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## Discharge of Indebtedness-- A Source of Surprises: Part II

-by Neil E. Harl\*

In a previous issue, we covered "Discharge of Indebtedness-- A Source of Surprises: Part I." In this issue, the focus is on discharge of *farm* indebtedness (and how it differs from the general rules on discharge of indebtedness) and on *purchase price adjustment*. Both play a vital role in handling problems of indebtedness.

### Discharge of indebtedness for a solvent farm taxpayer.

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 under a special provision if specified conditions are met.<sup>1</sup> That qualified person must be "actively and regularly engaged in the business of lending money" who is not – (1) related to the taxpayer, (2) a person from whom the taxpayer acquired the property (or a related person) and a person who receives a fee with respect to the taxpayer's investment in the property (or a related person).<sup>2</sup>

*What is "qualified farm indebtedness"?* To be eligible to be treated as "qualified farm indebtedness," the indebtedness must be 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.<sup>3</sup> Cash rents are not considered to be "gross receipts" attributable to the "trade or business of farming."<sup>4</sup>

*Order of reduction of tax attributes.* The solvent farm taxpayer rule specifies a different rule for handling the reduction of tax attributes to reduce discharge of indebtedness income in the following order – (1) net operating losses for the taxable year and any carryover losses to that year;<sup>5</sup> (2) general business credits;<sup>6</sup> (3) the minimum tax credit, if any;<sup>7</sup> (4) capital losses for the year and any carryover losses to that year;<sup>8</sup> (5) passive activity loss and credit carryovers from the taxable year of discharge;<sup>9</sup> and (6) foreign tax credits for or to the taxable year.<sup>10</sup> 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.<sup>11</sup> For purposes of reduction of basis, property is limited to that used in a "trade or business" or "held for the production of income."

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.<sup>12</sup> The statute is not clear on the point but the apparent intent is to include inventory property but the statute states that the term "qualified property" means any property ". . . which is used or is held

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for use in a trade or business or for the production of income.”<sup>13</sup> Stored commodities, for example, are not held for use in a trade or business and are not held for the production of income. Stored commodities are held for sale in the ordinary course of business. Informal advice from IRS several years ago indicated that inventory property should be eligible for basis reduction but no authority has been issued that supports that point.

*Reduction of basis – how far can it go?* The basis reduction rule allowing basis reduction down to the debt on the property applies only to instances where the debtor *is insolvent or in bankruptcy*.<sup>14</sup> Therefore, it appears that basis can be reduced to zero in instances involving a solvent debtor.<sup>15</sup>

*Election to reduce the basis of depreciable property first.* An election under the solvent farm debtor provision can be made to reduce the basis of depreciable property first.<sup>16</sup>

*The “bottom line.”* The amount of the exclusion from income cannot exceed the aggregate amount of tax attributes and basis reduction described above and income must be recognized to the extent the amount of discharged indebtedness exceeds the available tax attributes and basis.

#### **Purchase price adjustment.**

The final exception to the general rule that discharged indebtedness constitutes income is applicable to situations where the reduction of a purchase money debt constitutes a “purchase price adjustment.”<sup>17</sup> That term is defined to include situations where the debt of an original purchaser of property (such as land) is reduced by the original seller of the property if the debtor is not insolvent or in bankruptcy.<sup>18</sup> However, IRS has indicated that it will not challenge a partnership’s treatment of a reduction of indebtedness owed by the partnership as a purchase price adjustment if the transaction would qualify as a purchase price adjustment otherwise and no partner adopts an inconsistent reporting position.<sup>19</sup>

*Requirements for purchase price adjustment.* The reduction in basis must be based solely on direct, arm’s length negotiations between *the original buyer and the original seller although* a reduction in basis has been allowed after a merger of the buyer.<sup>20</sup> Likewise, a reduction in basis has been approved following a tax-free exchange under I.R.C. § 351.<sup>21</sup> Also, IRS has approved a reduction of tax attributes under the insolvent debtor rule which was followed by a purchase price adjustment.<sup>22</sup>

*Rules governing reduction in basis.* The reduction in basis under the purchase price adjustment rule is governed by rules different from reduction of basis under other provisions. Thus, investment tax credit recapture occurs inasmuch as I.R.C. § 1017(c)(2) which protects against investment tax credit recapture does not apply.<sup>23</sup> The recapture calculations assume “disposition” occurs on the date the property was placed in service.<sup>24</sup> The holding period apparently is deemed to be “less than 3 years” so the investment tax credit may be fully recaptured even though the time for recapture has passed.<sup>25</sup>

With the reduction in basis, an adjustment is made in depreciation claimed. Basis is also modified for purposes of figuring gain or loss on sale. But debt reduction as a purchase price adjustment is not debt discharge income so the reduction is not subject to later recapture under I.R.C. §§ 1245 or 1250.

