

# Agricultural Law Digest

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## FORGIVING DEBT: PURCHASE PRICE ADJUSTMENT

by Neil E. Harl\*

In the last three issues, the discussion focused upon the discharge of indebtedness as a result of transfers of property to creditors,<sup>1</sup> discharge of indebtedness for insolvent debtors and those in bankruptcy,<sup>2</sup> and discharge of indebtedness for solvent farm debtors.<sup>3</sup> Another possibility for handling discharged debt, and one that has been very important to many farm debtors in recent years, is purchase price adjustment.<sup>4</sup>

Example (1): Debtor purchased a 160-acre farm from an uncle in 1978 for \$300,000 with nothing down, interest at eight percent on the unpaid principal and the purchase price payable in equal annual installments over 25 years. By 1990, the debtor had paid the annual interest but no principal. Meanwhile, the farm had declined in value to \$160,000. After extended discussion over several months, the uncle agreed to write the contract balance down from \$300,000 to \$200,000. The \$100,000 write-down of the debtor's obligation would not produce discharge of indebtedness income to the debtor.<sup>5</sup>

The purchase price adjustment rule tends, therefore, to be highly favorable for debtors, with little direct income tax consequence from the discharge of indebtedness.<sup>6</sup> There is no income tax liability from discharge of debt under the purchase price adjustment rule.<sup>7</sup> The reduction of indebtedness is treated as a purchase price adjustment involving a write-down of the balance due under the

obligation and a reduction of basis and not a discharge of indebtedness.<sup>8</sup> The effects on debtors are discussed below.<sup>9</sup>

In recent months, there has been some uncertainty as to the effects of purchase price adjustment on the creditor.<sup>10</sup> That, too, is discussed below.<sup>11</sup>

**General requirements.** To be eligible for the purchase price adjustment exception to the general rule that discharge of indebtedness is income,<sup>12</sup> several requirements must be met.

- The debt that is reduced must have been the debt of an original purchaser of the property reduced by the original seller of the property.<sup>13</sup> In other settings, involving other relief provisions, the Internal Revenue Service has taken a conservative stance where the property had been transferred by death or in corporate liquidation. Thus, in 1969 IRS ruled that the special relief provisions on the income tax treatment of reacquisition of real property<sup>14</sup> did not apply to reacquisition by the *estate* of a deceased taxpayer.<sup>15</sup> That position was not reversed legislatively until enactment of the Installment Sales Revision Act of 1980<sup>16</sup> that specifically permitted the estate of a deceased taxpayer to utilize the relief provision on reacquisition.<sup>17</sup>

In 1986, IRS ruled that the nonrecognition provisions on reacquisition of real property did not apply to a former shareholder of a corporation who received an installment obligation from the corporation in a corporate liquidation and who subsequently acquired the real property securing the installment obligation.<sup>18</sup>

Thus, it is anticipated that IRS will take a narrow view of the original buyer-original seller requirement.

- The purchase price adjustment rule does not apply if the debtor is insolvent or in bankruptcy.<sup>19</sup> Thus, the debtor must be solvent and not in bankruptcy. The apparent reason is that insolvent debtors and those in bankruptcy have ample options for dealing with discharged debt.<sup>20</sup>

- The purchase price adjustment rule is open to related debtors and creditors, even those related as parent and child,<sup>21</sup> but it appears that the reduction in purchase price must have been based on direct, arms' length negotiations between the original buyer and the original seller.

- The reduction in basis is not elective;<sup>22</sup> if the requirements are met, the forgiven debt must be handled as a purchase price adjustment.<sup>23</sup>

### Rules for reduction of basis.

The reduction of basis under the purchase price adjustment provision as the purchase price is written down is governed by rules different from reduction of basis under the other discharge of indebtedness provisions.

