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REDUCING BASIS IN DEBT RESTRUCTURINGS

— by Neil E. Harl*

Frequently, as part of debt restructuring where indebtedness is discharged, the income tax basis of part or all of the debtor's assets is to be reduced.¹ The procedures for reduction of basis vary some depending upon whether the discharge of indebtedness is in bankruptcy,² is for a debtor who is insolvent but not in bankruptcy,³ is for a solvent farm debtor,⁴ or involves a purchase price reduction.⁵ In some instances, the basis is reduced down to the aggregate indebtedness on the property;⁶ in other instances, notably when the election is made to reduce the basis of the depreciable property first,⁷ the basis is to be reduced to zero.⁸

Taxpayers are not permitted to pick and choose among assets in reducing basis. The sequence of basis reduction is prescribed in regulations⁹ with adjustment of each category on a pro rata basis. Thus, it is not possible to choose freely as to which items will have their basis reduced.

General Rules

The legislative history of the Bankruptcy Tax Act of 1980 indicates that the order of basis reduction among the various items of property is to be in accord with the existing regulations.¹⁰ Under the regulations, money, not surprisingly, is excluded from basis reduction.¹¹ Also, not surprisingly, any reduction in basis is prohibited that would result in a negative basis.¹²

Sequence of Basis Reduction

Corporate debtors. The basis reduction rules¹³ establish four categories of property for corporate debtors—

- Noninventory property acquired through the incurrence of the cancelled debt.

Example: a taxpayer got into financial trouble because of borrowing to purchase a four-wheel drive tractor. The tractor would be first in line to have its basis reduced.

- Non inventory property securing the cancelled debt.

Example: in the facts of the above example, if the lender financing the purchase of the four-wheel drive tractor obtained a security interest in the entire line of farm equipment, the basis of the line of equipment would be second in line for basis reduction.

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- Other non inventory property.

- Inventory and receivables.

Noncorporate debtors. For debtors other than corporation, the regulations identify six categories of property for basis reduction.

- Non inventory property *used in the trade or business* acquired through incurrence of the cancelled debt.

- Non inventory property *used in the trade or business* securing the cancelled debt.

- Other non inventory property *used in the trade or business*.

- Inventory and receivables *used in the trade or business*.

- Property held for the production of income.

- Other property.¹⁴

Rules applicable to both categories. In general, the rules require basis reduction to be allocated to property within each category, eliminating any remaining basis (eligible for basis reduction) in that property before property in the next category is subjected to basis adjustment.¹⁵

As an exception to the general rule, depreciable, amortizable or depletable property in the third category for corporate and noncorporate taxpayers is subject to basis adjustment before property in the second category which is not depreciable, amortizable or depletable.¹⁶ Within any particular category after the second category, if there are multiple assets, the reduction of basis is to be allocated among the assets *in proportion to relative adjusted bases*, not on the basis of relative fair market values.¹⁷

Special Procedure for Basis Reduction

A taxpayer may have the basis of property adjusted in a different manner upon approval of IRS on a request filed with the return for the taxable year of discharge of indebtedness.¹⁸ The requested variation in adjustment method must be consistent with the general principles of the regular adjustment, however.¹⁹ Under *Rev. Proc. 85-44*,²⁰ 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. An advance ruling or closing agreement may be obtained if — (1) the taxpayer is not insolvent or in bankruptcy,

(2) the discharged indebtedness is not treated as a purchase price reduction, (3) the taxpayer has no preconceived plan or intention to dispose of the assets, (4) 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, (5) the taxpayer has sufficient bases to absorb the basis adjustment, (6) in no instance will basis be reduced below salvage value and (7) the assets are not depreciable using the retirement-replacement-betterment method. In addition, the taxpayer must agree to treat basis reduction as ordinary income on later sale and to adjust depreciation subsequently claimed accordingly.²¹

Planning principles

Basis reduction is deemed to have occurred at the beginning of the taxable year following the taxable year in which the discharge of indebtedness occurs.²² That means, for most taxpayers, reduction of basis is carried out as of January 1 of the year following the year of debt discharge. This creates a "zone of manipulation" for debtors in terms of making advantageous adjustments in property ownership. The adjustments may involve —

- Disposal of property before the end of the taxable year in which the indebtedness is cancelled if it would be advantageous not to reduce the basis of those assets.
- Acquisition of additional property before the start of the taxable year following the year of debt discharge in order to absorb basis reduction and perhaps avoid recognition of income from discharge of indebtedness (which could happen with solvent debtors generally and even with solvent farm debtors).²³

- Delay in acquisition of property until after the start of the following taxable year.

