Foreclosure ATG - Chapter 4 - Tax Attribute Reduction

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Reduction of Tax Attributes

When cancellation of debt income is excluded from income under IRC §108(a)(1), tax attributes are generally reduced (but not below zero) by the amount of cancellation of debt income excluded. The reduction in tax attributes defers the tax treatment rather than eliminate CODI. The taxpayer files Form 982 to report the exclusion of CODI and the reduction of tax attributes. If the excluded CODI exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income (Treas. Reg. §1.108-7(a)(2)) as illustrated in Example 22. Each exclusion has its own tax attribute reduction rules that are discussed in this section.

IRC §108(b) prescribes how and in what order tax attributes must be reduced, for the bankruptcy, insolvency, and farm exclusions. The farm indebtedness exclusion requires two calculations to determine the amount to reduce tax attributes. Once specific rules of the qualified real property business exclusions are applied, basis will be reduced in accordance with IRC §108(c) and IRC §1017. See Table 3, Tax Attribute Reduction Rules, discussed later.

IRC §108(b) does not apply to the qualified principal residence exclusion. The qualified principal residence exclusion only requires a reduction in basis (but not below zero) of the principal residence when the taxpayer continues to own the property after debt is canceled (e.g. loan modification) as prescribed in IRC §108(h). See Table 3, Tax Attribute Reduction Rules, discussed later.

Any assets disposed of during the taxable year when debt is discharged are not subject to basis reduction under IRC §108(b)(2)(E), with the exception of the qualified real property business indebtedness exclusion, discussed later. If the sale of an asset gives rise to an unused ordinary or capital loss (e.g., it creates or adds to a net operating or capital loss), that loss is subject to reduction under IRC §108(b)(2)(A) for net operating loss or IRC §108(b)(2)(D) for capital loss carryover.

The basis reductions under IRC §108(b)(2)(E) are accomplished under ordering rules set forth in Treas. Regs. §1.1017-1(a) for bankruptcy and insolvency exclusions. Again, the other exclusions have different basis reduction rules. The ordering rules require a reduction (but not below zero) in the following order, to the extent of excluded cancellation of debt income. The reduction to bases of property is made on the first day of the following year that the taxpayer excluded CODI from gross income (in proportion to adjusted basis):

- Real property used in a trade or business or held for investment (other than IRC§1221(a)(1) real property, held for sale to customers in the ordinary course of business) that secured the discharged indebtedness immediately before the discharge;
- Personal property used in a trade or business or held for investment, but not inventory, accounts receivable, or notes receivable, that secured the indebtedness immediately before the discharge;
- Remaining property used in a trade or business or held for investment, but not inventory, accounts receivable, notes receivable, or IRC §1221(a)(1) real property, held for sale to customers in the ordinary course of business;
- Inventory, accounts receivable, notes receivable, and IRC §1221(a)(1) real property, held for sale to customers in the ordinary course of business; and
- Property not used in a trade or business nor held for investment.
- Reductions in basis on account of the exclusion from gross income of discharge of indebtedness income are not treated as dispositions of the property (IRC §1017(c)(2)).

Election to Reduce Basis First

In lieu of following the tax attribute reduction ordering rules in IRC §108(b), a taxpayer may make an election under IRC §108(b)(5) to reduce the basis in depreciable property first, before reducing other tax attributes. The taxpayer may elect to apply any amount of the CODI excluded from income to reduce basis. The election to reduce basis first may be made for all exclusions except for the qualified real property business exclusion and the qualified principal residence exclusion. The taxpayer makes an election by attaching Form 982 to their tax return in the year of discharge and completing Part II, line 5. Depreciable property can both be trade or business or held for investment (rental). It can also be real or personal property. The key is that it must be depreciable.

IRC §1017 describes how basis of depreciable property should be reduced. Any excess CODI after basis is reduced is applied in the order or manner prescribed for the specific exclusion, as applicable, and then IRC §108(b). The basis reduction is limited to the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year of discharged debt.

Election to Treat Certain Inventory as Depreciable Property

As discussed earlier, the basis reductions under IRC §108(b)(2)(E) are accomplished under ordering rules set forth in Treas. Reg. §1.1017-1(a) for bankruptcy and insolvency exclusions. The bases of the fourth type of property reduced are inventory, accounts receivable, notes receivable, and IRC §1221(a)(1) real property, held for sale to customers in the ordinary course of business. IRC §1017(b)(3)(E) allows a taxpayer to make an election to treat certain inventory as depreciable property, which includes real property described in IRC §1221(a)(1). The election is made on Form 982, line 3. The election may be revoked only with the consent of the Secretary. The election is not available for the qualified real property business exclusion. Application of this election is not discussed in this guide.

Depreciation Recapture Reductions

There is no depreciation recapture for IRC §1250 property for which ACRS or MACRS depreciation deductions are computed using the straight-line method under IRC §1017(d). Depreciation taken in excess of straight line depreciation must be recaptured as ordinary income.

Property that is neither IRC §1245 or IRC §1250 property is treated as IRC §1245 property.

