt is canceled under the qualified farm debt rules, excluded debt must be used to reduce tax attributes. (If canceled debt was also excluded under the insolvency rules, first reduce tax attributes under the insolvency rules and second under the qualified farm debt rules.

(See Section 11.6 Tax Attribute Reduction for additional information.)

11.3.7 Ordering rules for basis reduction

When there is excluded farm debt, the basis of qualified property is reduced in the following order. (IRC Section 1017 (b)(4)(A)(ii))

1. Depreciable qualified property.(The S corporation can make an election on federal Form 982 to treat real property held as inventory as depreciable property.)
2. Land that is qualified property and is used or held for use in the farming business.
3. Other qualified property.

11.4 DISCHARGE OF INDEBTEDNESS INCOME FROM QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS (QRPBI) FOR TAXPAYERS OTHER THAN A C CORPORATION.

No amount is included in a solvent debtor's gross income by reason of a discharge of indebtedness of the taxpayer if the discharge is QRPBI. This exclusion applies only where the bankruptcy and insolvency exceptions do not apply. (IRC Sections 108(a)(1)(D) and IRC 108(c))

The amendments to IRC Section 108 made by Section 13150 of the Revenue Reconciliation Act of 1993 (Public Law 103-66) relating to exclusions from gross income from discharge of qualified real property business indebtedness, applies to discharges occurring on or after January 1, 1996, in taxable years beginning on or after January 1, 1996. (R&TC Section 24307(f)(1))

IRC Section 108(a)(1)(D) was added to the IRC because of the decline in real property values. In some cases, the declines in real property values were so severe that the property could no longer support the debt that it secured. Congress legislated that where there is discharge of indebtedness income resulting from a decline in the value of business real property securing that indebtedness, it is appropriate to provide for deferral, rather than current inclusion, of the resulting income. Generally, that deferral should not extend beyond the period that the taxpayer owns the property.

The amount excluded from income results in a basis reduction in the taxpayer's depreciable real property (IRC Section 108(c)(1)(A)). The basis reduction takes effect on the first day of the tax year following the tax year in which the discharge takes place (IRC Section 1017(a)). However, if the taxpayer disposes of the real property before the beginning of the

next tax year, the reduction in basis is made immediately before the disposition of the property. (IRC Section 1017 (b)(3)(F)(iii))

11.4.1 Definition of QRPBI

The term QRPBI means indebtedness which:

- Was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property, **and**
- Was incurred or assumed before January 1, 1993, or, if incurred or assumed on or after that date, is qualified acquisition indebtedness as defined below, **and**
- The taxpayer makes an election relating to the treatment of discharge of qualified real property business indebtedness. A separate election is not allowed for California. (IRC Section 108(c)(3), R&TC Section 24307(f)(2))

11.4.2 Qualified Acquisition Indebtedness

The term qualified acquisition indebtedness means with respect to real property used in a trade or business which is security for the debt, indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property. (IRC Section 108(c)(4))

11.4.3 Ordering rules

See Section 11.6 Reduction of Tax Attributes for the tax attribute ordering rules used when there is QRPBI.

Example A

Corporation M (an S corporation) purchased business property for \$550,000 and financed \$500,000 with a bank loan in taxable year ending 12/31/2015. The loan was secured by the property. Three years after the purchase, Corporation M entered into an agreement with the bank in which the bank canceled \$50,000 of the debt. Immediately before the cancellation, the loan's outstanding principal balance was \$450,000, the FMV of the property was \$420,000, and the adjusted basis of the property was \$525,000.

Corporation M elects to exclude the canceled debt from income under the QRPBI exclusion. The limitation on the excluded amount is \$30,000, which is the excess of the outstanding principal balance over the fair market value of the business property securing the debt (\$450,000-\$420,000).

The \$30,000 of canceled debt income is allowed to be excluded. Corporation M reduces the property's depreciable basis by \$30,000.

