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Income Tax Consequences of Loss of Personal Property to Creditors

— by Neil E. Harl*

A recent inquiry by a tax practitioner on the proper reporting of a turnover of a farm tractor to the creditor focused attention on an area in which there is confusion by both taxpayers and tax practitioners.¹ *Real* property rates a special procedure in the event of repossession following an installment sale;² personal property repossessions are governed by the general rules for repossessions, not those for real property.³ However, the turn over of property to the creditor is the same for both types of property.

No relief from gain

The second important point to understand is that, while there is relief from discharge of indebtedness⁴ for taxpayers in bankruptcy,⁵ for insolvent taxpayers,⁶ for those who are involved with qualified farm indebtedness,⁷ for taxpayers (other than C corporations) faced with qualified real property indebtedness⁸ and for taxpayers who encounter a purchase price adjustment,⁹ *there is no relief for gain triggered in conjunction with a turnover of personal property such as a tractor to a creditor.* The return of the property to the lender is treated essentially as a sale of the tractor by the debtor to the lender. Limited relief from gain on repossessions was proposed in 1986 but was not enacted.

Example: a heavily indebted taxpayer loses a tractor to voluntary repossession by the secured creditor who agreed to cancel the outstanding debt. The tractor had an income tax basis of zero (fully depreciated out) and a fair market value (based on a subsequent sale of the tractor by the secured creditor at auction) of \$35,000. The debtor still owed \$45,000 on the machine. Once the taxpayer's right to redeem has expired for Uniform Commercial Code repossessions, upon disposition of the collateral by the secured creditor,¹⁰ the taxpayer must recognize gain of \$35,000 on the tractor (the fair market value of \$35,000 minus the basis of zero). The difference between the fair market value of \$35,000 and the indebtedness owed of \$45,000 or \$10,000 is discharge of indebtedness at the time the indebtedness is cancelled *if the obligation is a recourse loan.* For a non-recourse obligation, the entire difference between income tax basis and the debt is gain or loss and there is no discharge of indebtedness income.¹¹ If the obligation remains effective, there is no discharge of indebtedness income until collection on the debt is barred by the applicable statute of limitations. In the event indebtedness is discharged or cancelled, there is relief for the discharge of indebtedness involved.¹² The relief from discharge of indebtedness does not apply to gain realized on transfer of property however.¹³

Relief from discharge of indebtedness

In the event a taxpayer experiences discharge of indebtedness, the general rule is

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that the discharge of indebtedness amount is taxed as ordinary income.¹⁴ Moreover, the discharge of indebtedness amount is subject to self-employment tax if related to the operation of a trade or business or a trade or business investment in which the taxpayer materially participates.¹⁵

Involuntary repossessions

In the event a repossession is involuntary, with the remaining debt not cancelled, the secured lender may obtain a deficiency judgment for the balance, which complicates the handling of the transaction for income tax purposes. The issue of discharge of indebtedness is delayed until the deficiency judgment issue is resolved. If a deficiency judgment is satisfied out of the debtor's other property, the debtor has effectively conveyed additional amounts to the lender. In the event the deficiency judgment remains unsatisfied, the indebtedness involved remains uncanceled and undischarged until the deficiency judgment becomes uncollectible.¹⁶

Non-recourse debt

For non-recourse debt, where the value of the property is less than the unpaid balance of the debt, the amount realized on the asset portion of the transaction must be calculated by reference to the unpaid balance of the debt, rather than by reference to the fair market value of the property.¹⁷ Indeed, the fair market property is ignored and there is no discharge of indebtedness income.

One disturbing aspect of non-recourse debt treatment is that IRS has taken the position that a debtor in bankruptcy may encounter non-recourse debt treatment (even though the obligation was originally recourse) where property subject to the debt is abandoned to the debtor with the secured creditor able to acquire the abandoned property to satisfy the debt.¹⁸ In that instance, the entire difference between the income tax basis of the property and the debt involved is taxed as gain.

FOOTNOTES

¹ See generally 5 Harl, *Agricultural Law* § 39.02 (2003); Harl, *Agricultural Law Manual* § 4.02[13][c] (2003).

² I.R.C. § 1038. See 5 Harl, *supra* note 1, § 39.05[1]; Harl, *supra* note 1, § 4.02[12][a].

³ See note 1 *supra*.

⁴ I.R.C. § 108.

⁵ I.R.C. § 108(a)(1)(A).

⁶ I.R.C. § 108(a)(1)(B).

⁷ I.R.C. § 108(a)(1)(C).

⁸ I.R.C. § 108(a)(1)(D).

⁹ I.R.C. § 108(e)(5).

¹⁰ UCC § 9-504-4. See 13 Harl, *Agricultural Law* § 18.04 (2003).

¹¹ See note 17 *infra* and accompanying text.

¹² See notes 5-9 *supra*.

¹³ See Ltr. Rul. 9120010, Feb. 14, 1991. See also Gehl v. Comm'r, 95-1 U.S. Tax Cas. (CCH) ¶ 50,191 (8th Cir. 1995).

¹⁴ I.R.C. § 61(a)(12).

¹⁵ See Rev. Rul. 76-500, 1976-2 C.B. 254 (cancellation of part of FmHA emergency loan).

¹⁶ Cf. Ryan v. Comm'r, T.C. Memo. 1988-12, *aff'd*, 873 F.2d 194 (8th Cir. 1989) (accrual basis limited partners realized income from discharge of indebtedness in taxable year appeal of foreclosure action completed, not year of foreclosure sale).

¹⁷ See Commissioner v. Tufts, 461 U.S. 300 (1983); Newman v. Comm'r, T.C. Memo. 1990-230; Rev. Rul. 82-202, 1982-2 C.B. 36; Ltr. Rul. 9302001, Aug. 31, 1992 (difference between property basis and debt is gain; no discharge of indebtedness income).

¹⁸ Ltr. Rul. 8918016, Jan. 31, 1989 (unsecured portion of debt discharged in bankruptcy).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

ELIGIBILITY. The Chapter 12 debtor owned a farm on which the debtor grew various crops and fruits. The debtor operated the farm as an S corporation which leased the land from the debtor. The debtor's pre-petition farm income was entirely from the rent paid by the corporation. If the corporation had insufficient income to pay the rent, no rent was paid. After filing for Chapter 12, the debtor operated the farm as a sole proprietor. A creditor argued that the debtor did not qualify for Chapter 12 because the rent payments were not income from

farming because the corporation and not the debtor operated the farm. The court reviewed the three approaches to farm rental income as determined by *In re Armstrong*, 812 F.2d 1024 (7th Cir. 1987) (rental income must be subject to risks of farming to be income from farming); *Matter of Burke*, 81 B.R. 971 (Bankr. S.D. Iowa 1987) (farm rental income determined by totality of circumstances as to whether debtors continued farming); and *In re Creviston*, 157 B.R. 380 (Bankr. S.D. Ohio 1993) (totality of circumstances includes risk from farming). The court held that the debtor rental income met the tests of all three approaches because (1) if the corporation did not have enough income, the debtor received less rent; (2) the debtor was actively involved in the farm operation; (3) the rent income came from farming operations; and (4) the debtor continued to farm the property after bankruptcy. The court held that the rent payments qualified as