Any tax attribute, basis reduction for property treated as section 1245 property is treated as if the reduction was from depreciation under IRC §1017(d)(1)(B).

IRC §1245 property is defined as any property which is or has been property of a character subject to the allowance for depreciation provided in IRC §167 and is either personal property, other property, real property, single purpose agricultural or horticultural structure, storage facility, or any railroad grading or tunnel bore.

IRC §1250 property is defined as any real property other than §1245 property which is or has been property subject to the allowance for depreciation provided in IRC §167, for example, rental property. Under a special rule for IRC §1250 property, when determining whether there is excess depreciation for IRC §1250 depreciation recapture, basis reductions under IRC §1017 are ignored (IRC §1017(d)(2)). In other words, excess depreciation is determined without consideration of IRC §1017 basis reduction.

Summary of Tax Attribute Reduction Rules

Table 3 is a summary of the primary and secondary Internal Revenue Code sections applicable for each exclusion's tax attribute reduction rules. Although, a Form 982 should be attached to a timely filed return to report the type of exclusion(s) and amount of CODI excluded from income, the qualified real property business exclusion is the only exclusion that is an election where a Form 982 is required. Under IRC §108, a taxpayer may make certain elections where a Form 982 or a statement is required to be attached to a timely filed return. For example, a Form 982 is required to make the election to reduce basis first and to make the election to treat certain inventory as depreciable property.

Exclusion	Primary Attribute Reduction Rules	Secondary Attribute Reduction Rules	Form 982 Required?
Bankruptcy	IRC §108(b)	IRC §108(d)(8) IRC §1017(b)(2)	No
Insolvency	IRC §108(b)	IRC §1017(b)(2)	No
Farming	IRC §108(g) – First, determine limitations & excludable amount	IRC §108(b) IRC §1017(b)(4) only basis of qualified property is reduced	No
Real Property Business	IRC §108(c)(2) – First, determine limitations & excludable amount	IRC §108(c) basis of depreciable real property IRC §1017(b)(3)	Yes
Principal Residence	IRC §108(h)(1)	none	No
Bankruptcy, Insolvency, & Farming	IRC §108(b)(5) & IRC §1017(a) Election to first reduce depreciable property held at the beginning of the following year of discharge	IRC §108(b)	Yes
All exclusions except, Real Property Business and Principal Residence	IRC §1017(b)(3)(E) Election to treat certain inventory as depreciable property	IRC §108(b)	Yes

Table 3. Tax Attribute Reduction Rules

Failure to attach a Form 982 to a tax return for the bankruptcy, insolvency, farm, and principal residence exclusions does not prevent a taxpayer from excluding cancellation of debt income from gross income. As such, a taxpayer can present documentary evidence for consideration during an examination. An examiner should gather all necessary documents and develop relevant facts to determine whether a taxpayer meets the exclusion(s).

Keep in mind that a taxpayer may qualify for more than one exclusion at one time. If that is the case, the exclusion that has precedence is applied first thus, multiple attribute reduction rules may apply. See Examples 24 and 25.

As stated earlier, IRC §108(b) prescribes the type and order of tax attributes that should be reduced at the beginning of the following year of discharge. Certain tax attributes are reduced dollar for dollar and other tax attributes are reduced by 33 1/3 cents per dollar. As shown in Table 4, *Order and Timing of Tax Attributes* , within the order of reduction, most attributes that exist after the computation of taxable income for the year of discharge are reduced. Other attributes that exist in the beginning of the following year of discharge are reduced.

IRC §108(b)(4) prescribes the ordering rules for tax attributes. IRC §108(b)(4)(B) and (C) prescribe the order of carryovers. Losses in the year of discharge are reduced first and then any carryovers into the year of discharge are reduced. See Table 4, *Order and Timing of Tax Attributes*.

Order Reduced – IRC§ 108(b):	Year Reduced
NOL – current & carryovers	Year of discharge, then oldest year
General business credits	Year of discharge, then oldest year
Minimum tax credit	Following taxable year of discharge
Capital loss carryovers	Year of discharge, then oldest year
Basis in property	Following year of discharge
Passive activity loss & credits	Year of discharge
Foreign tax credit	Year of discharge, then oldest year

Table 4. Order and Timing of Tax Attributes

Explanation of Table 4, Order and Timing of Tax Attributes:

Reductions in tax attributes are made after the determination of tax for the year of discharge. Losses and credits that exist after the determination of tax are reduced first. Carryovers to or from the year of discharge that were not applied in the determination of tax are then reduced. Bases in property that are held on the first day of the taxable year following the year that CODI is excluded are reduced.

For example, a calendar year taxpayer was discharged of debt in year 2 and tax attributes listed in Table 4 existed on January 1st of year 3. On January 1st year 3, the taxpayer would first reduce year 2 net operating loss and then the net operating loss carryover from year 1. See Chapter 4, Example 21.

Bankruptcy, Insolvency, and Farm – Attributes Reduction

Under IRC §108(b)(4)(A), tax attributes are reduced after the determination of tax for the year of discharge. As discussed earlier and in Table 4, *Order and Timing of Tax Attributes*. IRC §108(b) describes the type and order of attribute reduction for the bankruptcy, insolvency, and qualified farm indebtedness exclusions. The farm indebtedness exclusion requires two calculations to determine the amount to reduce tax attributes.