11.5 PURCHASE-MONEY DEBT REDUCTION FOR SOLVENT DEBTOR TREATED AS PRICE REDUCTION

When a debt from a buyer to a seller arises from a purchase of property and the debt is later reduced by the seller, the reduction is treated as a purchase price reduction and not as cancelation of indebtedness income. (IRC Section 108(e)(5))

If the transaction is treated as a purchase price reduction, then a corresponding reduction must be made to the basis of the property.

This follows both from legislative history, which provides that a reduction satisfying the requirements of the statute is to be treated (for both the seller and the buyer) as a purchase price adjustment on that property (H.R. Rep. No. 96-833, 96th Cong., 2nd Sess. 13 (1980)), and from case law, which regarded the debt reduction as a credit against the cost of the capital investment and imposed a corresponding basis reduction (*Hirsch v. Commissioner*, 40-2 USTC 9791, *Commissioner v. Sherman*, 43-1 USTC ¶ 9367, and *Helvering v. A.L. Killian Co.*, 42-2 USTC ¶ 9487).

11.5.1 Requirements

IRC Section 108(e)(5) sets forth the following three requirements:

1. The debt is purchase-money debt from the purchaser to the seller, and
2. The debt reduction did not arise while the debtor is bankrupt or insolvent, and
3. "But for" this statutory exception, the reduction would be treated as debt-discharge income.

A purchase price reduction under IRC Section 108(e)(5) **will not apply**:

- Where the debt is to a third-party lender (*Preslar v. Commissioner*, 83 AFTR 2d 99-851 (167 F.3d 1323), or
- Where the seller has transferred the debt to a third party, whether or not related to the seller, or
- Where the buyer has transferred the debt to a third party, whether or not related to the buyer; or
- Where the debt of the seller to the buyer is reduced by a cause not involving agreement between buyer and seller, such as expiration of the statute of limitations on the debt

In Revenue Ruling 92-99, the IRS concluded that if the principal amount of an unsecured nonrecourse debt related to the purchase of property is reduced by the third-party lender, then the debt reduction may not be treated as a purchase price adjustment under IRC Section 108(e)(5) but rather results in discharge of indebtedness income under IRC Section 61(a)(12).

The Service said that it would only treat such a debt reduction as a purchase price adjustment to the extent that it "is based on an infirmity that clearly relates back to the original sale," such as the seller's inducement of a higher price by misrepresenting a

material fact or by fraud. Purchase price adjustment treatment results in a reduction of basis rather than discharge of indebtedness income.

11.6 REDUCTION OF TAX ATTRIBUTES

11.6.1 Reduction of Tax Attributes Under the Bankruptcy, Insolvency, and Qualified Farm Indebtedness Provisions

If an S corporation excludes CODI from gross income by reason of the bankruptcy, insolvency, or qualified farm indebtedness provisions, then the amount excluded must be applied to reduce certain tax attributes as provided under IRC Section 108(b) unless the S corporation makes an election to reduce the basis of depreciable property first, as explained later. By reducing these attributes, tax on the canceled debt is in part postponed instead of being entirely forgiven.

For insolvent taxpayers that exclude or defer debt discharge income under the insolvency and the qualified farm indebtedness provisions, the attribute reduction is first applied by reducing tax attributes by that amount excluded by reason of insolvency (IRC Section 108(g)(3)(D)). Any remaining debt discharge income that qualifies for qualified farm indebtedness treatment is then limited to attributes remaining after reduction by reason of insolvency. If there is debt discharge income left, then that income is recognized under IRC Section 61(a)(12) and R&TC Sections 17071 and 24307.