*What about assets with no basis or little basis remaining?* What if some assets (buildings, fences or tile lines, for example) have been depreciated out or at least depreciated to the level not permitting a proportionate reduction in basis? Neither the statute<sup>26</sup> nor the regulations<sup>27</sup> provide a direct answer to that question.

One argument is that the taxpayer has income to the extent the basis reduction allocable to a depreciable asset exceeds the basis in the item at the time of basis reduction.<sup>28</sup> The other argument, under the assumption that relief provisions should be construed broadly and reasonably to achieve the relief provisions, is that the basis should be reduced using the relative adjusted basis figures at the time of basis reduction *with relatively greater basis reduction for the land and other non-depreciable assets*.<sup>29</sup>

*Income for the seller?* A seller who agrees to a purchase price adjustment may have income from cancellation of part of the obligation.<sup>30</sup> However, a private letter ruling in 1987<sup>31</sup> held that there was no income to the seller in cancelling indebtedness as part of the restructuring of an installment contract.<sup>32</sup>

#### **In conclusion**

Hopefully, we will not again experience the magnitude of discharge of indebtedness incurred in the 1980s.<sup>33</sup> However, some discharge of indebtedness is likely to occur in the face of declines in commodity prices for those who suffer losses whether from the market or from the elements or both.

#### **ENDNOTES**

<sup>1</sup> I.R.C. § 108(g).

<sup>2</sup> I.R.C. §§ 108(g)(2)(A), 49(a)(1)(D)(iv).

<sup>3</sup> I.R.C. § 108(g)(2).

<sup>4</sup> *Lawinger v. Comm’r*, 103 T.C. 428 (1994) (sales of farm machinery were eligible gross receipts but Farmland Preservation Act credits under state law were not gross receipts and cash rents from farming were less than 50 percent of gross receipts from farming).

<sup>5</sup> I.R.C. §§ 108(b)(2)(A), 108(g)(3)(A)(i), 108(g)(3)(A)(i), (3)(b).

<sup>6</sup> I.R.C. §§ 108(b)(2)(B), 108(g)(3)(A)(i), (3)(B).

<sup>7</sup> I.R.C. §§ 108(b)(2)(C), 108(g)(3)(A)(i), (3)(B).

<sup>8</sup> I.R.C. § 108(b)(2)(D), 108(g)(3)(A)(i), (3)(B).

<sup>9</sup> I.R.C. §§ 108(b)(2)(F), 108(g)(3)(A)(i), (3)(B).

<sup>10</sup> I.R.C. §§ 108(b)(2)(G), 108(g)(3)(A)(i), (3)(B).

<sup>11</sup> I.R.C. §§ 108(g)(3)(A)(ii), 1017(b)(4).

<sup>12</sup> I.R.C. § 1017(b)(4).

<sup>13</sup> I.R.C. § 1017(b)(4)(B).

<sup>14</sup> I.R.C. § 1017(b)(2).

<sup>15</sup> I.R.C. § 108(g).

<sup>16</sup> I.R.C. § 108(b)(5).

<sup>17</sup> I.R.C. § 108(e)(5). See Ltr. Rul. 20336032, June 10, 2003 (debt reduction was purchase price adjustment).

<sup>18</sup> I.R.C. § 108(e)(5)(B).

<sup>19</sup> Rev. Proc. 92-92, 1992-2 C.B. 505.

<sup>20</sup> Ltr. Rul. 9338029, June 25, 1993. See Ltr. Rul. 9338049, June 15, 1993.

<sup>21</sup> Ltr. Rul. 9037033, June 18, 1990 (reduction of accrued unpaid interest (with application of the tax benefit rule) followed by reduction of principal).

<sup>22</sup> Ltr. Rul. 9037033, June 18, 1990.

<sup>23</sup> *Id.*

<sup>24</sup> Treas. Reg. § 1.47-2(c).

<sup>25</sup> See Treas. Reg. § 1.47-2(c)(1).

<sup>26</sup> I.R.C. §§ 168, 1011, 1016, 1017.

<sup>27</sup> Prop. Treas. Reg. § 1.168-2(d)(3); Treas. Reg. § 1.1017-1.