- Investment tax credit recapture occurs to the debtor to the extent of the reduction in basis of the "qualified investment" in eligible investment tax credit property<sup>24</sup> *even though the time has otherwise run for recapture of investment tax credit on the property in question.* That is because the provision that protects against investment tax credit recapture on basis reduction because of discharge of debt<sup>25</sup> does not apply to a purchase price adjustment. Moreover, the holding period apparently is deemed to be "less than 3 years" so the investment tax credit is recaptured to the extent of the reduction in basis even though the time for recapture otherwise has passed.<sup>26</sup>

Example (2): Returning to Example (1), with a \$300,000 original purchase price reduced to \$200,000 in a purchase price adjustment, if the original transaction involved a \$60,000 allocation to a grain storage facility on which \$4200 of investment tax credit was claimed in 1978 at the then-applicable seven percent rate, a reduction of purchase price from \$300,000 to \$200,000 would be accompanied by a presumption that the original \$60,000 allocated to the grain storage facility had been reduced to \$40,000. That would cause recapture

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of investment tax credit on \$20,000 (a recapture amount of \$1400) even though the write-down of purchase price in 1990 occurs long after the expiration of the time for recapture otherwise on the 1978 transaction. Arguably, evidence could be adduced showing that the grain storage facility had dropped in value by a greater or lesser extent than the rest of the assets involved in the transaction.

- Debt reduction handled as a purchase price adjustment is not discharge of indebtedness income and the reduction in basis is not subject to later recapture under I.R.C. §§ 1245, 1250.<sup>27</sup> That is because the rules applying depreciation recapture treatment to basis reduction because of discharge of indebtedness do not apply to purchase price adjustment.<sup>28</sup>

- With the reduction in basis from purchase price adjustment, an adjustment must be made in depreciation claimed after the purchase price adjustment takes place.<sup>29</sup> Although the regulations have been issued only in proposed form, and at that under a prior version of the depreciation statute,<sup>30</sup> the rules applicable to redetermination of basis (including, specifically, redeterminations made necessary because of discharge of indebtedness<sup>31</sup>) specify that the recovery allowance after the basis write-down is determined by multiplying the "redetermined adjusted basis" by the "redetermined applicable percentage."<sup>32</sup> The effect of the redetermination rule is to reduce the depreciation deduction allowed to the taxpayer over each taxable year after the

write-down in proportion to the depreciation otherwise allowable.

A major question, however, is how to handle the calculations if depreciation already claimed has reduced the basis below the point where the purchase price adjustment can be made.

Example (3): Returning to Example (2), if the grain storage facility had been depreciated to zero by 1990, the basis of the facility obviously could not be reduced by \$20,000. In that event, there are two possibilities — (1) the taxpayer has \$20,000 of ordinary income to report (in order to permit a \$20,000 reduction of basis) or (2) the taxpayer reduces the basis of other assets in the transaction by the \$20,000 amount). While it is not completely clear which is the correct approach, it seems likely that IRS will insist on the first of the two possibilities.

**Consequences to the creditor.** A seller as creditor who agrees to a purchase price adjustment may have income from cancellation of the obligation.<sup>33</sup> A 1980 amendment to the installment sale rules specifies that —

*"...if any installment obligation is cancelled or otherwise becomes unenforceable —*

*"(1) the obligation shall be treated as if it were disposed of in a transaction other than a sale or exchange, and*

*"(2) if the obligor and obligee are related persons...the fair market value of the obligation shall be treated as not less than its face amount." [Id.]*

Thus, the cancelled or forgiven amount must generally be reported as though the amount had been received as payment.

If the parties are not related,<sup>34</sup> the gain is determined by the fair market value of the obligation.<sup>35</sup> Thus, if the value of the collateral falls, the fair market value of the obligation should likewise fall, thus reducing or eliminating the amount of gain, unless the debtor has sufficient assets to satisfy a deficiency judgment.

In the event the parties are related, the fair market value of the obligation is treated *as not less than its face amount*.<sup>36</sup> Thus, the most serious problem of income tax liability for sellers who forgive or cancel principal is where the seller and buyer are related.