Any reduction of basis arising from the income exclusion under IRC §108(a)(1)(A) in a bankruptcy proceeding must be applied to property other than property that is exempt property for purposes of the bankruptcy proceeding (IRC §1017(c)(1)).

Any basis reduction under IRC §108(b)(2)(E) for the bankruptcy or insolvency exclusion is limited, as demonstrated in Example 20.

Tax attributes are reduced in the following order in accordance with IRC §108(b):

- Net operating loss (NOL) is reduced by one dollar for each dollar of excluded canceled debt. First, reduce any current year NOL and then reduce any NOL carryover to the current year in the order of the tax years from which the carryovers arose, starting with the earliest year.

- General business credit. Any carryover to or from the taxable year of discharge. A carryover is reduced by 33 1/3 cents for each dollar of excluded canceled debt. For more information on the credit ordering rules, refer to the instructions for Form 3800, General Business Credit.
- Minimum tax credit available under IRC §53(b) is reduced by 33 1/3 cents for each dollar of excluded canceled debt as the beginning of the taxable year immediately following the taxable year of discharge.
- Net capital loss is reduced by one dollar for each dollar of excluded canceled debt. First, reduce any current year net capital loss and then any capital loss carryover.
- Basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year of the discharge.
- Passive activity loss and credit carryovers under IRC §469(b) from the taxable year of the discharge. Credit carryovers are reduced by 33 1/3 cents for each dollar of excluded canceled debt.
- Foreign tax credit carryovers. Any carryover to or from the taxable year of the discharge for the purposes of determining the amount of the credit allowable under IRC §27. Carryovers are reduced by 33 1/3 cents for each dollar of excluded canceled debt.

Under IRC §108(d)(8), a taxpayer who is discharged of debt in a Chapter 7 or 11 (e.g., bankruptcy) of title 11 of the United States Code to which IRC §1398, Rules relating to individuals' title 11 cases, applies, the estate and not the individual is treated as the taxpayer for discharged debt. Tax attribute reduction is therefore made by the estate and not the individual, except for property that the estate transfers to the individual. If basis reduction is required when the discharge occurs in the final year of a bankruptcy estate, the reduction is made in the basis of assets transferred to the debtor from the estate at the time the property is transferred. No tax affect exists if a bankrupt taxpayer does not have any attributes to reduce at the beginning of the year following the discharge.

Bankruptcy Attribute Reduction Examples

Example 18 (Part II of Chapter 3, Example 5). Tara owed several creditors and was no longer able to meet her financial obligations. As a result, she filed for Chapter 7 bankruptcy and was granted a discharge of $174,678 of her debt in 2012. Tara excluded the $174,678 from taxable income on her 2012 Form 1040 return and attached Form 982 to report the exclusion.

On Form 982 Part II, Tara elected to first reduce basis in depreciable property held on January 1, 2013 by $160,000, under IRC §108(b)(5). The only depreciable property owned was a residential rental property held for investment. The adjusted basis after the discharge of debt on January 2, 2013, was zero ($160,000 rental property adjusted basis on December 31, 2012 minus $160,000 basis reduction on January 1, 2013).

CODI of $174,678 minus the basis reduction of $160,000 equals the remaining amount of tax attributes that must be reduced by $14,678.

The taxpayer elected to reduce basis first, therefore, the next step is to reduce tax attributes in order under IRC §108(b)(2). The tax attributes on January 1, 2013, included a 2012 Net operating loss (NOL) for $3,000 and a 2012 General business credit carryover for $58,200.
Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount that each tax attribute is reduced. For example, the NOL is reduced to the extent to which the amount excluded from income does not reduce basis, and so on. Under IRC §108(b)(1), the amount excluded from gross income shall be applied to reduce tax attributes.

Description	Attribute Reduction	CODI
Remaining CODI 174,678 *less* 160,000 *equals*		14,678
Minus 2012 NOL	3,000	
CODI Balance		11,678

Minus2012 General business credit carryover	11,678	
CODI Balance		0

Tax Attributes Reduction on January 1, 2013

As shown in the table above, tax attributes are reduced by the amount of cancellation of debt income excluded from gross income. The reduction to the net operating loss is dollar for dollar and the reduction to the general business credit carryover is computed as $11,678 multiplied by .3333 equals $3,892.

Tax attribute balances on January 2, 2013, for the 2012 net operating loss was zero ($3,000 minus $3,000) and the 2012 general business credit carryover was $54,308 ($58,200 less $3,892). Tara had no other tax attributes subject to reduction under IRC §108(b). Therefore, further attribute reduction is not required. The 2012 Form 982 is completed as shown in the following table.

