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**Recommended Citation**
Harl, Neil E. (1990) "Discharge of Indebtedness: For a Solvent Farm Debtor," *Agricultural Law Digest*: Vol. 1: No. 11, Article 1. Available at: [http://lib.dr.iastate.edu/aglawdigest/vol1/iss11/1](http://lib.dr.iastate.edu/aglawdigest/vol1/iss11/1)

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DISCHARGE OF INDEBTEDNESS: FOR A SOLVENT FARM DEBTOR

by Neil E. Harl*

Until 1987, a procedure was available for avoiding income tax for solvent debtors generally. That procedure involved an election to reduce the income tax basis of depreciable assets for qualified business indebtedness. However, that elective procedure was repealed in 1986 effective at the end of that year.

The statute was amended substantially in 1988. Eligibility requirements. Even though amended substantially in 1988, the solvent farm debtor rule is effective for discharges of indebtedness occurring after April 9, 1986, provided several requirements are met. To be eligible for the special provision, the discharge of indebtedness must arise from an agreement between a person engaged in "the trade or business of farming" and a "qualified person" to discharge "qualified farm indebtedness." Each of those requirements is important and is discussed below.

The 1988 amendments made it clear that an insolvent farm debtor first makes use of the rules for insolvent debtors and the rules for those in bankruptcy and only to the extent of solvency would be eligible for the solvent farm debtor provisions and then only if not in bankruptcy.

Qualified farm indebtedness. To be eligible to be treated as qualified farm indebtedness, the indebtedness must be incurred directly in connection with the operation by the taxpayer of the trade or business of farming and 50 percent or more of the average annual gross receipts of the taxpayer for the three preceding taxable years must be attributable to the trade or business of farming. The gross receipts test is applied on an aggregate basis over the three year period.

The statute does not define "gross receipts" for this purpose. However, informal communications to date from IRS indicate that a broad definition is envisioned, including gains from the sale or other taxable disposition of machinery, equipment, livestock and land as well as income from farm or ranch operations.

The term "trade or business" is likewise undefined. While farm operators would meet the test, and materially participating landlords should be eligible, a question is raised whether cash rent landlords would meet the test. A question exists as to whether non-material participation land owners would be eligible. In other settings, cash rent landlords and non-material participation share landlords have generally not been considered as involved in a trade or business.

Qualified person. Not only must the debtor meet certain requirements, the creditor must also pass a major hurdle for the debtor to be eligible for the solvent farm debtor rule. The creditor must be a "qualified person." That term is defined as someone, including state and federal agencies, who is "actively and regularly engaged in the business of lending money" and who is not — (1) related to the taxpayer, (2) a person from whom the taxpayer acquired the property (or a related person) or (3) a person who received a fee with respect to the taxpayer's investment in the property (or a related person). The definition of "related person" is to be determined as of the close of the taxable year and includes —

- Brothers and sisters, spouse, ancestors and lineal descendants.
- An individual and a corporation more than 10 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the individual and various combinations of controlled or related entities.
- A partnership and a person owning, directly or indirectly, more than 10 percent of the capital or profits interest in the partnership or two partnerships in which the same persons own, directly or indirectly, more than 10 percent of the capital or profits interest.
- Persons who are engaged in trades or businesses under common control.

Thus, discharged debts based on loans from parents, other close family members, neighbors or friends are not eligible. The requirement that the creditor be "actively and regularly engaged in the business of lending money" essentially limits the provision to institutional lenders. Moreover, not all institutional lenders are eligible. For example, if a debtor had purchased land from the Federal Land Bank, which financed the purchase, any later discharge of the debt would not be eligible for the solvent farm debtor rule because the land was acquired from the Federal Land Bank.

Ordering rules. Once the conditions of eligibility are satisfied, attention shifts to the rules for offsetting the discharge of indebtedness against the debtor's tax attributes and income tax basis of property. The procedure differs in several important respects from that prescribed for debtors in bankruptcy and insolvent debtors not in bankruptcy.

