Internal Revenue Code Section 1017(b)(3)(E)
Discharge of indebtedness

(a) General rule.
If-
    (1) an amount is excluded from gross income under subsection (a) of section 108 (relating to discharge of indebtedness), and
    (2) under subsection (b)(2)(E), (b)(5), or (c)(1) of section 108, any portion of such amount is to be applied to reduce basis,
then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.

(b) Amount and properties determined under regulations.
    (1) In general.
The amount of reduction to be applied under subsection (a) (not in excess of the portion referred to in subsection (a)), and the particular properties the bases of which are to be reduced, shall be determined under regulations prescribed by the Secretary.

    (2) Limitation in title 11 case or insolvency.
In the case of a discharge to which subparagraph (A) or (B) of section 108(a)(1) applies, the reduction in basis under subsection (a) of this section shall not exceed the excess of-
    (A) the aggregate of the bases of the property held by the taxpayer immediately after the discharge, over
    (B) the aggregate of the liabilities of the taxpayer immediately after the discharge.
The preceding sentence shall not apply to any reduction in basis by reason of an election under section 108(b)(5).

    (3) Certain reductions may only be made in the basis of depreciable property.
        (A) In general. Any amount which under subsection (b)(5) or (c)(1) of section 108 is to be applied to reduce basis shall be applied only to reduce the basis of depreciable property held by the taxpayer.
        (B) Depreciable property. For purposes of this section, the term "depreciable property" means any property of a character subject to the allowance for depreciation, but only if a basis reduction under subsection (a) will reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction.
(C) Special rule for partnership interests. For purposes of this section, any interest of a partner in a partnership shall be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by such partnership. The preceding sentence shall apply only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.

(D) Special rule in case of affiliated group. For purposes of this section, if-

(i) a corporation holds stock in another corporation (hereinafter in this subparagraph referred to as the "subsidiary"), and

(ii) such corporations are members of the same affiliated group which file a consolidated return under section 1501 for the taxable year in which the discharge occurs,

then such stock shall be treated as depreciable property to the extent that such subsidiary consents to a corresponding reduction in the basis of its depreciable property.

(E) Election to treat certain inventory as depreciable property.

(i) In general. At the election of the taxpayer, for purposes of this section, the term "depreciable property" includes any real property which is described in section 1221(a)(1).

(ii) Election. An election under clause (i) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary. Such an election, once made, may be revoked only with the consent of the Secretary.

(F) Special rules for qualified real property business indebtedness. In the case of any amount which under section 108(c)(1) is to be applied to reduce basis-

(i) depreciable property shall only include depreciable real property for purposes of subparagraphs (A) and (C),

(ii) subparagraph (E) shall not apply, and

(iii) in the case of property taken into account under section 108(c)(2)(B), the reduction with respect to such property shall be made as of the time immediately before disposition if earlier than the time under subsection (a).

(4) Special rules for qualified farm indebtedness.

(A) In general. Any amount which under subsection (b)(2)(E) of section 108 is to be applied to reduce basis and which is attributable to an amount excluded under subsection (a)(1)(C) of section 108 -

(i) shall be applied only to reduce the basis of qualified property held by the taxpayer, and
(ii) shall be applied to reduce the basis of qualified property in the following order:

(I) First the basis of qualified property which is depreciable property.

(II) Second the basis of qualified property which is land used or held for use in the trade or business of farming.

(III) Then the basis of other qualified property.

(B) Qualified property. For purposes of this paragraph, the term "qualified property" has the meaning given to such term by section 108(g)(3)(C).

(C) Certain rules made applicable. Rules similar to the rules of subparagraphs (C), (D), and (E) of paragraph (3) shall apply for purposes of this paragraph and section 108(g).

(c) Special rules.

(1) Reduction not to be made in exempt property.
In the case of an amount excluded from gross income under section 108(a)(1)(A), no reduction in basis shall be made under this section in the basis of property which the debtor treats as exempt property under section 522 of title 11 of the United States Code.

(2) Reductions in basis not treated as dispositions.
For purposes of this title, a reduction in basis under this section shall not be treated as a disposition.

(d) Recapture of reductions.

(1) In general.
For purposes of sections 1245 and 1250 -

(A) any property the basis of which is reduced under this section and which is neither section 1245 property nor section 1250 property shall be treated as section 1245 property, and

(B) any reduction under this section shall be treated as a deduction allowed for depreciation.

(2) Special rule for section 1250.
For purposes of section 1250(b), the determination of what would have been the depreciation adjustments under the straight line method shall be made as if there had been no reduction under this section.