Line Number	Form Line Description	Mark or Amount
Line 1a	Discharge of debt in a title 11 case	Mark an X
Line 2	Total amount of discharged debt excluded from gross income	$174,678
Line 5	Election to reduce basis first	$160,000
Line 6	Net operating loss	$3,000
Line 12	2012 General business credit carryover	$3,892

2012 Form 982 Parts I and II

Example 19. Gary was granted a discharge of $123,100 debt in bankruptcy court for tax year ending December 31, 2012. Taxable income was $45,000 before the use of a 2011 net operating loss carryover of $109,969. Gary qualifies to exclude CODI under IRC §108(a)(1)(A), bankruptcy, and does not elect to reduce basis first. Additional facts are shown below. Under IRC §108(b)(4)(A), taxable income must first be determined to identify the amount and type of attribute to reduce. The 2012 taxable income was zero ($45,000 taxable income before 2011 NOL carryover minus $45,000 net operating loss deduction).

Tax attributes that existed on January 1, 2013, were the net operating loss carryover of $64,969 ($109,969 minus $45,000), 2012 general business credit of $26,624, and a 2012 capital loss of $31,507.

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced. Under IRC §108(b)(1) the amount excluded from gross income shall be applied to reduce tax attributes.

Description	Tax Attribute	CODI
CODI excluded from income		$123,100
Minus NOL	64,969	
CODI Balance		$58,131
Minus 2012 Gen. Bus. Credit	26,624	
CODI Balance		$31,507
Minus 2012 Capital Loss	31,507	

CODI Balance		$0

IRC §108(b) - Tax Attribute Reduction on January 1, 2013

The tax attribute balances on January 2, 2013, for the 2012 NOL carryover was zero ($64,969 minus $64,969), the 2012 general business credit was $17,750 ($26,624 multiplied by .3333 minus $26,624), and the 2012 capital loss was zero ($31,507 minus $31,507).
IRC §108(b)(4) prescribes the ordering rules for tax attributes. IRC §§108(b)(4)(B) and (C) prescribe the order of carryovers. Tax attributes in the year of discharge are reduced first and then any carryovers into the year of discharge are reduced. See Table 4, *Order and Timing of Tax Attributes*.

Insolvency Attribute Reduction Examples

Example 20 (Part II of Chapter 3, Example 6). Ashley was unable to pay her recourse mortgage for her second home after her divorce. She entered into a deed in lieu of foreclosure agreement with the lender on October 1, 2012, and was simultaneously forgiven of the outstanding debt. The bank subsequently issued a Form 1099-C for $50,000 discharged debt. Ashley was insolvent by $30,260 ($756,589 total liabilities, includes mortgage of second home, minus $726,329 total assets,(includes FMV of second home)). The cancellation of debt income reported in gross income was $19,740 ($50,000 debt forgiven minus $30,260 insolvent amount).

On January 1, 2013, Ashley prepared the following worksheet to figure her tax attribute reduction. Tax attributes are reduced (but not below zero) by the amount of CODI excluded from income. Keep in mind that Ashley no longer owned her home as of October 1, 2012.

On October 2, 2012, the bases reduction is limited to $43,411 ($590,000 aggregate of bases of the property held by the taxpayer immediately after the discharge (excludes second home) minus $546,589 aggregate of the liabilities immediately after the discharge (excludes second home)) under IRC §108(b)(2)(E) and IRC §1017(b)(2).

The tax attributes that existed on January 1, 2013, was a 2012 capital loss of $2,000, basis in property owned (includes purchases of assets) described in Treas. Reg. Treas. Reg. §1.1017-1(a) of $610,000, and a 2012 passive activity loss of $19,000.

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced. Under IRC §108(b)(1) the amount excluded from gross income shall be applied to reduce tax attributes.

Description	Tax Attribute	CODI
CODI excluded from income		30,260
Less 2012 Capital loss	2,000	
CODI Balance		28,260
Less Bases in Treas. Reg. §1.1017-1(a) property	28,260	
CODI Balance		0

Tax Attribute Reduction on January 1, 2013

Ashley reported $19,740 of the CODI as other income on her 2012 Form 1040 and excluded $30,260 from gross income under IRC §108(a)(1)(B), the insolvency exclusion. She attached Form 982 to her return. Form 982 would be completed with a check mark on Form 982 line 1b (insolvency), $30,260 on line 2

(CODI excluded from income), $2,000 on line 9 (2012 capital loss), and $28,260 on line 10a (basis in depreciable and nondepreciable property).

Tax attributes balances on January 2, 2013 included the basis in Treas. Reg. §1.1017-1(a) property of $581,740 (610,000 minus $28,260), a 2012 PAL carryover of $19,000, and a zero balance of the 2012 capital loss ($2,000 minus $2,000).

Example 21. Constance was unable to make her mortgage payments on her second home and entered into a short sale agreement with the lender. The property was sold on August 5, 2012 and the lender forgave the remaining outstanding debt of $112,753. Constance excluded cancellation of debt income under the insolvency exclusion.

Additional facts include:

- Insolvent immediately before the discharge by $120,000
- 2012 Net operating loss of $63,820
- 2012 Capital loss of $3,312
- 2011 Capital loss carryover of $2,970
- Bases in property of $885,963
- Basis limitation-IRC §1017(b) of $10,000
- 2012 Passive activity loss of $97,963

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced. Under IRC §108(b)(1) the amount excluded from gross income shall be applied to reduce tax attributes.