11.6.2 Tax Attribute Ordering Rules

The debtor must reduce the following tax attributes in the following order except where the debtor elects to first reduce the basis of depreciable property. (IRC Section 108(b)(2) and Treas. Reg. Section 1.108-7)

1. Net operating loss (NOL). Any NOL for the taxable year of the discharge and any NOL carryover to such taxable year. (IRC Section 108(b)(2)(A)) See special rules for S corporation NOLs below.
2. General business credit. Any carryover to or from the taxable year of the discharge of an amount for purposes for determining the amount allowable as a credit. IRC Section 108(b)(2)(B), modified by R&TC Section 24307.
3. Minimum tax credits.
4. Capital loss carryovers. Any capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under IRC Section 1212. (IRC Section 108(b)(2)(D))
5. Basis reduction. Reduce the basis of any property held by the S corporation at the beginning of the taxable year following the taxable year in which the discharge occurs. (IRC Section 108(b)(2)(E) and IRC Section 1017(a)). This reduction applies to the basis of both depreciable and nondepreciable property. Special rules apply to basis reduction for qualified farm indebtedness as provided under IRC Section 1017(b)(4). See Section 11.3 Special Rules for Qualified Farm Indebtedness for

additional information. Special rules also apply to basis reductions under the bankruptcy or insolvency provisions as described further below.

6. Passive activity loss and credit carryover. Reduce the passive activity loss and credit carryovers from the tax year of the debt cancellation.
7. Foreign tax credit carryover. IRC Section 108(b)(2)(G) is not subject to attribute reduction for California income tax purposes. (R&TC Section 24307(c))

If the taxpayer reduces tax attributes in the order specified in IRC Section 108(b)(2), (that is, NOL, General Business Credit, Capital Losses, Basis reduction, etc.), and is either bankrupt or insolvent, then any basis reduction may not exceed the excess of the aggregate basis of the property held by the taxpayer immediately after the discharge, over the aggregate of the liabilities of the taxpayer immediately after the discharge. (IRC Section 1017(b)(2)) However, this basis limitation does not apply if the taxpayer elects to apply reductions first against depreciable property under IRC Section 108(b)(5), as explained further below. (IRC Section 1017(b)(2))

11.6.3 Special Rules for S Corporation NOLs

If a corporation excludes COD income from gross income under a Title 11 (bankruptcy) case, Insolvency, or the Qualified Farm Indebtedness provisions, the amount excluded is applied to first reduce the S corporation's NOL attributes. (Treas. Reg. Section 1.108-7(d)(1))

11.6.4 Computing the Deemed NOL of the S Corporation

The aggregate amount (current year losses and deductions and prior year suspended losses or deductions) of the shareholders that are disallowed for the taxable year of the discharge under Section 1366(d) (1), including disallowed losses or deductions of a shareholder that transfers all of the shareholder's stock in the S corporation during the taxable year of the discharge is treated as the net operating loss tax attribute (deemed NOL) of the S corporation for the taxable year of the discharge. (Treas. Reg. Section 1.108-7(d)(1))

$$\begin{array}{rcl}
 & \text{Shareholder current year losses and deductions} & \\
 + & \text{Shareholder suspended losses and deductions} & \\
 = & \text{Deemed NOL of the S Corporation} &
 \end{array}$$

11.6.5 Allocation of Excess Losses or Deductions

If the S corporation's deemed NOL exceeds the amount of the S corporation's COD income that is excluded from gross income under IRC Section 108(a)(1)(A)(B) or (C), the excess deemed NOL is allocated to the shareholders of the corporation as a loss or deduction that is disallowed under section 1366(d) for the taxable year of the discharge. (Treas. Reg. Section (d)(2)(i))

11.6.6 Multiple Shareholders

To determine the amount of the S corporation's excess deemed NOL to be allocated to each shareholder, each shareholder's excess amount must be calculated as provided under Treas. Reg. Section 1.108-7(d)(2)(ii). If a shareholder does not have an excess amount, none of the corporation's excess deemed NOL is allocated to that shareholder. Each shareholder that has an excess amount is allocated NOL as follows:

Step 1: Calculate **each** shareholder's excess amount

- Shareholder's losses and deductions disallowed
- The amount of COD income (before reduction of tax attributes)
- = Shareholder's excess amount (if any)

Step 2: Calculate **each** shareholder's allocated NOL amount

[Shareholder's excess amount X (Shareholder's excess amount /sum of all shareholders' excess amounts)] = NOL allocated to the shareholder

