

August 1987

A.E. Ext. 87-21

**INCOME TAX CONSEQUENCES OF SALE OF FARM
ASSETS AND DEBT CANCELLATION DUE TO FINANCIAL
DISTRESS AND BANKRUPTCY**

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This bulletin is not intended to be an exhaustive treatment of income taxes related to farm financial distress. The intent is to give farmers and their financial and tax advisors some basic information about the tax consequences of financial distress. Sound advice should be sought from competent attorneys and tax practitioners.

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In the mid-1980's a substantial number of farmers have suffered financial difficulties which have led to debt restructuring and consideration of liquidation alternatives including bankruptcy. This bulletin considers some of the income tax consequences of such actions.

Gains and Losses from Sale of Property

Sale of assets used in the farm business (such as real estate, equipment and breeding animals) usually results in income tax obligations due to capital gain, ordinary gain and the recapture of investment credit. There may also be tax liability due to the alternative minimum tax and/or state minimum taxes. These topics are covered in many publications dealing with farm income taxes such as annual issues of the Farmers Tax Guide and will not be dealt with in detail here. However, it is critical to point out that even though the debt on an item of property will consume all or most of the sale price, there still may be substantial capital gain or ordinary income which will create income tax liability for the seller. This is because the gain or loss from the sale of property is the difference between the sale price and the tax basis of the property (rather than the amount of debt on the property).

Alternative Minimum Tax Relief

Some relief from the alternative minimum tax for insolvent farmers was provided by Congress and the President in April 1986. An insolvent farmer who sold farmland after 1981 does not need to include the 60 percent capital gain exclusion on land in the computation of alternative minimum tax (AMT) to the extent of the insolvency. The exclusion from AMT applies only to land, not to capital gain excluded on buildings or other depreciable property. To qualify, the land must have been transferred to the creditor in cancellation of indebtedness or sold or exchanged under threat of foreclosure. To qualify as a farmer, a taxpayer must have received at least 50 percent of annual gross income in the three previous years from farming. To meet the insolvency requirement, the taxpayer must, immediately before the transaction, have had an excess of liabilities over the fair market value of his assets.

At the time the legislation was enacted, there were only a few days left in which a taxpayer could have filed an amended return for 1982. Under the

legislation, unless that was done before April 15, 1986, the taxpayer had lost the opportunity to make the AMT exclusion for 1982. The Tax Reform Act of 1986 extended the time for filing an amended return for this purpose to one year after the date of enactment of TRA 1986 which was October 22, 1986.

Example

A. Farmer sold (before 1987) for \$300,000, under the threat of foreclosure, a parcel of real estate with a basis of \$225,000. The sale price allocated to land was \$200,000, basis \$150,000. The remaining sale price of \$100,000 was allocated to buildings. At the time of the sale, Farmer's total assets were \$490,000 and total debts were \$590,000 so he was insolvent \$100,000. The gain on the land was \$50,000, 60 percent of which was excluded from taxable income. This amount, \$30,000, normally would be included in the AMT calculation. Under the new law, this would not be included in the AMT calculation because it is less than the amount of insolvency. If the insolvency was less than \$30,000, the amount excluded from alternative minimum taxable income would be limited by the amount of the insolvency.

Effect of the Tax Reform Act of 1986

The effect of this provision is not important for sales or transfers of land after December 31, 1986 because the 60 percent capital gain exclusion no longer applies due to the Tax Reform Act of 1986. Therefore there will not be AMT caused by the capital gain exclusion on land.

Income from Cancellation of Debt

The United States Tax Code specifies that cancellation of debt by the lender (creditor) is ordinary income to the borrower, similar to salaries, wages, net farm income, etc. The difference between income from the cancellation of debt and other forms of ordinary income is that in many situations, the taxpayer does not have to report the income from cancellation of debt and pay tax on it. However, in return for not reporting the income, the taxpayer must reduce "tax attributes" such as investment credit, net operating loss carryover, etc. More detail on this will be presented later.

Assume that Stressed Farmer owes his creditor \$300,000 on farm real estate that has a fair market value of \$275,000. Stressed is unable to make the payments on the mortgage. Rather than foreclose on the property, the creditor agrees to reduce the principal on the loan to \$250,000 which will make the payments manageable by Stressed. In this example, there is \$50,000 of canceled debt. Whether the \$50,000 will be included in taxable income will depend on a number of factors to be discussed later.