Description	**Tax Attribute**	**CODI**
CODI excluded from gross income		$112,753
Minus 2012 Net operating loss	63,820	
CODI balance		48,933
Minus 2012 Capital loss	3,312	
CODI balance		45,621
Minus 2011 Capital loss carryover (unused in 2012)	2,970	
CODI balance		42,651
Minus Basis limitation-IRC §1017(b)	10,000	
CODI balance		32,651
Minus 2012 PAL	32,651	
CODI balance		$ 0

Tax Attribute Reduction on January 1, 2013

Constance would complete Form 982 as a check mark on line 1b Insolvency, line 2, CODI excluded of $112,753, line 6, NOL of $63,820, line 9, capital loss of $6,282 (3,312 *plus* 2,970), line 10a, basis of $10,000, and line 12, 2012 PAL of $32,651.

The tax attribute balances as of January 2, 2013, included bases in property of $875,963 ($885,963 minus $10,000), a 2012 PAL carryover of $65,312 ($97,963 minus $32,651), a 2012 NOL of zero (63,820 less 63,820), and a 2012 capital loss carryover of zero (6,282 *less* 6,282).

Other Considerations for Bankrupt or Insolvent Taxpayers
What happens if a taxpayer is bankrupt or insolvent and does not have any tax attributes to reduce other than personal-use property? If a taxpayer does not have any tax attributes as previously discussed, the basis in personal-use property held at the beginning of the year following the discharge is reduced. Personal-use property would be property not used in a trade or business nor held for investment such as a personal residence, home furnishings, car, etc.

Basis reduction limitations prescribed in IRC §1017(b)(2) and Treas. Reg. §1.1017-1(b)(3) apply to bankrupt or insolvent taxpayers. The total basis reduction for all personal-use property is limited to one criterion described under step 1 below. Once the basis limitation is determined, the basis in each personal-use property is reduced in proportion to the total adjusted basis of the personal-use property, described in step 2.

Step 1 is the basis reduction limitation which is the smallest of the bases of personal-use property held at the beginning of the following year of discharge or the amount of canceled non-business debt (other than qualified principal residence indebtedness) that is excluded from income on Form 982 line 2 or the excess of the total bases of the property and the amount of money held immediately after the cancellation over total liabilities immediately after the cancellation.
Step 2 is the amount from step 1 multiplied by the basis of personal-use property **divided by** the adjusted basis of all personal-use property equals the amount of basis reduction for the respective property. See Example 22 for further clarification.
Example 22. Ayden's second home was foreclosed and the lender forgave $105,000 of the debt after the sale. She is insolvent by $90,000 and she did not have any tax attributes other than basis in personal-use property.

Facts developed during the examination revealed that the bases of personal-use property held at the beginning of the year following discharge was $330,000, the amount of canceled non-business debt (other than qualified principal residence indebtedness) that is excluded from income on Form 982 line 2 was $90,000, and the excess of the total bases of the property and the amount of money held immediately after the cancellation over total liabilities immediately after the cancellation was $10,000.

Ayden reduced basis in personal-use property by $10,000, which is the smallest of the three amounts. In addition, Form 982 is completed with a check box on line 1b (insolvency), $90,000 on line 2 (amount of discharged debt), and $10,000 on line 10a (basis reduction of nondepreciable and depreciable property). The basis reduction limited to $10,000.

Basis in personal-use property follows:
- Principal residence $300,000
- Furniture $13,300
- Automobile $15,200
- Jewelry $1,500
- Total property bases $330,000

The basis in each personal property is reduced in proportion to the total adjusted basis as shown in the following table:

Description	Allocation	Total
Principal Residence	10,000 *multiply by* (300,000 *divided by* 330,000) *equals*	9,091
Furniture	10,000 *multiply by* (13,300 *divided by* 330,000) *equals*	403
Auto	10,000 *multiply by* (15,200 *divided by* 330,000) *equals*	461

Jewelry	10,000 *multiply by* (1,500 *divided by* 330,000) *equals*	45
Total		10,000

Basis Reduction Calculation

The basis in each personal property before and after the bases reduction is shown in the following table:

Description	Adjusted Basis Before Reduction	Adjusted Basis After Reduction
Principal Residence	$300,000	$290,909
Furniture	$13,300	$12,897
Auto	$15,200	$14,739
Jewelry	$1,500	$1,455
Totals	$330,000	$320,000

Adjusted Bases Balances after Reduction

In summary, Ayden would report $15,000 as other income on Form 1040 line 21. She excludes $90,000 from gross income. The exclusion is reported on Form 982 as a check mark on line 1b (extent of insolvency), line 2 (excluded CODI) of $90,000, and line 10a (nondepreciable property) of $10,000.
In this example, CODI exceeds the sum of the tax attributes that are required to be reduced by $80,000 (90,000 *less* 10,000). Per Treas. Reg. §1.108-7(a)(2), no further tax attribute reduction is required and Ayden is not required to include any of the $90,000 in income.