11.6.7 Terminating Shareholder

Any amount of the S corporation's excess deemed NOL allocated to a shareholder that had transferred all of their stock in the corporation during the year of the discharge is permanently disallowed under Treas. Reg. Section 1.1366-2(a)(6), unless the transfer is to a spouse or former spouse as described under IRC Section 1041(a). If the transfer of stock is described in 1041(a), the amount of the S corporation's excess deemed NOL allocated to the transferor is treated as a loss or deduction incurred by the corporation in the succeeding taxable year with respect to the transferee. (Treas. Reg. Section 1.108-7(d)(2)(iii))

11.6.8 Character of Excess Losses or Deductions Allocated to a Shareholder

The character of an S corporation's excess deemed NOL that is allocated to a shareholder consists of a proportionate amount of each item of the shareholder's loss or deduction that is disallowed for the taxable year of the discharge under IRC Section 1366(d)(1). (Treas. Reg. Section 1.108-7(d)(3))

11.6.9 Information Requirements

Each shareholder must report to the S corporation the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under IRC Section 1366(d)(1), even if that amount is zero.

If a shareholder does not report the amount of their losses and deduction that are disallowed to the S corporation, or if the S corporation knows the amount reported by the shareholder is inaccurate, or if the information as reported appears to be incomplete or incorrect, the S corporation may rely on its own books and records as well as other information available to the S corporation to determine the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge. Provided that the S corporation knows or reasonable believes that its information presents an

accurate reflection of the shareholder's disallowed losses and deductions under IRC Section 1366(d)(1).

The S corporation must report to each shareholder the amount of the S corporation's excess deemed NOL that is allocated to that shareholder, even if that amount is zero.

Example A - Allocation of Deemed NOL to Shareholders

During taxable year 12/15, XYZ an S Corporation has two 50% shareholders, A and B with \$0 stock and debt basis. XYZ has \$56,000 of excluded COD income. The COD income had it not been excluded would have been allocated \$28,000 to A and \$28,000 to B. XYZ has \$30,000 in losses and deductions that pass through to the shareholders, but the shareholders' losses are disallowed since their basis is \$0. A and B have suspended losses carried over from prior tax years.

XYZ's total current year (deemed) NOL is \$91,000.

	Shareholder A	Shareholder B	Totals
Current year losses	\$15,000	\$15,000	\$30,000
Suspended losses c/o	\$1,000	\$60,000	\$61,000
Total	\$16,000	\$75,000	\$91,000
Allocation			
Deemed NOL	\$91,000		
- COD income	\$56,000		
= Deemed excess NOL	\$35,000		

XYZ has a \$35,000 excess NOL to allocate to shareholders.

None of the \$35,000 excess deemed NOL is allocated to A because A's losses and deductions (\$16,000) immediately prior to the COD reduction do not exceed A's share of the excluded COD income (\$23,000).

B's share of losses and deductions (\$75,000) immediately prior to the COD income reduction exceeds B's share of the excluded COD income (\$23,000). B's excess amount is \$52,000 (\$75,000 - \$23,000).

XYZ will allocate \$35,000 of the deemed NOL to B.

The total of all shareholder's excess amounts is \$52,000. Therefore, XYZ will allocate \$35,000 of the \$35,000 excess deemed NOL to B (\$35,000 X \$52,000/\$52,000/\$52,000 = \$35,000). This amount is treated as a loss or deduction disallowed under IRC section 1366(d)(1) for the taxable year of the discharge. At the beginning of 2016 A does not have any loss carryovers and B has \$35,000 of loss carryover.

See Treas. Reg. Section 1.108-7(e) for additional examples.

11.6.10 General Rules for Basis Reductions That are Required by the Bankruptcy or Insolvency Provisions When CODI is Excluded From Gross Income (Treas. Reg. Section 1.1017-1(a))

A taxpayer must reduce in the following order, to the extent of the excluded CODI (but not below zero) the adjusted basis of property held on the first day of the taxable year following the taxable year that the taxpayer excluded CODI.

