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TURN OVER OF ASSETS TO CREDITORS
by Neil E. Harl*

From 1983 to 1989, US agricultural debt dropped by about $60 billion1 as debts were discharged in bankruptcy, obligations were restructured with debt written off and property was deeded back to creditors.2 The resulting tax consequences created highly significant income tax burdens for debtors and contributed to various proposals for debtor relief from tax liability.3 However, except for relief from alternative minimum tax liability stemming from capital gains4 and a new solvent farm debtor rule for discharge of indebtedness,5 farm and ranch debtors were consigned to working through their debt problems within existing tax law.

Recourse debt. For property conveyed to creditors in satisfaction of recourse debt, the outcome has been relatively clear.6 A two-step procedure has been applied—
- Asset gain or loss is triggered from the transfer of property to the creditor, measured by the difference between the adjusted income tax basis of the property and its fair market value,7 and
- The difference between fair market value of the property and the amount of debt discharged is treated as discharge of indebtedness income to be reported by the debtor8 with the outcome dependent upon whether the debtor is insolvent, solvent or in bankruptcy.9 If the fair market value of

the property exceeds the unpaid balance of the debt, the excess is taxable to the creditor.10

In Rev. Rul. 90-16,11 IRS has re-affirmed the two-step procedure for recourse debt.

Nonrecourse debt. For nonrecourse debt, a one-step rule has been imposed.12 If the value of the property conveyed to a creditor is less than the unpaid balance of the discharged debt, the amount realized must be calculated by reference to the unpaid balance of the debt rather than by reference to the fair market value of the property.13 Thus, the entire difference between the income tax basis of the property conveyed and the amount of the debt is gain or loss from disposition of the property. The debtor realizes no discharge of indebtedness income.

The one-step calculation procedure for nonrecourse debt was prescribed by a 1983 U.S. Supreme Court decision, Commissioner v. Tufts.14 That case involved a determination of the amount realized from the sale of debt-encumbered property having a value substantially less than the nonrecourse encumbrance. Although the case involved a nonrecourse obligation, the court did not limit the holding to nonrecourse debt.

Most farm debt is recourse debt but nonrecourse obligations are not uncommon. Contracts of sale with the remedy limited to forfeiture are treated as nonrecourse debt.15 Commodity loans from the Commodity Credit Corporation are nonrecourse loans to the extent the debtor may pay off the loans with a sufficient amount of an eligible commodity having a price support value equal to the outstanding amount of the outstanding loan.16 However, CCC loans are a peculiar kind of nonrecourse loan for if an insufficient amount of commodity of acceptable quality (or a sufficient amount of unacceptable quality) is transferred, the debtor remains personally liable for any deficiency.17

A debtor in bankruptcy may encounter nonrecourse debt treatment where property subject to recourse debt is abandoned to the debtor.18 In a 1989 private letter ruling,19 the unsecured portion of a real estate mortgage was discharged in bankruptcy. The mortgage, however, survived the bankruptcy. IRS ruled that the taxpayer had to reduce income tax attributes by the amount of the mortgage discharged in bankruptcy, including reduction of the income tax basis of the mortgaged property. IRS further ruled that the taxpayer, upon foreclosure of the mortgage after abandonment, had to treat the entire remaining secured portion of the mortgage as proceeds of a nonrecourse loan (the personal liability of the debtor having been discharged in bankruptcy) and recognize gain to the extent the remaining mortgage exceeded the taxpayer’s basis in the property after the reduction for the discharge of indebtedness in bankruptcy.

When discharge occurs. A key question for income tax purposes is when discharge of indebtedness occurs. That depends upon whether the discharge occurs within bankruptcy or out of bankruptcy.
- In Chapter 7 bankruptcy, if no objection to discharge are sustained, indebtedness is discharged 60 days after the meeting of creditors at which the debtor appears and is examined under oath.19
- Under Chapter 11 bankruptcy, with some exceptions discharge occurs on confirmation of the plan of
reorganization as to debts arising before confirmation.\textsuperscript{20}  

- Under Chapter 12 bankruptcy, discharge occurs "as soon as practicable" after completion of payments under the plan.\textsuperscript{21}  That means, in most cases, discharge in Chapter 12 cases does not occur until three to five years after bankruptcy filing.\textsuperscript{22}  