In some transactions, the debtor will have a combination of "discharge of indebtedness" (IRC Sec. 61(a)(12)), capital gain income and ordinary income due to recapture of depreciation. Suppose that Stressed Farmer, rather than obtaining a reduction in the debt, decided to transfer the property to the creditor in return for the discharge of the \$300,000 mortgage. Whether there is discharge of indebtedness income (DII) depends on whether the debt is recourse or

non-recourse debt. Recourse debt means that the lender has the right to obtain a judgment against the debtor for the portion of the debt not covered by the value of the property, in this example $\$300,000 - \$275,000 = \$25,000$. Most farm debt is recourse and the debt in this example is recourse. (It is likely that the debt in some seller financed installment sales is non-recourse.)

The adjusted basis of the property in this example is $\$200,000$ and $\$40,000$ of rapid depreciation under the Accelerated Cost Recovery System (ACRS) had been taken on the dairy facilities (single purpose livestock structures and silos). With recourse debt, Stressed would have the following income:

Debt discharged	\$300,000
Fair market value	<u>275,000</u>
Discharge of indebtedness income	\$ 25,000

Fair market value	\$275,000
Basis	<u>200,000</u>
Gain	\$ 75,000
Ordinary gain (recapture of depreciation)	<u>40,000</u>
Capital gain	\$ 35,000

In the recourse debt situation an appraisal will be necessary to establish the fair market value (FMV) of the property.

If the creditor had foreclosed on the property and it had been sold for $\$275,000$ the result would be exactly the same as in the example. An appraisal would not be necessary because the sale established the FMV. The only difference (from a tax standpoint) between a foreclosure sale and a voluntary transfer is that the FMV may differ because the appraiser may put a different price on the property than the auctioneer and his bidders do. This would affect the allocation between discharge of indebtedness income and gain.

If the debt had been non-recourse (which is unlikely), the fair market value would be ignored. Essentially, for tax calculation purposes, Stressed sold the property to the creditor for the loan balance of $\$300,000$.

Loan balance (sale price)	\$300,000
Basis	<u>200,000</u>
Gain	\$100,000
Ordinary Gain (recapture of depreciation)	<u>40,000</u>
Capital gain	\$ 60,000

Tax Treatment of Discharge of Indebtedness Income

While discharge of indebtedness income initially is included in the taxpayer's gross income, it is excluded from income if any of the following three exceptions applies.

Exception 1: The discharge of indebtedness occurs in either a Chapter 7, Chapter 11 or Chapter 12 bankruptcy case.

Exception 2: The discharge occurs when the taxpayer is insolvent.

Exception 3: The discharge of "qualified farm indebtedness" of solvent farmers after April 9, 1986. (Prior to 1987, there was an exception for "qualified business indebtedness" of solvent taxpayers).

In addition, income is not recognized from discharge of indebtedness if payment of the debt would have resulted in a deduction that could have been claimed by the taxpayer. For example, suppose Stressed Farmer (a cash basis taxpayer) owed \$10,000 for fertilizer and was unable to pay it. The dealer canceled the debt. Stressed would have been able to claim the \$10,000 as an expense if he had paid it. Therefore, there is no discharge of indebtedness income in this example.

If a canceled debt includes interest (perhaps that had been added to the principal) the interest should not become DII because it would have been deductible had it been paid. (This assumes a cash basis taxpayer who did not deduct the interest in the year that it was added to the principal.) However, it may be difficult to separate the interest from canceled principal unless the debtor and creditor have good records.

Debts Discharged in Bankruptcy

If the debt is discharged in either a Chapter 7, 11 or 12 proceeding, the discharge of indebtedness income (DII) is not included in the taxpayer's gross income. However, the DII must be used to reduce tax attributes of the debtor. (A tax attribute is something that will decrease the tax bill of a taxpayer at some time in the future.) These tax attributes, listed in the order in which the reductions are taken are:

1. Net operating losses (NOL) for the taxable year of the discharge and any NOL carryover to that taxable year.
2. Specific credit carryovers to or from the taxable year of the discharge. The credits involved are the general business credit (Sec. 38), and the credit for increasing research activities (Sec. 30). Unlike all the other reductions which are dollar for dollar, these credits are reduced \$.50 for each dollar of DII excluded from income.
3. Capital loss carryovers. Any net capital loss for the taxable year of the discharge and any capital loss carryover to such taxable year under section 1212. (Such capital loss carryovers are unusual for farmers.)
4. Basis reduction. The basis of property owned by the taxpayer must be reduced if the reduction of the tax attributes listed above does not offset all the DII excluded from income. (The basis is reduced only to the amount of debt remaining on each item of property.)
5. Foreign tax credit carryovers.