1. Real property used in a trade or business or held for investment, other than real property described in IRC Section 1221(a)(1), which 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(a)(1);
4. Inventory, accounts receivable, notes receivable, and real property described in IRC Section 1221(a)(1); and
5. Property not used in a trade or business nor held for investment

Limitation on basis reductions under IRC Section (b)(2)(E) in bankruptcy or insolvency. (Treas. Reg. Section 1.1017-1(b)(3))

If CODI arises from a discharge of indebtedness in a bankruptcy proceeding or while the taxpayer is insolvent, the amount of any basis reduction may not exceed the excess of:

The aggregate of the adjusted basis of property and the amount of money held by the taxpayer immediately after the discharge; over the aggregate of the liabilities of the taxpayer immediately after the discharge.

**11.6.11 Modification of Ordering Rules for Basis Reductions Under IRC Section 108(b)(5) (election to reduce depreciable property first)
Election to Apply Basis Reductions First Against Depreciable Property**

The taxpayer may elect to apply basis reductions first against depreciable property under IRC Sections 108(b)(5) and 1017(b)(3)(E) in order to preserve current year tax deductions or credits. This election limits the amount of depreciable basis that may be reduced in lieu of or prior to reducing other tax attributes.

Depreciable property (as defined in IRC Section 1017(b)(3)(B)) basis reduction may not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs. (IRC Section 108(b)(5)(B)). Other tax attributes are not reduced when this election applies. See Section 11.7 Reporting and Election Requirements for information on filing an election.

11.6.12 Basis Reductions Under QRPBI (IRC Section 108(c))

A taxpayer that elects to apply IRC Section 108(c) may reduce only the adjusted basis of depreciable real property. In addition, the adjusted basis of the qualifying real property must first be reduced by to the extent of the discharged QRPBI before reducing the adjusted basis of other depreciable real property.

The IRC does not provide guidance in either IRC Section 108 or IRC Section 1017 on whether the taxpayer is required to re-compute the rate of depreciation over the remaining life of the asset subsequent to basis reduction. Without a specific requirement, it is reasonable to expect taxpayers to continue depreciating affected assets at the depreciation rate scheduled when the asset was originally acquired. If the depreciation rate is not adjusted, a taxpayer will completely eliminate the depreciable basis sooner than if the rate was re-computed. In either case, the gain recognized would be dependent on the adjusted basis of the property that is reduced as depreciation expense is used to offset income.

However, legislative history suggests the collection of tax on ordinary debt discharge income deferred pursuant to IRC Section 108 should occur within a reasonable amount of time. FTB could argue legislative intent requires the rate of depreciation on depreciable property be re-computed to accommodate the reduction of depreciable basis.

Example B - Basis reduction for real property

XYZ Corporation (XYZ) is an S corporation that files on a calendar year basis. It is in financial difficulty, but it has been able to avoid declaring bankruptcy. In 2015, XYZ Corporation reached an agreement with its creditors, whereby the creditors agreed to forgive \$10,000 of debt, in return for setting up a repayment schedule for the remainder of the term of the loan.

Before the debt cancellation, XYZ's liabilities totaled \$120,000, the FMV of its assets was \$100,000 and its basis in the assets was \$90,000. Therefore, XYZ Corporation was insolvent by \$20,000. XYZ may exclude from income the entire \$10,000 debt cancellation since it is not more than the amount by which it was insolvent.

XYZ's only depreciable asset is a rental condominium with an adjusted basis of \$50,000. Of this, \$10,000 is allocated to the land, leaving a depreciable basis of \$40,000.

In 2015, XYZ had a net capital loss of \$5,000 on the sale of stock and it also had a net operating loss carryover from tax year 12/14 of \$3,000. The corporation does not have tax credits from current or prior tax years.

XYZ's income without considering the discharge of debt income, the capital loss, or the net operating loss carryover, is \$20,000.

In applying the \$10,000 debt discharge amount to reduce tax attributes, XYZ would first eliminate the \$5,000 current year capital loss and then the \$3,000 net operating loss carryover from 12/14. XYZ would then have \$2,000 remaining to apply to basis reduction, but it would not have to reduce basis because total basis in the assets (\$90,000) was less

than total liabilities, immediately after the debt cancellation (\$120,000-\$10,000=\$110,000).

