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Discharge of Indebtedness for Farm and Ranch Debtors

-by Neil E. Harl*

In almost every economic downturn, there is indebtedness that could not be paid and the indebtedness, in whole or in part, is discharged.¹ That was certainly the case in the farm debt crisis of the 1980s² and promises to occur, probably on a much smaller scale, for the current downturn which is characterized by lower commodity prices.

Consequences of discharge of indebtedness

In general, if indebtedness is cancelled or forgiven, the amount cancelled or forgiven must be included in gross income.³ In general, there must be an identifying event or forgiveness on the part of creditors to give rise to discharge of indebtedness income.⁴

Cancellation of accrued interest. Cancellation of accrued interest (unless deducted by a taxpayer on the accrual method of accounting) is of no income tax consequence since the receipt of interest income is offset by a deduction of interest expense.⁵

Forgiveness of principal balances. Cancellation or forgiveness of principal balances has income tax consequences, also, for secured claims. Cancellation or forgiveness of debt is treated essentially as a sale up to the fair market value of the property, in which that amount is treated as gain or loss; amounts above the fair market value of the property are taxed up to the debt cancelled or forgiven. I.R.C. § 108 providing relief for discharge of indebtedness does not apply to gain realized on transfer of property.⁶

When discharge occurs. In Chapter 7 bankruptcy, if no objections to discharge are sustained, discharge of indebtedness occurs 60 days after the meeting of creditors after the meeting of creditors at which the debtor appears and is examined under oath.⁷ Under Chapter 11 bankruptcy, discharge takes place upon confirmation of a plan of reorganization as to debts before confirmation with some exceptions.⁸ Under Chapter 12 (farm and ranch bankruptcy), discharge takes place "as soon as practicable" after completion of payments under the plan.⁹ That puts the date of discharge months and months into the future. For Chapter 13 bankruptcy, discharge also occurs on completion of payments under the plan.¹⁰

Discharge of indebtedness for a solvent farm debtor

Effective for discharges of indebtedness occurring after April 9, 1986, discharge of indebtedness arising from an agreement between a person engaged in the trade or business of farming and a "qualified person" to discharge "qualified farm indebtedness" is treated for federal income tax purposes under a special provision of the Internal Revenue Code if specified conditions are met.¹¹ The insolvency rules take priority over the qualified farm indebtedness rule.

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Qualified person.” A qualified person is defined as someone, including state and federal agencies, who is “actively and regularly engaged in the business of lending money” and is *not*— (1) related to the taxpayer; (2) a person from whom the taxpayer acquired the property (or a related person); or (3) a person who receives a fee with respect to the taxpayer’s investment in the property (or a related person).¹²

Qualified farm indebtedness. To be eligible to be treated as “qualified farm indebtedness,” the indebtedness must have been incurred directly in connection with the operation by the taxpayer of the trade or business of farming and 50 percent or more of the average annual gross receipts of the taxpayer for the three preceding taxable years must be attributable to the trade or business of farming.¹³ The gross receipts test is applied on an aggregate basis over the three year period. Not surprisingly, cash rents are not considered to be “gross receipts.”¹⁴

Ordering rule for handling the reduction of indebtedness income

An important issue is the ordering rule for handling the reduction of indebtedness income (which comes first and which comes last) – (1) first is the net operating loss for the taxable year and any carryover loss to that year;¹⁵ (2) general business credits and any carryover of credits to that year;¹⁶ (3) the amount of the minimum tax credit under I.R.C. § 53(b) (if any) as of the beginning of the taxable year immediately following the taxable year of discharge;¹⁷ (4) capital losses for the taxable year and any carryover of capitals losses to that year;¹⁸ (5) passive activity loss and credit carryovers under I.R.C. § 469(b) from the taxable year of the discharge;¹⁹ and (6) foreign tax credits for or to the taxable year.²⁰

After the tax attributes have been reduced, any remaining discharge of indebtedness is used to reduce the income tax basis of “qualified property” of the debtor.²¹ For purposes of reduction of basis, the property is limited to that “used in a trade or business or for the production of income” and the order of basis reduction is specified – (1) depreciable property; (2) land used or held for use in the trade or business of farming; and (3) other qualified property.²² The statute is not clear on the point but the apparent intent is to include inventory property although the statute states that “qualified property” means any property “. . . which is held or held for use a trade or business or for the production of income.”²³ Stored commodities, for example, fall into neither category and are held “for sale in the ordinary course of business.”