In a bankruptcy situation, the debtor can elect to use all or part of the excluded DII to reduce the basis in depreciable property first, before reducing the other tax attributes. The election to reduce basis does not apply to non-depreciable assets such as farmland or a personal residence. Also, the limitation on not reducing the basis below the debt on the property does not apply if the election is made.

If there is discharge of indebtedness remaining after all the taxpayer's tax attributes are used, the remaining DII is not included in income. Basically, DII in a bankruptcy case is not included in income, but any tax attributes that are available must be used up to the extent of the DII.

The reductions in tax attributes are made after the income tax for the year of the discharge has been calculated. For example, suppose that Pete has \$50,000 of DII in 1987. He also has \$40,000 of taxable income in 1987 and an NOL carryover to 1987 of \$60,000. The NOL would first be used to reduce 1987 taxable income. The remaining NOL would be applied to the \$50,000 DII.

The provisions that allow the DII to be excluded from income mean that the taxpayer does not have to pay tax on the DII. However, the fact that any tax attributes available must be reduced means that the taxpayer loses the ability to use these tax attributes to reduce taxes in the future. Therefore, the taxpayer who has tax attributes that must be reduced eventually will pay tax on the DII to the extent that he has taxable income in the future.

Debts Discharged for Insolvent Debtors Outside Bankruptcy

Discharge of indebtedness income is excluded from the taxpayer's gross income if he is insolvent immediately before the discharge (because of Exception 2 listed earlier). However, the amount of DII excluded is limited to the amount of insolvency.

Insolvency is defined in balance sheet terms: the excess of liabilities over the fair market value of assets. To the extent of insolvency, the DII and reduction of the tax attributes are treated exactly the same as for bankruptcy situations described in the previous section. The taxpayer has the same election to reduce the basis of depreciable assets before reducing the other tax attributes.

Insolvent Farmer has the following balance sheet:

	<u>Assets</u>	<u>Liabilities</u>
Real estate	\$300,000	\$350,000
All other assets	<u>200,000</u>	<u>200,000</u>
Total	\$500,000	\$550,000
Net Worth		\$-50,000

The real estate creditor cancels \$50,000 of the real estate debt which becomes DII to the taxpayer. The \$50,000 is excluded from income, but the taxpayer must reduce his tax attributes to the extent that they total \$50,000 or less.

If the lender had canceled more than \$50,000 of debt, say \$75,000, the first \$50,000 of DII would be excluded from income (limited by the amount of insolvency) but the remainder of the DII would be treated under the rules applying to solvent debtors. As explained in the next section, the rules for solvent farmers were changed by the Tax Reform Act of 1976.

Debt Discharged for the Solvent Debtor

The Tax Reform Act of 1986 applies the insolvent debtor rules (see page 5) to solvent farmers for debt discharged after April 9, 1986. The discharged debt must be "qualified farm indebtedness". To meet the qualified farm indebtedness definition, (1) the debt must have been incurred directly in connection with the operation of the farm business, (2) 50 percent or more of the average annual gross receipts of the farmer for the three previous years must have been attributable to farming and (3) the discharging creditor must be (a) in the business of lending money and (b) not related to the farmer, did not sell the property to the farmer and did not receive a fee for the farmer's investment in the property. Also, for solvent farmers, the basis of farmland is added at the end of the list of tax attributes that will be reduced rather than including the DII in income. The basis reduction in property other than farmland moves below the foreign tax credit carryovers in the list of tax attributes to be reduced. The limit on reducing the basis below the remaining debt does not apply to solvent taxpayers.

Before 1987, a solvent debtor who had debts canceled had a possibility of avoiding the recognition of DII as income under Exception 3 which applied to "qualified business indebtedness" (QBI) which is debt incurred by an individual in connection with property used in his trade or business. Most farm debt probably is QBI but there are exceptions. Under the pre-1987 QBI rules, the only way for a solvent debtor to exclude DII from income was to reduce the basis of depreciable assets. Any excess of DII over the basis of depreciable assets was included in the taxpayer's income. However, any NOL or investment credit carryover could be used to help offset the DII that must be included in income. The qualified business indebtedness rules were repealed by the Tax Reform Act of 1986 for discharges after 1986. Therefore this exception no longer applies.