- For Chapter 13 bankruptcy, discharge occurs upon completion of payments under the plan.\textsuperscript{22}  

For those not in bankruptcy, discharge generally occurs at the time of the definitive act discharging the debtor from liability. In some instances, debt was never discharged, only set aside, in which case a claim could be asserted later against the debtor until the statute of limitations runs on the obligation. A 1989 Court of Appeals case indicated that, in a foreclosure action, for accrual basis taxpayers discharge of indebtedness occurs when all appeals of the action have been exhausted.\textsuperscript{23}  

**Discharge of indebtedness as gift.** One exception to recognition of discharge of indebtedness as taxable income is where the discharge is intended as a gift.\textsuperscript{24}  However, that is a concept with very limited applicability except between closely related parties.\textsuperscript{25}  

**Discharge of indebtedness as self-employment income.** An important issue for farm debtors in recent years is whether discharged of indebtedness is subject to self-employment tax. In a 1976 revenue ruling,\textsuperscript{26} cancellation of part of an FmHA emergency loan was considered subject to self-employment tax. The *Farmer's Tax Guide*\textsuperscript{27} states that discharge of indebtedness income from farm debt is reported on Schedule F. That would make the discharged amount subject to self-employment tax. That would seem to be the correct treatment if the debt was related to the operation of a trade or business or business investment in which the taxpayer materially participates. Otherwise, it would seem that discharged debt would not be subject to self-employment tax.  

**FmHA position.** In a letter dated May 22, 1989,\textsuperscript{28} IRS took the position that debt was considered discharged even though subject to a recapture agreement or a shared appreciation agreement and might later be paid.\textsuperscript{29}  That position has been criticized by commentators as not reflective of existing law on the subject.\textsuperscript{30}  This author agrees with that criticism of the IRS position.  

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**FOOTNOTES**  
\textsuperscript{1} USDA, ERS, Economic Indicators of the Farm Sector, National Financial Summary, 1988, Oct. 1989.  
\textsuperscript{6} See 4 Harl, *supra* note 2, § 39.05[1].  
\textsuperscript{7} See Treas. Reg. § 1.1011-2(c), Ex. 8.  
\textsuperscript{9} *Id.* See I.R.C. § 108.  
\textsuperscript{10} See Rev. Rul. 68-523, 1968-2 C.B. 82 (amount by which value of property received in involuntary conveyance exceeds creditor's basis is includible in creditor's gross income).  
\textsuperscript{13} *Id.*  
\textsuperscript{14} 461 U.S. 300 (1983).  
\textsuperscript{15} See Treas. Reg. §§ 1.1038-1(d), 1.453-9(a).  
\textsuperscript{16} 7 C.F.R. § 1421.19(a).  
\textsuperscript{17} 7 C.F.R. § 1421.23(d).  
\textsuperscript{18} Ltr. Rul. 8918016, Jan. 31, 1989 (real property of Chapter 7 debtor abandoned to debtor).  
\textsuperscript{19} *Id.*  
\textsuperscript{20} Bkrcy. C. 89-1 U.S.T.C. ¶ 2782 (8th Cir. 1989) (accrual basis limited partners realized income from discharge of indebtedness in taxable year appeal of foreclosure action completed and not year of foreclosure sale).  
\textsuperscript{22} *Id.* See DiLaura v. Comm'r, T.C. Memo. 1987-291 (no evidence gift intended on discharge of indebtedness).  
\textsuperscript{25} Letter from Acting Chief Counsel, Peter K. Scott, Internal Revenue Service, to Chet Bailey, Farmer Program Division, Farmers Home Administration.  
\textsuperscript{27} See, e.g., Bock & Harris, *Farm Income Tax School Workbook* 209 (Univ. of Illinois, Nov. 1989).  

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**DEFERRAL OF FEDERAL DISASTER BENEFITS**  

In the January 19, 1990, *Agricultural Law Digest*, at page 33, we reported that Congress had not acted to permit deferral of benefits under the Disaster Assistance Act of 1989\textsuperscript{1} as had been done for the Disaster Assistance Act of 1988.\textsuperscript{2} Thus, benefits on the 1989 act received in 1989 were not deferrable to 1990 under the provision permitting crop insurance proceeds (and eligible federal disaster assistance act benefits) to be deferred to the following year by a farmer on the cash method of accounting if, under the taxpayer's