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FORGIVING PRINCIPAL IN A PURCHASE PRICE REDUCTION

— by Neil E. Harl

For purchasers of property unable to make payments as required by the obligation, a purchase price reduction may be a possible solution. If the debt of an original purchaser of property is reduced by the original seller of the property, the adjustment is treated as a purchase price adjustment and not as a discharge of indebtedness if the debtor is solvent.

Buyer’s Concerns

The most serious problems from the buyer’s point of view are that investment tax credit originally claimed on the property may be proportionately recaptured regardless of the elapsed time since the property was considered to have been placed in service by the buyer and an adjustment must be made in the buyer’s income tax basis for the property. If some assets have been depreciated out or depreciated below a level permitting a proportionate reduction in basis for all assets involved, the outcome is not completely clear. Neither the regulations nor the statute provide a direct answer to the question.

• One argument is that the taxpayer has income to the extent the basis reduction allocable to a depreciable item exceeds the basis in the item at the time of basis reduction.
• The other argument, under the assumption that relief provisions should be construed reasonably to achieve the relief objectives, is that the basis would be reduced using the relative adjusted basis figures at the time of basis reduction with relatively greater basis reduction for land and other nondepreciable assets.

Seller’s Income Tax Liability

A seller who agrees to a purchase price adjustment may have income from reduction of the obligation. That is because of the 1980 amendment specifying that cancellation or forgiveness of an installment obligation is treated as a disposition by the holder. If the obligor is a related party, the amount taken into account as a disposition triggering recognition of unreported gain attributable to the obligation is not less than the face amount of the installment obligation. Thus, the entire amount of reduction is treated as though received by the seller. In the event the parties are not related any gain is determined by the fair market value of the obligation. Presumably, the fair market value of the obligation would reflect the value of the underlying asset unless the buyer holds other assets reachable by creditors.

Despite the 1980 amendment, IRS nonetheless held in a 1987 private letter ruling that a seller agreeing to a purchase price reduction did not have recognizable gain where the forgiveness of principal was to help a financially troubled buyer. The ruling ignored the 1980 change in the law and instead cited to pre-1980 revenue rulings. That ruling has been criticized although the 1987 ruling continues to be the only statement of IRS position on the issue. Quite clearly, the 1987 ruling is highly favorable to sellers forgiving debt.

Use With Other Provisions

Neither the statute nor the regulations are clear as to whether purchase price reduction can be used in tandem with other relief provisions. In a 1990 private letter ruling, IRS approved a reduction of tax attributes under the insolvent debtor rule followed by a purchase price reduction. This ruling adds to the list of planning strategies available for use by taxpayers facing actual or imminent default on installment obligations.

FOOTNOTES

2 IRS has approved a reduction following a tax-free corporate exchange under I.R.C. § 351, however. Ltr. Rul. 9037033, June 18, 1990.
3 I.R.C. § 108(e)(5).
4 See Treas. Reg. § 1.47-2(c)(1). I.R.C. § 1017(c)(2) which protects against investment tax credit recapture does not apply to a purchase price reduction.

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BANKRUPTCY

GENERAL

DISCHARGE. The debtor failed to list a state income tax refund on the bankruptcy estate property schedules, including amended schedules and during creditors' examinations. The district court had held that the failure to list the property did not subject the debtor to denial of a discharge because the tax refunds were exempt property. The appellate court held that the exempt nature of the refunds was immaterial because the debtor never listed the property and never claimed an exemption. The appellate court denied the debtor's discharge because the failure was substantial, over $1,300, and repeated, demonstrating intent to omit the assets from the bankruptcy estate. Mertz v. Rott, 955 F.2d 596 (8th Cir. 1992).

EXEMPTIONS.

BUSINESS HOMESTEAD. The debtor operated a retail automotive parts business at two locations in the same city. The court held that the debtor was entitled to a business homestead exemption only as to one of the businesses under Tex. Const. art. XVI, § 51. In re Webb, 954 F.2d 1102 (5th Cir. 1992), rev'g unrep. D. Ct. dec. rev'g, 119 B.R. 114 (Bankr. N.D. Tex. 1990).

HOMESTEAD. The debtor owned a residence with a nondebtor spouse as tenants by the entireties. The debtor claimed the homestead exemption and sought to avoid a judicial lien against the homestead as impairing the homestead exemption. The court held that the debtor could not claim an exemption in the debtor's contingent survivorship interest in the residence where the trustee did not seek to sell the residence. In re Dick, 136 B.R. 1000 (Bankr. W.D. Tenn. 1992).

The debtors, husband and wife, owned a residence as tenants by the entireties and claimed the homestead exemption. The debtors sought to avoid a joint judicial lien against the homestead as impairing the homestead exemption. The court held that the judicial lien could be avoided. In re Maino, 136 B.R. 1006 (Bankr. W.D. Tenn. 1992).

The debtor and nondebtor spouse owned a residence as tenants by the entireties and the trustee sought to sell the house to obtain the debtor's share of the proceeds for the bankruptcy estate. The court allowed the sale because the debtor failed to provide any evidence of adverse effect upon the nondebtor spouse. In re Grabowski, 137 B.R. 1 (S.D. N.Y. 1992).


PROVISIONS. The Chapter 13 farm debtors claimed 2,400 bushels of corn as exempt under Neb. Rev. Stat. § 25-1556, as six months of provisions for the debtors' family. The court held that the corn did not qualify for the exemption because the corn would not be eaten by the family but sold for cash. Matter of Dana, 136 B.R. 813 (Bankr. D. Neb. 1990).

SETOFF. Warehouse creditors who had stored cotton owned by the debtor sought setoff of the proceeds of the cotton against storage and other costs resulting from the previous storage of the debtor’s cotton. The creditors argued that the cotton stored at the time of filing of bankruptcy represented a pre-petition debt to the debtor which could be setoff against the storage charges owed by the debtor to the creditors pre-petition. The court held that the warehouses were bailees of the cotton stored at the time of the bankruptcy filing; therefore, no debt was owed to the creditors pre-petition and no setoff was allowed. The court also denied recovery to the creditors under an equitable recoupment theory for the same reasons as denial of the setoff. In re Julien, 136 B.R. 765 (Bankr. W.D. Tenn. 1992).

CHAPTER 12

DISMISSAL. The debtor had filed a Chapter 12 plan and had received confirmation but had not completed the plan when the debtor filed a Chapter 11 case in another jurisdiction. The court held that the filing of a second case while an existing case was still open was not in good faith and dismissed the Chapter 11 case and imposed costs on the debtors. In re Befort, 137 B.R. 56 (Bankr. D. Kan. 1992).

SETTLEMENT. The Chapter 12 debtor reached an agreement in settlement of claims by a creditor bank and had the agreement read into the court record. After the debtor learned that the bank official with whom the debtor negotiated was sued by the bank for wrongful acts, the debtor moved for withdrawal of approval of the agreement. The court held that although the wrongful acts of the bank official may have made the agreement unfair to the debtor, the substantial costs to the estate and other creditors from rejecting the agreement required that the agreement be enforced. The court also found that the debtor had not