<sup>28</sup> Cf. *Delman v. Comm'r*, 73 T.C. 15 (1979).

<sup>29</sup> See Treas. Reg. § 1.1017-1(a)(3).

<sup>30</sup> See I.R.C. § 453B(f).

<sup>31</sup> Ltr. Rul. 8739045, June 30, 1987.

<sup>32</sup> *Id.* There was no recognition of the enactment of I.R.C. § 453B(f).

<sup>33</sup> See Harl, *Farm Debt Crisis of the 1980s*, Iowa State University Press, 1990.

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

### BANKRUPTCY

#### CHAPTER 12

##### TAX CLAIMS FROM SALE OF CHAPTER 12 PROPERTY.

The debtors, husband and wife, filed for Chapter 12 in 2010. The IRS was given notice of all proceedings but did not file any proof of claims. The debtors' plan was confirmed without objection by the IRS and contained a provision governing the treatment of tax claims resulting from the sale of farm property during the case:

"Debtors owe claims to the United States of America acting by and through the Internal Revenue Service and to the State of Iowa acting by and through the Iowa Department of Revenue for income taxes arising from the sale of farm assets used in Debtors' farming operation (machinery) in calendar year 2010; and (land) that this Court has approved a sale that will close in 2011. In addition, the Debtors will owe income taxes for depreciation recapture when they sell milking equipment and grain bins post-confirmation and pay the proceeds to Farm Credit Services of America as is set forth in Paragraph 5.3(b) below. The amount of these tax claims shall be classified, treated and discharged as unsecured claims, and shall be calculated by subtracting that amount of tax resulting on the income tax return, as if the taxable income for the sale, exchange, transfer or other disposition of the farming asset was excluded from the tax return, and from the tax resulting had the taxable income been reported on the Debtors' return. The unsecured classification, treatment and discharge described in the preceding sentence is [sic] known as the Marginal Method approved by the Court in *In re Knudsen*, 581 F.3d 696 (8th Cir. 2009). The amount of these taxes is estimated to be \$81,000, but, however, is not ascertainable until the tax returns for both tax years 2010, 2011 and 2012 have been filed."

The debtors filed their 2010 and 2011 income tax returns based on the quoted confirmed plan provision, resulting in tax refunds. The IRS denied the refund for 2011 and demanded additional taxes based on the sales of farm property during the case. The IRS argued that it is not bound by the terms of the confirmed plan because it was not a creditor in the bankruptcy case since the taxes arose post-

petition. The court agreed, holding that a bankruptcy case creditor is determined as of the date of the petition and, on the date of the petition, the IRS had no claim against the debtors. The court held that, under *Hall v. United States*, 2012-1 U.S. Tax Cas. (CCH) ¶ 50,345 (Sup. Ct. 2012), taxes resulting from the sale of the debtors' property after the filing of the petition were not eligible for Section 1222(a)(2)(A) treatment; therefore, the IRS was not bound by the plan provision governing tax claims arising from the post-petition sale of farm property. *In re Legassick*, 2015-1 U.S. Tax Cas. (CCH) ¶ 50,272 (N.D. Iowa 2015).

### FEDERAL FARM PROGRAMS

**CONSERVATION.** The FSA has issued interim regulations amending the regulations that specify the conservation compliance requirements that participants in USDA programs must meet to be eligible for certain USDA benefits. The USDA benefits to which conservation compliance requirements currently apply include marketing assistance loans, farm storage facility loans, and payments under commodity, disaster, and conservation programs. The conservation compliance requirements apply to land that is either highly erodible land (HEL) or that is wetlands. The interim regulations amend the regulations to implement the Agricultural Act of 2014 (2014 Farm Bill) provisions that: (1) make the eligibility for federal crop insurance premium subsidy benefits subject to conservation compliance requirements; and (2) convert the wetland mitigation banking pilot to a wetland mitigation banking program. The regulations specify the conservation compliance requirements, exemptions, and deadlines that apply in determining eligibility for federal crop insurance premium subsidy from the FCIC, modifies the easement provisions relating to mitigation banks as specified in the 2014 Farm Bill, and clarifies provisions regarding the extent of agency discretion with respect to certain violations. **80 Fed. Reg. 22873 (April 28, 2015).**

**ORGANIC FOOD.** AMS has issued proposed regulations which amend the origin-of-livestock requirements for dairy animals under the USDA organic regulations. The proposed regulations specify