Tax attributes. The tax attributes are reduced first in the following order —

- Net operating losses for the taxable year and any carryover of losses to that year on a dollar-for-dollar basis.
- General business credits, including investment tax credits, for the taxable year and any carryover of credits to that year on a basis of 33-1/3 cents of credit offset-

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ting a dollar of discharge of indebtedness income. 27
• Capital losses for the taxable year and any carryover of capital losses to that year, 28 on a dollar-for-dollar basis. 29

Reduction of basis. After all of the above reductions have been accomplished, attention shifts to the reduction of the income tax basis of the debtor's property. 30 However, basis reduction is limited to property used in a trade or business or held for the production of income. 31 The order of basis reduction is specified —
• Depreciable property. 32
• Land used or held for use in the trade or business of farming. 33

• Other qualified property. 34 Although the statute is not clear on that point, the apparent intent is to include inventory property such as stored grain under CCC loan where the election has been made to treat the loan as income, thus giving the commodity a basis. 35 Technically, inventory property is neither property used in a trade or business nor held for the production of income. 36

A highly significant question is whether the reduction of basis is limited to the amount in excess of the aggregate liabilities (the rule applicable to insolvent debtors and those in bankruptcy) 37 or whether the income tax basis of assets is reduced to zero as is the case where the election is made to reduce the basis first before reducing the tax attributes. 38 Because the basis reduction rule limiting basis reduction to the debt on the property where the debtor is insolvent or in bankruptcy, it appears that basis is reduced to zero in instances involving a solvent farm debtor.

Foreign tax credit. The last reduction for discharged indebtedness is for the foreign tax credit 39 of which farm debtors usually have none.

Discharge of indebtedness exceeding tax attributes and basis. If the amount of discharge of indebtedness exceeds the amount offset by the debtor's tax attributes and the amount absorbed by reduction of income tax basis of property, the excess must be recognized as income. 40

FOOTNOTES
4 I.R.C. § 108(g), enacted by the Tax Reform Act of 1986, Sec. 405(a), 100 Stat. 2224 (1986).
6 Id., sec. 1004(c).
14 Id.
15 I.R.C. §§ 46(c)(8)(D)(iv), 108(g)(3).
16 I.R.C. §§ 46(c)(8)(D)(v).
20 I.R.C. §§ 465(b)(3)(C)(i), 52(a), (b).
21 See note supra.
31 I.R.C. §§ 1017(b)(4)(A)(i), (B), 108(g)(3)(C).
35 See I.R.C. § 77(a).
36 See note supra.
37 See I.R.C. § 1017(b)(2).
38 I.R.C. § 108(b)(5). See also I.R.C. § 1017(b)(2).

CASES, REGULATIONS AND STATUTES

ANIMALS

HORSES. The plaintiff was injured when thrown from a horse ridden at a resort stables. The stables argued assumption of risk defense. The court held that the assumption of risk defense was still available after adoption of comparative negligence by the California Supreme Court but that the trial court's granting of summary judgment for the defendant stables because the plaintiff assumed the risk that the horse might throw her was reversed. The court held that the plaintiff had not assumed the risk of being thrown by the particular horse, because the stables had not warned her that the horse had thrown a rider in the past. Harrold v. Rolling "J" Ranch, 734 Cal. Rptr. 734 (Cal. App. 1990).

The plaintiff, a nine year old boy, was injured from a kick by a horse while playing with the horse. The court held that the horse's owner was not liable for the injury because the plaintiff failed to show that the owner had actual or constructive notice of the horse's vicious nature. Williams v. Tysinger, 388 S.E.2d 616 (N.C. App. 1990). As part of a breeding agreement between the owner of a stallion and the owner of a mare, the owner of the mare agreed to pay the owner of the stallion $60,000 if the owner of the mare "elects to sell the mare prior to foaling." The court held that the mare owner's cataloging of the mare at a horse auction prior to foaling constituted an election to sell and ordered the owner of the mare to pay the nomination fee of $60,000 under the foaling agreement. Fried v. Picariello, 551 N.Y.S.2d 274 (App. Div. 1990).

BANKING

FAILURE TO MAKE LOAN. A farm debtor sued a production credit association for failure to make loans to enable the debtor to continue operating. The debtor alleged breach of contract, misrepresentation and negligence. The court held that the parties did not agree to a contract for the lending of money because the terms of the contract were not certain. The court held that the lender did not make any misrepresentations as to its conditions for making the loans and that the lender did