Discharge of Indebtedness Income vs. Gain from Sale of Property

The reader will recognize that the fair market value of the property will affect the allocation between DII and gain. Is the taxpayer better off with DII or gain? There is no general answer to this question because it depends on the specific situation. If the taxpayer is bankrupt or insolvent and has no tax attributes to be reduced, he is better off with DII because it will be excluded from income and he gives up nothing in return. (For the non-bankrupt insolvent debtor, this is true only to the extent of insolvency). Before 1987, if there were tax attributes to be reduced, the taxpayer may have been better off with gain, to the extent that it was capital gain, because only 40 percent was included in income. But watch out for AMT! In 1987, the taxpayer may be better off with gain, if it is capital gain, because the top Federal tax rate on capital gain is 28 percent compared to 38.5 percent on ordinary income. In 1988 and later, capital gain and ordinary income effectively will be taxed at the same rates so the FMV will not affect the tax bill of a taxpayer with no tax

attributes to be reduced. The taxpayer and his tax practitioner should carefully review the consequences before trying to influence the appraiser who is setting the FMV.

Bankruptcy

There are four types of bankruptcy, Chapter 7, Chapter 11, Chapter 12 and Chapter 13.

Chapter 7 bankruptcy, sometimes called real bankruptcy, usually means that the debtor disposes of all of his assets (except exempt assets) and discontinues the business.

Chapter 11 bankruptcy is a reorganization in which the debtor at least hopes to continue in business. The debtor must prepare a plan for restructuring debt and have it approved by the court.

Chapter 12 bankruptcy is a reorganization that applies only to family farmers with debts not exceeding \$1.5 million. This provision is effective beginning November 26, 1986 and lasts for seven years.

Chapter 13 bankruptcy is primarily a way for wage earners and small businesses to develop a plan to pay debts over a period of time. The proceedings are less expensive and complicated than for Chapters 11 or 12 but the limits on the total value of assets are low enough that only quite small farm businesses could use Chapter 13.

Realistically, most farmers in financial difficulty would choose between Chapter 7 and Chapter 11 or 12. Experience has shown that a large proportion of farm Chapter 11 reorganizations are not successful. This is because either the bankruptcy judge will not approve the plan, or because the debtor is unable to carry out the plan even if the judge approves it. The underlying reason is that farmers who are so heavily in debt (perhaps with liabilities exceeding assets) that they petition for Chapter 11 have already restructured their debt one or more times and therefore little room is left for a reorganization that will enable payments to be made. It is too early to know whether Chapter 12 reorganizations will be more successful than those under Chapter 11.

Some Income Tax Aspects of Bankruptcy

When an individual files for Chapter 7 or 11 bankruptcy, an entity called a "Bankruptcy Estate" is created. (This is not true when a partnership or corporation files for bankruptcy nor is it true in a Chapter 12 bankruptcy). The individual will file a tax return (two if he selects two short tax years) for the year in which the bankruptcy occurred and the bankruptcy estate will also file a tax return. If assets are to be sold, the decision of whether they are sold by the individual before declaring bankruptcy or by the bankruptcy estate can make a difference in the tax bill to be paid by the individual.

The normal tax year of an individual who enters bankruptcy does not change. For example, if the taxpayer is on a calendar year, he will continue on a calendar year. However, the individual who goes bankrupt has an election to

split his own tax year into short tax years. The first short year would end on the day before the bankruptcy is filed and the second short year would start the next day. Therefore a total of three tax returns would be filed, two by the individual and one by the bankruptcy estate.

Any tax due on the first short tax year becomes an obligation of the bankruptcy estate rather than of the taxpayer. The tax on the second short year is an obligation of the taxpayer. If two short years are not elected, the entire tax bill of the individual remains the obligation of the individual.

For example, suppose that John, who is in financial difficulty, sells some assets early in the year in an attempt to lighten his debt load and payments. As a result of this sale, the income to be reported is \$60,000. Later in the year he files for Chapter 7 bankruptcy and assets are sold which produce \$70,000 of reportable gain. He then quits farming and takes a non-farm job which produces \$12,000 of taxable income during the balance of the year.