- Giving special attention to property acquired through incurrence of the cancelled debt or securing the cancelled debt because those items are first and second in line for basis adjustment.

FOOTNOTES

- 1 See generally 4 Harl, *Agricultural Law* § 39.03[6] (1993).
- 2 I.R.C. § 108 (a)(1)(A).
- 3 I.R.C. § 108(a)(1)(B).
- 4 I.R.C. § 108(a)(1)(C).
- 5 I.R.C. § 108(e)(5).
- 6 I.R.C. § 1017[b][2].
- 7 I.R.C. § 108(b)(5).
- 8 I.R.C. § 1017(b)(2).
- 9 Treas. Reg. § 1.1017-1.
- 10 S. Rep. No. 96-1035, 96th Cong., 2d Sess. 15 (1980).
- 11 Treas. Reg. § 1.1017-1.
- 12 *Id.*
- 13 Treas. Reg. § 1.1017-1[a].
- 14 *Id.*
- 15 *Id.*
- 16 Treas. Reg. § 1.1017-1[b][7].
- 17 Treas. Reg. § 1.1017-1 [a][3].
- 18 Treas. Reg. § 1.1017-2(a).
- 19 Treas. Reg. § 1.1017-2. 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 the general rule).
- 20 1985-2 C.B. 504.
- 21 See, e.g., Ltr. Rul. 8544001, July 12, 1985. For a citation to other rulings approving special basis reduction, see 4 Harl, *supra* n. 1, § 39.03[6], n. 142.
- 22 I.R.C. §§ 1017(a), 108(b)(5)(B).
- 23 See I.R.C. § 108(g)(3)(D).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

CHAPTER 11

PLAN-ALM § 13.03[5].* The debtor operated a cattle ranch. The Farm Credit Bank (creditor) had two claims, one secured by land and the other an unsecured deficiency judgment resulting from foreclosure of other mortgages. The value of the debtor's assets exceeded the value of the total debts by 3 to 1. The debtor's plan (1) placed the creditor's unsecured claim in a separate class and provided for security of that claim from the debtor's cattle, and (2) provided for payment of the secured claim over 20 years at the contract rate of interest. Although the debtor had substantial losses in pre-petition years, the plan provided that plan payments would be made from the sales of cattle, including additional sales if necessary to meet monthly payments. The creditor objected to the plan in that (1) it was unfair to place the creditor's unsecured claim in a separate class, (2) the 20 year payment period was unfair, and (3) the debtor's pre-petition loss record demonstrated that the debtor could not meet the plan payments without liquidation

of the herd. The court upheld the plan, noting that the pre-petition losses were self-inflicted as the debtor attempted to increase the quality of the herd. The court also held that placement of the creditor's unsecured claim in a separate class was reasonable because of the security provided. The court also held that the 20 year payment period was not unfair in that the creditor had caused the bankruptcy filing in the first place by failing to negotiate a payment schedule with a debtor who had more than enough assets to secure the payments. *In re Shoeneberg*, 156 B.R. 963 (Bankr. W.D. Tex. 1993).

CHAPTER 12-ALM § 13.03[8]*

TRUSTEE FEES. The debtors' plan provided for annual \$1,500 payments for the trustee's fee; however, a standing trustee had been appointed in the district and the trustee objected to the plan because the plan did not include the statutory 10 percent fee. The debtors argued that the 10 percent fee was excessive in this case for the amount of effort and expenses incurred by the trustee. The debtors also argued that the court had the power to review the standing trustee's fee for reasonableness. The court held that it had