Qualified Farm Indebtedness – Basis Attribute Reduction

As discussed earlier, tax attributes under the qualified farm indebtedness exclusion are reduced in the same manner as the bankruptcy and insolvency exclusions under IRC §108(b), except for basis. Only basis of qualified property is reduced under this exclusion. Qualified farm property is defined in IRC §108(g)(3)(C) as any property used or held for use in a trade or business or for the production of income.

IRC §108(b) provides the order in which the taxpayer must reduce tax attributes when qualified farm indebtedness is excluded from income. IRC §1017(b)(4)(A)(i) provides that only qualified property held by the taxpayer is eligible for basis reduction due to the discharge of qualified farm indebtedness. IRC §1017(b)(4)(A)(ii) further provides that the basis of qualified property must be reduced in the following order:

1. Depreciable qualified property.
2. Land used or held for use in the trade or business of farming.
3. Other qualified property.

Example 23 (Part II of Example 10). An overview of the facts from Example 10 is:

- Chuck did not file for bankruptcy and he is solvent.
- $455,000 discharged debt related to Chuck's farming business
- $425,433 CODI limitation
- $29,567 CODI reported in farming gross income
- Tax attributes on January 1, 2013--2012 NOL of $75,433.
- Chuck did not elect to treat real property held primarily for sale to customers as depreciable property.
- The basis of qualified property is reduced in the following order Depreciable qualified property of $200,000
- Qualified land of $135,000
- Other qualified property $15,000

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced. Under IRC §108(b)(1) the amount excluded from gross income shall be applied to reduce tax attributes.

Description	Tax Attribute	CODI
CODI excluded from gross income		$425,433
2012 NOL	75,433	
CODI balance		350,000
Minus depreciable qualified property	200,000	
CODI balance		150,000
Minus qualified land	135,000	
CODI balance		15,000
Minus other qualified property	15,000	
CODI balance		$ 0

Attribute Reduction on January 1, 2013

All tax attributes had a zero balance on January 2, 2013, after the tax attributes were reduced. The 2012 NOL carryover was zero ($75,433 minus $75,433), the depreciable qualified property adjusted basis was zero ($200,000 minus $200,000), the qualified land adjusted basis was zero ($135,000 minus $135,000), and the other qualified property adjusted basis was zero ($15,000 minus $15,000).

Qualified Real Property Business Indebtedness – Attributes Reduction

As discussed earlier, an eligible taxpayer can make an election to exclude cancellation of debt income under the qualified real property business indebtedness exclusion in IRC §108(a)(1)(D). Under IRC §108(c)(1) the amount of CODI excluded under this exclusion is applied to reduce the basis of the depreciable real property of the taxpayer. The term qualifying real property means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of IRC §108(c)(3).

In applying basis reduction for the qualified real property business indebtedness exclusion, IRC §1017(b)(3)(F) is relied upon and basis reduction must first be made **to the property securing the debt** that is canceled. Treas. Reg. §1.1017-1(c)(1)). Furthermore, if the property is sold/foreclosed in the same year as the debt cancellation, IRC §1017(b)(3)(F) requires that the **basis reduction be made immediately before the disposition**. This will result in section 1250 recapture as ordinary income upon the deemed sale of the property. IRC §1017(b)(3)(F)(iii)).

Bottom line, if a taxpayer is able to exclude CODI under the qualified real property business indebtedness exclusion in IRC §108(a)(1)(D), the taxpayer must first reduce the basis of the property securing the debt that is discharged. By reducing the adjusted basis of the property, the realized gain from the foreclosure or short sale would be increased (or the loss reduced). The amount of COD income excluded and the section 1250 recapture amount would cancel one another. Thus, the immediate recapture will negate any tax benefit from the CODI exclusion under IRC §108(a)(1)(D).

Recapture Reductions

- IRC §1245 property is defined as any property which is or has been property of a character subject to the allowance for depreciation provided in IRC §167 and is either personal property, other property, real property, single purpose agricultural or horticultural structure, storage facility, or any railroad grading or tunnel bore. Refer to IRC §1245 for more details.
- IRC §1250 property is defined as any real property other than IRC §1245 property which is or has been property subject to the allowance for depreciation provided in IRC §167, for example, rental real estate property.
- Property that is neither IRC §1245 or IRC §1250 property is treated as IRC §1245 property (IRC §1017(d)(1)(A)).
- Any basis reduction as a result of excluding CODI from gross income is treated as depreciation for IRC §1245 and IRC §1250 property (IRC §1017(d)(1)(B)).

- Depreciation taken in excess of straight line depreciation is recaptured. Under a special rule for IRC §1250 property, when determining whether there is excess depreciation for IRC §1250 depreciation recapture, basis reductions under IRC §1017 are ignored (IRC §1017(d)(2)).

Example 24. Michael owns depreciable real estate property used for his retail business. His adjusted basis in the property is $200,000 (includes bases reductions) before the discharge of debt. The outstanding recourse loan balance is $180,000. Michael had no other debt secured by this depreciable real property. The retail business incurred a net operating loss of $18,000 in 2012.

