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Adjusting Basis for Discharged Debt

by Neil E. Harl*

The final step in handling discharged debt involves the reduction of the basis of the debtor's property¹ or of the debtor's depreciable property² if the debtor elects to reduce basis before reducing the other tax attributes.³ The *timing* of basis reduction is the same in all instances – basis is reduced at the beginning of the year after the year of debt discharge.⁴ The major concern with basis reduction is the order in which the debtor's assets are subject to basis reduction.⁵

General considerations. The problem of basis reduction is relatively simple if the debtor has no more than one asset. The basis of the asset is reduced dollar for dollar with respect to the discharged debt down to the amount of the debtor's liability on the property (when the debtor is insolvent or in bankruptcy)⁶ or to zero for solvent farm debtors⁷ and for debtors who elect to reduce the basis of depreciable property before reducing other tax attributes.⁸

If a taxpayer has more than one item of property eligible for basis reduction, the question is how basis reduction is allocated among the items of property. The statute specifies that the allocation of basis among assets is to be determined by regulation.⁹ The legislative history of the Bankruptcy Tax Act of 1980¹⁰ indicated that the order of basis reduction among property items was to be in accord with the existing regulations.¹¹

Under those regulations, money is excluded from basis reduction so there is no reduction of basis for cash, bank accounts or similar items.¹² Moreover,

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any reduction in basis is prohibited that would result in a negative basis for the property.¹³ Beyond those general guidelines, basis is reduced in accordance with specified guidelines for corporate and non-corporate taxpayers.

SPECIFIC GUIDELINES FOR BASIS REDUCTION.

Corporate taxpayers. The rules for basis reduction establish four categories of property for corporate debtors –¹⁴

- Non-inventory property acquired through incurrence of the cancelled debt.¹⁵

Example (1): A taxpayer is in financial trouble because of purchase of a new four-wheel drive tractor for \$80,000 in 1988. The remaining basis in the tractor would be reduced first if the indebtedness arising from the purchase is discharged.

- Non-inventory property which secures the cancelled debt.¹⁶

Example (2): If, in Example 1, the machinery dealer had acquired a security interest in the debtor's entire line of farm machinery and equipment at the time of the purchase of the four-wheel drive tractor, the rest of the machinery and equipment line would be subject to basis reduction after reduction of the basis for the tractor itself.

- Other non-inventory property.¹⁷

Example (3): Returning again to Example 1, if the debtor owns a pickup, which did not secure the discharged debt and did not give rise to the discharged debt, the remaining income tax basis in the pickup would be reduced next.

- Inventory and receivables.¹⁸

Example (4): If the taxpayer in Example 1 had purchased feeder cattle on hand at the time of basis reduction, and grain under CCC loan where the election had been made to treat CCC loans as income, thus giving the raised grain a basis,¹⁹ the basis reduction process would require the

reduction of basis of such items of inventory as well as a reduction of basis of notes or accounts receivable.

Non-corporate taxpayers (including individuals). For non-corporate or individual debtors, there are six categories of property for purposes of basis reduction in the event of discharged debt –²⁰

- Non-inventory property *used in the trade or business* acquired through incurrence of the cancelled debt.²¹ The similarity to the first rule applicable to corporate debtors is obvious except that the non-corporate rule is limited to property used in any trade or business of the debtor.²²

- Non-inventory property *used in the trade or business* securing the cancelled debt.²³ Again, the parallel to the corporate rule is clear except for the limitation to property used in any trade or business of the debtor.

- Other non-inventory property used in the trade or business.²⁴ This rule continues the trade or business limitation, thus distinguishing the individual or non-corporate debtor from corporate taxpayers.

- Inventory and receivables used in the trade or business.²⁵ This rule, in similar fashion, limits basis reduction to property "used in any trade or business" of the taxpayer.²⁶

- Property held for the production of income.²⁷ This provision *does not* specify that the property must be used in a trade or business of the debtor, merely that it be property held for the production of income.²⁸

- Other property.²⁹ This final rule governing basis reduction for individuals specifies merely that the assets be property *other than* property used in any trade or business of the debtor (thus ruling out the first four categories of property above) and property held for the production of income (ruling out property in category five above).³⁰

Handling basis reduction within and between categories. In general,

the regulations specify that basis reduction be allocated to property within each category, proceeding down the list of categories in order, with the basis of property in each category reduced before property in the next category is subjected to basis adjustment.³¹

Example (5): Returning to Example 1, if debt is discharged and \$60,000 is available for basis reduction, but only \$40,000 of basis on the four-wheel drive tractor is subject to basis reduction, \$40,000 of the basis reduction amount would be applied to the four-wheel drive tractor with the remaining \$20,000 carried over to the next category of property.

As an exception to the general rule that property is reduced category by category for corporate and non-corporate debtors, property in the third category for corporate and non-corporate taxpayers is subjected to basis adjustment before property in the second category *which is not depreciable, amortizable or depletable*.³² Within any category after the second category for both corporate and non-corporate debtors, if there are multiple assets, basis reduction is to be allocated among the assets *in proportion to their relative adjusted bases*.³³ This rule should be contrasted with the rules applicable elsewhere specifying an allocation of basis among multiple assets *on the basis of fair market value* of the assets.³⁴

Requesting approval for different procedure. A taxpayer may have the income tax basis of property adjusted in a different manner.³⁵ To be eligible for a different adjustment procedure, a request must be made to the Commissioner of Internal Revenue with the income tax return for the taxable year of the discharge of indebtedness.³⁶ The requested variation in adjustment method must be consistent

with the general principles of the regular method of adjustment.³⁷ The typical situation for seeking approval for a different adjustment approach is where the taxpayer has a relatively large number of assets subject to basis adjustment and to reduce the basis of each item would impose a substantial burden on the taxpayer.