XYZ decides it is better to preserve the \$3,000 current year NOL carryover, \$3,000 net capital loss, plus the \$2,000 capital loss carryover to the following year. Therefore, XYZ makes an election to reduce basis first.

The result of the election is that XYZ can reduce the depreciable basis of the rental condominium (its only depreciable asset) by \$10,000. This results in a decrease to XYZ's depreciation deductions for years following the year of the debt cancellation. However, if XYZ later sells the condominium at a gain, the part of the gain attributable to the basis reduction will be taxable as ordinary income.

11.6.13 Other Rules

Tax attributes are reduced after taxable income is determined for the year the discharge occurred without regard to the reduction of tax attributes. (IRC Section 108(b)(4)(A))

Noncredit tax attributes are reduced on a dollar for dollar basis. (IRC Section 108(b)(3)(A)) Thus, one dollar of NOL is reduced for every dollar of debt discharge income deferred. Current year NOLs and capital losses are reduced prior to reducing carryover amounts in the order in which the carryover amounts arose. (IRC Section 108(b)(4)(B))

Tax credit attributes are reduced at a rate of 33 1/3 cents and 11.1 cents per debt discharge income dollar deferred for Federal and State income tax purposes, respectively (IRC Section 108(b)(3)(B), R&TC Section 17144(c) and R&TC Section 24307(d)). In addition, credits are reduced in the order in which they would be applied against taxable income (IRC Section 108(b)(4)(C)). For California income tax purposes, if more than one credit is available, all credits are reduced on a pro rata basis. (R&TC Sections 17144(c) and 24307(d))

11.6.14 Recapture

When debt discharged amounts are excluded from a debtor's income, any gain upon a debtor's subsequent disposition of reduced basis property is subject to recapture as ordinary income.

IRC Section 1017(d) provides recapture rules for property whose basis is reduced under IRC Section 1017. The recapture rule is that, for purposes of IRC Section 1245 (certain depreciable property) and IRC Section 1250 (certain real property) any reduction in basis is treated as a deduction allowed for depreciation, and property that is not IRC Section 1245 or IRC Section 1250 property is treated as IRC Section 1245 property.

The effect of IRC 1017(d) is that where any depreciable or nondepreciable property whose basis was reduced under 1017(d) is disposed of in a transaction that would trigger recapture, any portion of the gain realized attributable to the basis reduction is ordinary income.

In determining the amount of recapture under IRC Section 1250 any such basis reduction is treated as a deduction allowed for depreciation and the determination of what would have been the depreciation adjustment under the straight line method is made as if there had been no such reduction. Thus, the amount of the basis reduction that is recaptured as ordinary income is reduced over the time which the taxpayer continues to hold the property since the taxpayer foregoes depreciation deductions due to the basis reduction. The computation of the amount of straight line depreciation for IRC Section 1250 property whose basis has been reduced under the tax attributes reduction rules is determined as if there has been no reduction of basis under IRC Section 1017 due to the discharge of indebtedness. (IRC Section 1017(d)(2)).

Example C - Property Treated as Section 1245 Property

MMM Corporation (MMM) is an S corporation that files on a calendar year basis. MMM owns stock with a basis of \$500. The stock's basis was reduced to \$200 under IRC Section 108(b)(2)(E) in taxable year ending 12/31/15. The stock is treated as Section 1245 property under IRC Section 1017(d). The \$300 stock basis reduction is treated as a deduction for depreciation. In taxable year ending 12/31/16, XYZ sells the stock for \$600 resulting in a gain of \$400. Since the stock's basis was reduced by \$300 under 1017(d), \$300 of the gain is recaptured as ordinary income under IRC Section 1017(d) and \$100 is capital gain.

Example D - IRC Section 1250 Property and Recapture

BBB Corporation (BBB) is an S corporation that files on a calendar year basis. BBB holds rental commercial real estate (IRC Section 1250 property) that was acquired on 1/1/2012 for \$41,000 of which \$2,000 is allocated to land. The \$39,000 building is depreciated using the straight line method using a period of 39 years and thus, is depreciated at a rate of \$1,000 per year.

