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DEFINITION OF “INSOLVENT”

— by Neil E. Harl

In handling discharge of indebtedness, the line between solvency and insolvency is of critical importance. If a debtor is insolvent, the debtor does not have discharge of indebtedness income although the debtor must “bleed” by reducing tax attributes and reducing the income tax basis of assets. In the event the debtor is solvent, with two exceptions, a debtor with discharge of indebtedness has ordinary income. Those exceptions are for real property business debt and qualified farm indebtedness.

A 1999 private letter ruling has signaled an important change in the position of the Internal Revenue Service on how to calculate solvency.

Calculating insolvency

The determination of solvency is made as of immediately before the discharge of indebtedness. Insolvency is defined as an “excess of liabilities over the fair market value of assets.” In making the calculation it appears that both tangible and intangible assets are included in the calculations. Both recourse and non-recourse liabilities are included in the insolvency computation but apparently contingent liabilities are not included. In a 1997 Tax Court case, a guarantee of partnership debt was treated as contingent debt and was not included in the debt total for purposes of the insolvency determination.

The separate assets of a debtor’s spouse are not included in determining the extent of insolvency.

Exempt property

The belief has been, for more than 50 years, that property exempt from creditors under state law was not included in the insolvency calculation. That conclusion, based on a 1941 Board of Tax Appeals case, was reinforced by three more recent Tax Court decisions and two private letter rulings issued in 1991. However, in a 1999 private letter ruling, one of the 1991 letter rulings was revoked and the Service indicated that it was changing its position on the issue. While it is unusual for IRS to announce a major change in position in a private letter ruling, it is not unprecedented. In 1983, for example, IRS signaled a change in position on whether special use valuation recapture was proportional in a letter ruling although that involved effectively only overruling a series of private letter rulings. It is much more unusual for a change in position to be announced in a private letter ruling where the new position was counter to four Tax Court decisions and two of the Service’s own private letter rulings.

So how did IRS justify the change in position? Basically, the Service said the statute was clear—it places no limitation on the assets that are taken into account in determining a taxpayer’s “insolvency.” Thus, the plain meaning of the statute would include all of the taxpayer’s assets in the insolvency calculations. Moreover, the

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legislative history does not provide clear guidance regarding the treatment of exempt assets for purposes of the insolvency definition.\textsuperscript{24} The Service, in a surprising move, stated that if the U.S. Supreme Court hasn't acknowledged or relied upon a position, a judicial position need not be considered in interpreting a statutory rule.\textsuperscript{25} The Service also pointed out that when Congress intended to exclude state-exempt assets, as in the Bankruptcy Code, it did so specifically.\textsuperscript{26} Finally, the Service pointed out that the revocation of the 1991 letter ruling\textsuperscript{27} applied to all open years under the statute of limitations unless IRS uses its discretionary authority\textsuperscript{28} to limit the retroactive effect of the revocation.\textsuperscript{29} The Service did not use the occasion to limit the retroactive effect.

Additional move

In a Field Service Advice letter ruling,\textsuperscript{30} issued six days after the key letter ruling signaling a change in position on the insolvency calculation,\textsuperscript{31} IRS took the position that assets owned in tenancy by the entirety by the taxpayer and spouse (where the spouse was not an obligor on the obligation in question) should be included in determining whether the taxpayer falls within the insolvency exception to the recognition of discharge of indebtedness income.\textsuperscript{32} The reasoning in the FSA paralleled the reasoning in the letter ruling indicating a change in the Service position\textsuperscript{33} and, in addition, noted that the wide disparity among state exemption statutes, particularly with respect to the residence, results in non-uniformity of tax treatment among taxpayers.\textsuperscript{34}

In conclusion

The key question is whether the new Service position will stand up in court. That seems doubtful in light of nearly 60 years of court decisions which have held to the contrary.

FOOTNOTES

5 I.R.C. § 108(c).
8 I.R.C. § 108(d)(3).
9 Id.
10 Merkel v. Comm’r, 109 T.C. 463 (1997), aff’d, 99-2 U.S. Tax Cas. (CCH) ¶ 50,848 (9th Cir. 1999).
11 Id.
14 Id.
21 4 Harl, supra n. 1, § 43.03[2][g][ii], footnotes 504-507.
23 Id.
24 Id.
25 Id.
28 I.R.C. § 7805(b).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.\textsuperscript{*}

EXEMPTIONS

HOMESTEAD. The Chapter 12 debtor was a farmer who grew strawberries and other fruits on a 30 acre parcel which included the debtor’s residence. The debtor claimed the parcel as an exempt rural homestead. The debtor had filed a liability lawsuit against a fungicide manufacturer, alleging that the fungicide contaminated the land so as to prevent the raising of fruit crops on the land. The parties reached a settlement and the debtor had received or would receive a substantial payment for damages to the debtor’s farm. The debtor used some of the proceeds, and planned to ultimately use all of the proceeds, for the rehabilitation of the farm. The debtor included the settlement proceeds in the rural homestead exemption, arguing that the settlement proceeds represented proceeds from the involuntary conversion of the farm. The court held that the settlement proceeds were included in the homestead exemption because the proceeds resulted from the involuntary conversion of the property and were to be used for the rehabilitation of the property. \textbf{In re Gilley}, 236 B.R. 441 (Bankr. M.D. Fla. 1999).

SECURED CLAIMS. The Chapter 12 debtor was a farmer who grew strawberries and other fruits on a 30 acre parcel which included the debtor’s residence. The farm was subject to a mortgage held by the FSA. The debtor had filed a liability lawsuit against a fungicide manufacturer, alleging that the

* Agricultural Law Manual (ALM).