During 2012, Michael lost major customers due to the economy's downturn and he was unable to make the monthly mortgage payments and had to close the store. This was Michael's only business and means of earning a living. The lender foreclosed on the property in 2012 and sold it for $150,000. The lender issued Michael a Form 1099-C for canceled debt of $30,000.

Immediately before the cancellation, Michael was insolvent to the extent of $13,000. He can exclude $13,000 of the canceled debt from income under the insolvency exclusion. Because of that exclusion, he reduced his NOL by $13,000.

Michael can elect to exclude the remaining $17,000 (30,000 minus 13,000) of canceled debt from income under the qualified real property business indebtedness provision. The amount he can exclude is subject to both of the following limitations.

The first step is to determine the debt in excess of value. The maximum amount of CODI that can be excluded from gross income is $30,000 ($180,000 outstanding principal loan amount immediately before discharge minus$150,000 fair market value of property minus zero, the outstanding principal amount of any other qualified real property business debt secured by the property immediately before discharge.

The overall limitation equals $200,000. The excluded debt shall not exceed the aggregate adjusted bases of depreciable real property held immediately before the discharge, (excluding depreciable real property acquired in contemplation of the discharge) reduced by the sum of certain bases reductions.

In this example, the aggregate adjusted bases of depreciable real property held before the discharge is $200,000 (includes bases reductions).

Since both limitation amounts ($30,000 and $200,000) are more than the remaining $17,000 of canceled debt, Michael can also exclude the $17,000 from income. Michael's tax attribute balances are the NOL carryover to 2013 of $5,000 ($18,000 minus $13,000 insolvency exclusion) and the adjusted basis of the retail business property of $183,000 ($200,000 adjusted basis immediately before the disposition minus $17,000 IRC §1017(b)(3)(F) qualified real property business exclusion).

Michael checks the boxes on lines 1b and 1d of Form 982 and enters $30,000 on line 2. He completes Part II of Form 982 to reduce his basis of depreciable real property by entering $17,000 on line 4 and entering $13,000 for the 2012 NOL on line 6. None of the $30,000 canceled debt is included in his income. The disposition of the business retail store building is reported on Form 4797 as shown in the following table.

Description	**Amount**
FMV of the property	150,000
Add any proceeds received from the foreclosure	0
Minus adjusted basis of the property reduced *before* the disposition IRC §1017(b)(3)(F)(iii)	183,000
Equals the loss from the foreclosure	33,000

Form 4797

Example 25 (Part II with facts modified from Example 11). Peter bought a grocery store in 2005 that he operated as his sole proprietorship. Peter made a $25,000 down payment and financed the remaining $250,000 of the purchase price with a recourse bank loan. Peter had no other debt secured by that depreciable real property, but he owned depreciable equipment and furniture with an adjusted basis of $76,000. Peter's tax attributes included the basis of depreciable property, a net operating loss, and a capital loss.

In 2012, Peter was approved for a loan modification with the lender and $25,000 of the outstanding balance of the debt was canceled. Peter qualifies to exclude CODI under IRC §108.

Other facts, immediately before the cancellation of debt include the following:

- Peter was not bankrupt, but he was insolvent to the extent of $15,000.
- Outstanding principal balance on the grocery store loan was $195,000.
- FMV of the store was $170,000.
- Adjusted basis of the store was $225,926
- The bank sent Peter a 2012 Form 1099-C showing canceled debt of $25,000.

Peter must apply the insolvency exclusion before applying the qualified real property business indebtedness exclusion. Peter can exclude $15,000 of the canceled debt from income under the insolvency exclusion. Peter elects to reduce his basis of depreciable property before reducing other tax attributes. The attribute reductions follow.

On January 1, 2013, the bases reduction shall 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. Peter was insolvent by $15,000 which is less than the basis limitation of $301,926 ($225,926 store plus $61,000 equipment plus $15,000 furniture).

Under the election to reduce depreciable property first in IRC §108(b)(5) and Treas. Reg. §1.1017-1(c), property that secured that discharged debt is reduced first. After the basis reduction, Peter's adjusted basis in the store property is $210,926 ($225,926 adjusted basis of store minus $15,000 insolvent amount). Peter now looks to the limitations under the qualified real property business indebtedness exclusion for the remaining CODI of $10,000 (25,000 *less* 15,000) as follows:

The first step is to determine the debt in excess of value. The maximum CODI amount that can be excluded from gross income equals $25,000 ($195,000 grocery store's outstanding principal loan amount, immediately before discharge minus $170,000 fair market value of property less $0 the outstanding principal amount of any other qualified real property business debt secured by the property).

The second step is to determine the overall limitation. The excluded debt shall not exceed the aggregate adjusted bases of all depreciable real property held before the discharge, (excluding depreciable real property acquired in contemplation of the discharge) reduced by the sum of certain basis reductions. The overall limitation is $210,926 ($225,926 aggregate adjusted bases (already reduced by 2012 depreciation) of depreciable realproperty held before the discharge minus $15,000 basis reduction made under the insolvency exclusion (IRC §108(b) plus zero basis reduction made under the qualified farm exclusion (IRC §108(g)).