It appears that income tax basis can be reduced to zero in instances involving a solvent farm or ranch debtor under I.R.C. § 108(g). An election can be made to reduce the income tax basis of depreciable property first.²⁴

ENDNOTES

¹ See generally 5 *Agricultural Law* § 39.03 (2016); Harl, *Agricultural Law Manual* § 4.02[15] (2016); 2 Harl, *Farm Income Tax Manual* § 9.03 (2016).

² See Harl, *Farm Debt Crisis of the 1980s*, Iowa State University Press, 1990.

³ I.R.C. § 61(a)(12). See, e.g., *Vukasovich, Inc. v. Comm’r*,

790 F.2d 1409 (9th Cir. 1986), *aff’g in part and rev’g in part*, T.C. Memo. 1984-611 (cancellation of indebtedness for less than amount owed resulted in ordinary income to debtor).

⁴ *Friedman v. Comm’r*, T.C. Memo. 1998-196, *aff’d*, 216 F.3d 537 (6th Cir. 2000) (filing of involuntary bankruptcy petition not sufficient). See *Alpert v. United States*, 481 F.3d 404 (6th Cir. 2007) (involuntary bankruptcy filed against S corporation; discharge occurred when bankruptcy case concluded, which placed the year in question outside the three year range for carrying back losses).

⁵ However, that rule does not apply if the exception in I.R.C. § 108(e)(2) is not applicable. *Brooks v. Comm’r*, T.C. Memo. 2012-25 (deduction of investment interest limited to net investment income).

⁶ Ltr. Rul. 9120010, February 14, 1991. See *Gehl v. Comm’r*, 95-1 U.S. Tax Cas. ¶ 50,191 (8th Cir. 1995) (gain from disposition of assets cannot be excluded under the insolvency exception; no discharge of indebtedness).

⁷ Bankr. Rule 4004(a), (c).

⁸ 11 U.S.C. § 1141.

⁹ 11 U.S.C. § 1228(a).

¹⁰ 11 U.S.C. § 1328(a).

¹¹ I.R.C. § 108(g).

¹² I.R.C. §§ 108(g)(3), 49(a)(1)(D)(iv).

¹³ I.R.C. § 108(g)(2). See *Campbell v. Comm’r*, T.C. Memo. 2001-51, *aff’d*, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,242 (8th Cir. 2002) (discharge of indebtedness could not be excluded under solvent farm debtor rule; failed to prove “50 percent” test was met).

¹⁴ *Lawinger v. Comm’r*, 103 T.C. 428(1994) (sales of farm machinery were gross receipts but Farmland Preservation Act credits under state law were not “gross receipts”; receipts from farming less than 50 percent of gross receipts).

¹⁵ I.R.C. §§ 108(b)(2)(A), 108(g)(3)(A)(i), (3)(B).

¹⁶ I.R.C. §§ 108(b)(2)(B), 108(g)(3)(A)(i), (3)(B).

¹⁷ I.R.C. §§ 108(b)(2)(C), 108(g)(3)(A)(i), (3)(B).

¹⁸ I.R.C. §§ 108(b)(2)(D), 108(g)(3)

¹⁹ I.R.C. §§ 108(b)(2)(F), 108(g)(3)(A)(i), (3)(B).

²⁰ I.R.C. §§ 108(b)(2)(G), 108(g)(3)(A)(i).

²¹ I.R.C. §§ 108(g)(3)(ii), 1017(b)(4).

²² I.R.C. § 1017(b)(4).

²³ I.R.C. §§ 1017(b)(4)(B), 108(g)(3)(C).

²⁴ I.R.C. §§ 108(b)(1), 108(b)(5).