Despite the relatively clear statutory language, the Internal Revenue Service has indicated in a private letter ruling that a seller cancelling indebtedness as part of a restructuring of an installment obligation to help a financially troubled buyer is not required to report income from the cancellation of indebtedness.<sup>37</sup> That ruling has been criticized<sup>38</sup> but recent informal statements by IRS indicate continued adherence to the basic thesis of the ruling that a seller does not recognize gain from cancellation of indebtedness to help a financially troubled debtor. The problem with the ruling is that it ignores the 1980 change in the statute requiring sellers to report income from cancellation or forgiveness of indebtedness<sup>39</sup> and cites to rulings issued in the 1950s and 1960s.

Therefore, some uncertainty continues over the seller's tax liability from cancellation or forgiveness of indebtedness.

## FOOTNOTES

<sup>1</sup> See Rev. Rul. 90-1, I.R.B. 1990-8, 5.

<sup>2</sup> I.R.C. §§ 108(a), (b), 108(b)(5).

<sup>3</sup> I.R.C. §§ 108(g).

<sup>4</sup> I.R.C. § 108(e)(5). See generally 4 Harl, Agricultural Law § 39.03[5] (1990).

<sup>5</sup> See I.R.C. § 108(e)(5).

<sup>6</sup> See I.R.C. § 108(e)(5).

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> See notes 24-32 *infra* and accompanying text.

<sup>10</sup> See I.R.C. § 453B(f). See also Ltr. Rul. 8739045, June 30, 1987.

<sup>11</sup> See notes 33-40 *infra* and accompanying text.

<sup>12</sup> I.R.C. § 61(a)(12).

<sup>13</sup> I.R.C. § 108(e)(5)(A).

<sup>14</sup> I.R.C. § 1038.

<sup>15</sup> Rev. Rul. 69-83, 1969-1 C.B. 202.

<sup>16</sup> Pub.L. 96-471, Sec. 4, 94 Stat. 2255 (1980).

<sup>17</sup> I.R.C. § 1038(g).

<sup>18</sup> Rev. Rul. 86-120, 1986-2 C.B. 145 (acquisition of the property by the shareholder did not restore the property to the original seller).

<sup>19</sup> I.R.C. § 108(e)(5)(B).

<sup>20</sup> See I.R.C. § 108(a),(b)(5).

<sup>21</sup> See I.R.C. § 108(e)(5).

<sup>22</sup> See *id.*

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

<sup>24</sup> See I.R.C. §§ 46(c)(1)(A), 46(c)(1)(B), 48(b), 48(c)(3)(B).

<sup>25</sup> I.R.C. § 1017(c)(2).

<sup>26</sup> See Treas. Reg. § 1.47-2(c)(1) (regulation has not been

amended to reflect more recent recapture rules).

<sup>27</sup> See I.R.C. §§ 1017(d), 1017(a).

<sup>28</sup> *Id.*

<sup>29</sup> I.R.C. § 168(d)(1)(B)(ii), before amendment by Tax Reform Act of 1986, Pub.L. 99-514, Sec. 201(a).

<sup>30</sup> See Prop. Treas. Reg. § 1.168-2(d)(3)(i).

<sup>31</sup> *Id.*

<sup>32</sup> Prop. Treas. Reg. § 1.168-2(d)(3).

<sup>33</sup> See I.R.C. § 453B(f).

<sup>34</sup> The relationship of the parties is determined by I.R.C. § 453(f)(1).

<sup>35</sup> I.R.C. §§ 453B(f)(1), 453B(a)(2).

<sup>36</sup> I.R.C. § 453B(f)(2).

<sup>37</sup> Ltr. Rul. 8739045, June 30, 1987.

<sup>38</sup> See Harl, "Forgiveness of Principal of Installment Obligations," 10 J. Agr. Tax'n & L. 67 (1988).

<sup>39</sup> See Installment Sales Revision Act of 1980, Pub.L. 96-471, Sec. 2(a), 94 Stat. 2253 (1980), enacting I.R.C. § 453B(f).