Peter's exclusion is also limited to the overall limitation of $210,926, the total adjusted basis (determined after reduction for the canceled debt excluded under the insolvency exclusion) of his depreciable real property, he held immediately before the cancellation of debt.

Since both of these limits exceed the $10,000 of the remaining canceled debt ($25,000 minus $15,000), Peter can exclude $10,000, under the qualified real property business indebtedness exclusion.

In summary, Peter can exclude the entire $25,000 of canceled debt, $15,000 under the insolvency exclusion and $10,000 under the qualified real property business indebtedness exclusion.

Peter would complete Form 982 with a check mark on lines 1b and 1d (insolvency & qualified real property business indebtedness exclusions, respectively), $25,000 on line 2 (total excluded from gross income), $10,000 on line 4 (amount of qualified real property business basis reduction) and $15,000 on line 5 (election to reduce basis first).

Qualified Principal Residence Indebtedness - Attribute Reduction

IRC Section §108(h)(1) provides that the amount of qualified principal residence indebtedness excluded will be applied to reduce (but not below zero) the basis of the taxpayer's principal residence. Furthermore, IRC §108(h)(1) only requires that the basis of the home be reduced under the qualified principal residence exclusion in the year that debt is discharged. Thus, if the taxpayer enters into a loan modification, the basis of the home is reduced in the same year that debt is forgiven. When the taxpayer ultimately sells the residence, the lowered adjusted basis will be used to compute the gain or loss.

Alternatively, if the home is foreclosed, the taxpayer is not required to reduce the basis of the home, because it is no longer owned and no other tax attributes (e.g. NOL, general business credit, etc.) are reduced. In this situation, any debt forgiven is generally after the repossession and sale of the property.

Example 26. Walter received a loan modification for his principal residence and the bank discharged $52,435 of the debt. The entire nonrecourse debt balance before and after the discharge is qualified principal residence indebtedness. IRC §108(h)(1) states that the basis in the principal residence is reduced by the same amount of debt that is discharged. Walter excludes the entire $52,435 from income and files Form 982 along with his return. He checks line 1e, enters $52,435 on line 2, and enters $52,435 on line 10b (reduce the basis of his principal residence). Three years later Walter sells his home for $600,000. He purchased his home for $580,250. His adjusted basis is $527,815 ($580,250 minus $52,435). Walter's gain on the sale is $72,185 ($600,000 minus $527,815) reported on Schedule D, but is excluded from gross income under IRC §121.

Example 27. Aaron's principal residence was foreclosed and the lender forgave $100,000 of the debt after the foreclosure sale. The entire recourse loan was qualified principal residence indebtedness. Aaron excludes the entire $100,000 from income and files Form 982 along with the return, checks line 1e, and enters $100,000 on line 2. Aaron does not enter any amount on line 10b (reduce basis of principle residence) because the residence is no longer owned. Furthermore, the taxpayer is not required to reduce the basis in any other assets owned.

Example 28. Betty purchased her principal residence in 2004 for $625,000 through a primary nonrecourse mortgage loan of $525,000 and a subordinate recourse loan for $100,000. During 2009 through 2012, she faced financial difficulties and ultimately entered into a short sale agreement with the lenders. On August 20, 2011, the subordinate lender forgave Betty $100,000. The house eventually sold for $500,000 on April 15, 2012.

Betty reported the canceled debt on her 2011 Form 982 with a check mark on line 1e, discharge of qualified principal residence indebtedness, $100,000 on line 2, amount of discharged debt excluded from gross income and $100,000 on line 10b, reduce basis in principal residence.

The adjusted basis of the principal residence on August 21, 2011 was $525,000 ($625,000 cost minus $100,000 basis reduction). The gain or loss on the short sale of the principal residence reported on the 2012 tax return Schedule D was zero ($525,000 outstanding nonrecourse loan balance minus $525,000 adjusted basis).

Example 29. Barton received a loan modification in 2013 for his principal residence. The loan qualifies as principal residence indebtedness in IRC §108(h)(2). The lender forgave Barton $90,000 of the principal recourse loan balance of $378,569. Barton plans to convert the property to a rental in 2014 and does not want to reduce the basis of his principal residence by the entire $90,000. Therefore, he elects to apply the insolvency exclusion in lieu of the principal residence exclusion under IRC §108(a)(2)(C). Barton is insolvent by $50,790 ($900,000 liabilities immediately before the discharge of debt minus $849,210 FMV of assets immediately before the discharge of debt). The only tax attribute was a 2013 NOL of $60,000. **Note:** The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced under IRC §108(b).

Description	Tax Attribute	CODI
CODI excluded from gross income		50,790
Minus 2013 NOL	50,790	
CODI balance		0

Tax Attribute Reduction Calculation on January 1, 2014

Barton is allowed to exclude $50,790 from gross income to the extent of insolvency. However, he is required to include $39,210 ($90,000 debt forgiven minus $50,790 extent of insolvency) in gross income. The taxpayer is not required to reduce the basis in his principal residence by electing the insolvency exclusion in lieu of the qualified principal residence exclusion. Only the 2013 NOL carryover is reduced to $9,210 ($60,000 NOL minus $50,790 tax attribute reduction).

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