On 12/31/14, the basis in the building is \$36,000. (Prior and current year depreciation deductions total \$3,000.)

On 1/1/15, the building's cost basis is reduced by \$10,000 under IRC Section 108(b)(2)(E). BBB's depreciation deduction for taxable year ending 12/15 is \$744 computed under the straight line method.

$((\$39,000 - \$10,000 = \$29,000) / 39 \text{ years} = \$744)$.

On 1/1/17, BBB sells the property for \$40,000. Under the special rule, depreciation recapture is determined as if the basis reduction had not been made.

Selling price	\$40,000	\$40,000
Basis	\$29,000	\$39,000
Depreciation allowed	\$3,744	\$4,000
Adjusted basis	\$25,256	\$35,000
Total gain	\$14,744	\$4,000

The taxpayer has a total gain of \$14,474 of which \$4,000 is considered ordinary income recapture.

11.7 REPORTING AND ELECTION REQUIREMENTS

If canceled debt is excluded from income under IRC Section 108(a), the S corporation must file Federal Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to report the amount qualifying for the exclusion and any corresponding reduction of tax attributes with their federal tax return. A copy should be attached to the California S corporation return. See the form instructions for additional information.

The election to reduce the basis of depreciable property under IRC Section 108(b)(5) and basis reductions for qualified real property business indebtedness (QRPBI) under IRC Section 108(c) must be made on a timely filed return (including extensions) and can be revoked only with the consent of the IRS as provided under IRC Section 108(d)(9). If the return was timely filed without making either of the elections, an amended return can be filed within 6 months of the due date of the return (including extensions).

If the taxpayer makes an election under IRC Section 108(c) for federal income tax purposes, a separate election is not allowed for California and if the taxpayer does not make an election for federal income tax purposes, then the taxpayer may not make an election for California purposes.

11.8 EFFECT OF EXCLUDED CODI ON SHAREHOLDER BASIS IN THE S CORPORATION

- Discharge of Indebtedness Occurring after October 11, 2001.

Congress passed a provision that reversed the U.S. Supreme court's decision in *Gitlitz v. Commissioner*, 2001-1 USTC 50, 147 and revised IRC Section 108. If an S corporation has discharge of indebtedness income that is excluded from income it is not taken into account as an item of income by the shareholder and thus, does not increase the basis of the shareholders stock in the S corporation.

CA conformed to the federal change by way of AB 1122. The effective date of the state's conformity is for discharges of indebtedness occurring after December 31, 2001, in taxable years ending after that date.

- Discharge of Indebtedness Occurring on or before December 31, 2001

The U.S. Supreme Court, reversing the 10th Circuit Court of Appeals, held in *Gitlitz v. Commissioner*, 2001-1 USTC 50, 147 that the S corporation's excluded discharge of debt is an item of income that passes through to the shareholders pursuant to IRC Section 1366(a)(1)(A).

The CODI increases the shareholder's stock basis before the tax attributes reduction takes place pursuant to IRC Section 108(b)(4)(A).

Previously, the Franchise Tax Board (FTB) took a position consistent with the 10th Circuit Court of Appeals in *Gitlitz*, which held that the S corporation's CODI does not pass through to the shareholder and does not increase the shareholder's basis. FTB has revised our position to conform to the U.S. Supreme Court decision to allow the S corporation to pass the CODI to the shareholder and increase the shareholder's basis. The basis increase takes place at the time of the discharge (the year in which the CODI is incurred) and before the tax attributes reduction (the year following the discharge).

Treas. Reg. Section 1.1366-1(a)(2)(viii) was amended to specifically state that the CODI is not tax-exempt income. The U.S. Supreme Court decision in *Gitlitz* held that S corporation CODI is an item of income for pass through purposes per IRC Section 1366. Treas. Reg. Section 1.1366-1(a)(2)(viii) no longer has a bearing on the CODI issue.

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