If two short tax years are not elected, the \$60,000 reportable gain and the \$12,000 of taxable earnings will produce tax liability for the bankrupt individual. The \$70,000 will produce tax liability which will be paid by the bankruptcy estate. In both cases, there may be tax attributes and other factors which will reduce the tax liability.

If two short years are elected by the individual, the tax liability on the \$60,000 of pre-bankruptcy gain will be passed to the bankruptcy estate. Only the \$12,000 of taxable income earned during the second short tax year will produce income tax liability for the individual. However, if the bankruptcy estate does not have enough assets to pay the tax liability on the first short year, the remaining tax liability is passed back to the individual. The tax bill is a priority claim on the bankruptcy estate, so it normally is paid before other claims against the bankruptcy estate are paid.

This example is somewhat oversimplified. In some cases, there would be profits or losses from this year's farm operations, NOL carryovers and investment credit carryovers which would affect the actual tax liability of both the debtor and the bankruptcy estate.

If two short tax years are not elected, the "tax attributes" of the debtor at the beginning of the normal tax year such as NOL's and investment credit carryovers automatically pass to the bankruptcy estate. Therefore, the debtor loses the ability to use these tax attributes to reduce his tax bill. If two short years are elected, such carryovers stay with the taxpayer during the first short year and can be used in the first short year before being passed to the bankruptcy estate as of the first day of the second short year.

If the debtor has taxable income in the period of his tax year before declaring bankruptcy, it usually will be to his advantage to elect two short years. The tax attributes will reduce the debtor's taxable income and tax if two short years are elected but not if the election is not made. In addition, any tax on the remaining taxable income will become a liability of the bankruptcy estate rather than of the debtor. Tax attributes such as investment credit and NOL's left over in the bankruptcy estate are passed back to the individual once the bankruptcy estate is terminated.

The debtor and his accountant should carefully estimate the tax consequences to the debtor before the decision is made to elect two short tax years. The election must be made before the 15th of the fourth month after the end of the month in which the bankruptcy petition is filed. Once it is made, the election is irrevocable.

The election of two short tax years will not necessarily reduce the total tax to be paid by the debtor plus the bankruptcy estate. However, because the debtor is not responsible for the tax on the bankruptcy estate, he should be interested in minimizing the tax that he will be obligated to pay. It should be noted that the tax paid by the bankruptcy estate will come out of the creditors in situations where there is not enough money in the bankruptcy estate to satisfy all the claims.

Timing of sale of assets

Timing of the sale of assets may be important in determining the tax liability of the debtor. This is particularly true in Chapter 7 cases. As noted earlier, the tax liability on the first short tax year becomes an obligation of the bankruptcy estate. However, if there are no assets in the bankruptcy estate to pay the tax due on the short year, the remaining tax liability is not discharged but goes back to the debtor and can be collected from him. If most or all of the assets are sold and the money is used to pay down debts before the bankruptcy petition is filed, the estate will be left with debts but little or no income. Therefore, there will be little or no funds with which to pay the tax on the first short year and it will become an obligation of the debtor.

The individual who is contemplating bankruptcy should, in consultation with his attorney and tax advisor, carefully consider whether assets should be sold before or after declaring bankruptcy. They should also keep in mind that the sale timing decision interacts with the election of two short tax years.

Additional Information

The following publications are among the sources of additional information on the subjects of this bulletin.

Bock, C. Allen and Philip E. Harris. "Farm Income Tax Schools Workbook." Cooperative Extension Service, University of Illinois. Published annually and available to tax practitioners who attend tax schools which use this workbook.

Brownbach, Sam, Douglas F. Beech, DeAnn E. Hupe, and David M. Saxowsky. "Foreclosure, Bankruptcy, and the Tax Implications of Liquidating a Farm Operation." Cooperative Extension Service, Kansas State University, Manhattan, Kansas.

Saxowsky, David M., David L. Watt and W. Allan Tinsley. "Tax Implications of Liquidating a Farm Operation." Published by the Federal Extension Service.

Saxowsky, David M., Philip E. Harris and W. Allan Tinsley. "Tax Implications of Liquidating a Farm Operation after the Tax Reform Act of 1986." Published by the Federal Extension Service.