The IRS has issued detailed guidance on the conditions to be met for a different adjustment procedure.³⁸ Under that guidance, found in *Rev. Proc. 85-44*,³⁹ IRS will not issue an advance ruling or enter into a closing agreement if it appears the taxpayer will gain a significant tax advantage by adjusting the basis of only selected assets.⁴⁰ An advance ruling or closing agreement may be obtained if the taxpayer is not insolvent or in bankruptcy, the discharged debt is not treated as a purchase price reduction,⁴¹ the taxpayer has no preconceived plan or intention to dispose of the assets, the selected assets are depreciable having a "weighted average remaining useful life" no longer than the weighted average remaining useful life of all the taxpayer's depreciable properties excluding fully depreciated assets, the taxpayer has sufficient bases to absorb the basis of adjustment, in no instance will basis be reduced below salvage value and the assets are not depreciable under the retirement-replacement-betterment method.⁴² In addition, the taxpayer must agree to treat basis reduction as ordinary income on later sale and to adjust depreciation claimed accordingly.⁴³ To date, about a dozen and a half letter rulings have been issued approving the use of the alternative adjustment procedures.⁴⁴

Planning principles. The intricate rules for income tax basis reduction suggest several "planning principles" to guide the debtor in planning for discharge of

indebtedness and reduction of basis of property.

- For planning purposes, where possible, it is generally advantageous to apply the basis reduction to Section 1250 property items and to Section 1250 property with relatively long depreciable lives and which are not expected to be disposed of in the foreseeable future. Keep in mind that reduction of basis is deemed to have occurred at the beginning of the taxable year following the taxable year in which the discharge of indebtedness occurs. This can be managed by disposing of Section 1245 property before the end of the taxable year in which the indebtedness was cancelled.

- Attention should be given to acquiring additional Section 1250 property, if possible and where advantageous, before the start of the following taxable year when basis reduction occurs.

- Similarly, it may be advantageous to delay acquisition of Section 1245 property until after the start of the following taxable year.

- If the indebtedness discharged was secured by a lien on property, the entire basis reduction amount (or as much of it as possible) is allocated to that property. Therefore, it may be important to dispose of that property, especially if it is Section 1245 property, before the close of the taxable year in which the discharge of indebtedness occurs.

- For solvent debtors to avoid income from discharge of indebtedness, attention should be given to acquiring sufficient property to absorb basis reduction before the end of the taxable year in which the discharge of indebtedness occurs if that would be advantageous.

FOOTNOTES

¹ I.R.C. § 1017(b)(2).

² I.R.C. § 1017(b)(3).

³ I.R.C. § 108(b)(5).

⁴ I.R.C. § 1017(a).

⁵ See 4 Harl, **Agricultural Law** § 39.03[6] (1990).

⁶ I.R.C. §§ 1017(b)(2), 108(a)(1)(A),(B).

⁷ I.R.C. §§ 108(g), 108(a)(1).

⁸ I.R.C. §§ 1017(b), 108(b)(5).

⁹ I.R.C. § 1017(b)(1).

¹⁰ Pub.L. 96-589, 94 Stat. 3389 (1980).

¹¹ See S. Rep. 96-1035, 96th Cong., 2d Sess. 15 (1980) (guidance to come from Treas. Reg. §§ 1.1017-1, 1.1017-2).

¹² Treas. Reg. § 1.1017-1.

¹³ *Id.*

¹⁴ Treas. Reg. § 1.1017-1(a)(1), (2),(3),(4).

¹⁵ Treas. Reg. § 1.1017-1(a)(1).

¹⁶ Treas. Reg. § 1.1017-1(a)(2).

¹⁷ Treas. Reg. § 1.1017-1(a)(3).

¹⁸ Treas. Reg. § 1.1017-1(a)(4).

¹⁹ I.R.C. § 77(a).

²⁰ Treas. Reg. § 1.1017-1(a)(1)-(6).

²¹ Treas. Reg. § 1.1017-1(a),(a)(1).

²² Treas. Reg. § 1.1017-1(a).

²³ Treas. Reg. § 1.1017-1(a),(a)(2).

²⁴ Treas. Reg. § 1.1017-1(a),(a)(3).

²⁵ Treas. Reg. § 1.1017-1(a),(a)(4).

²⁶ Treas. Reg. § 1.1017-1(a).

²⁷ Treas. Reg. § 1.1017-1(a)(5).

²⁸ *Id.*

²⁹ Treas. Reg. § 1.1017-1(a)(6).

³⁰ Treas. Reg. § 1.1017-1(a)(6).

³¹ Treas. Reg. § 1.1017-1(a).

³² Treas. Reg. § 1.1017-1(b)(7).

³³ Treas. Reg. § 1.1017-1(a)(3)-(6).

³⁴ See Treas. Reg. § 1.358-2(b) (allocation of basis between stock and securities on transfer of property to corporation in tax-free ex-change for transfers before October 2, 1989).

³⁵ Treas. Reg. § 1.1017-2(a).

³⁶ *Id.*

³⁷ *Id.*

³⁸ See Rev. Proc. 85-44, 1985-2 C.B. 504 (conditions under which IRS will issue advance rulings and closing letters permitting a variation from general rule).

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ See I.R.C. § 108(e)(5).

⁴² *Id.*

⁴³ *Id.*

⁴⁴ See, e.g., Ltr. Rul. 8840021, June 3, 1988.