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CALCULATING SOLVENCY: A NEW DEVELOPMENT
— by Neil E. Harl*

In handling discharge of indebtedness for income tax purposes, a highly important question is whether the taxpayer involved is solvent or insolvent. 1 Except for the solvent farm debtor rule, the provision for real property business debt and purchase price adjustment, 4 once a taxpayer becomes solvent, any further discharge of indebtedness produces ordinary income except for taxpayers in bankruptcy. 5 For an insolvent taxpayer, discharge of indebtedness is excluded from income although the taxpayer’s tax attributes and income tax basis of assets must be reduced. 7

General rules on determining solvency
The determination of solvency is made immediately before the discharge of indebtedness. 8 Insolvency is defined as an “excess of liabilities over the fair market value of assets.” 9

Both recourse and non-recourse liabilities are included in the insolvency computation although contingent liabilities are not included. 10 To determine the fact and extent of insolvency, an appraisal of assets may be necessary. In a 1989 Tax Court case, debtors were not allowed to use the insolvency rules where they failed to prove they were insolvent prior to the discharge of indebtedness. 11 The separate assets of a debtor’s spouse are not included in determining the extent of insolvency. 12

Exempt property
A major issue in recent months has been whether assets which are exempt from execution by creditors are included in the insolvency/solvency calculation. 13

Until 1999, the authority was compelling that exempt property was not included in the calculations of solvency or insolvency. 14 Beginning with a 1940 decision by the Board of Tax Appeals (the predecessor to the Tax Court), 15 and continuing through three more Tax Court decisions 16 and two Internal Revenue Service private letter rulings, 17 the authority clearly supported the exclusion of exempt property in calculating insolvency. However, in May of 1999, IRS signaled a change of position by revoking one private letter ruling 18 and issuing a pair of private letter rulings 19 and a Field Service Advice 20 stating that the prior IRS position had been in error and that exempt property should be included in the calculations.

Tax Court decision
On February 23, 2001, the U.S. Tax Court decided a case upholding the new IRS position announced in May of 1999. 21 In that case, Carlson v. Comm’r, 22 the value of a

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fishing permit, which was exempt under Alaska law to commercial fishermen, was not excluded from the taxpayer's assets in determining insolvency. The taxpayer had financed the purchase of a boat for $202,451, in 1988, with a bank loan. In 1993, when the loan balance stood at $137,142, the bank foreclosed on the boat. The boat was sold for $95,000 as part of the foreclosure. The bank discharged the remaining $42,142 on the loan. As a result of the foreclosure sale, the taxpayers realized capital gain of $28,621 and discharge of indebtedness income of $42,142.

In determining whether the discharge of indebtedness amount was income, the question was whether the taxpayer was solvent. The taxpayer had assets of $875,251 and liabilities of $515,930. However, the taxpayer’s “limited entry” fishing permit had a fair market value of $393,400 and was exempt from creditors under Alaska laws.

The taxpayer argued that exempt property should not count as “assets” for purposes of the insolvency determination with the result that the taxpayer would be insolvent and the discharge of indebtedness income of $42,142 would not be includible in income. The Internal Revenue Service took the position that the exclusion of exempt property from “assets” was a judicially-created exemption that had not been codified in I.R.C. § 108 in 1980 when enacted as part of the Bankruptcy Tax Act of 1980.

The Tax Court concluded that I.R.C. § 108(e)(1) (which states “there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness” except as provided in I.R.C. § 108(a)(1)(B)), eliminated the judicially-created exception for exempt property. This decision has important implications for farm and ranch estates where the value of exempt property is often $60,000 or more.

FOOTNOTES
2. I.R.C. § 108(g).
3. I.R.C. § 108(c).
10. Merkel v. Comm’r, 109 T.C. 463 (1997), aff’d, 192 F.3d 844 (9th Cir. 1999) (guarantee of partnership debt treated as contingent debt and not included in debts for purposes of insolvency determination).
22. Id.
25. Id.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

ADMINISTRATIVE EXPENSE. The debtor leased farm equipment from a creditor and was three months behind in the lease payments when the debtor filed for Chapter 11. The debtor continued to possess the equipment post-petition but made no use of the equipment. The case was later converted to Chapter 7 and the lessor obtained an order to reject the lease. The lessor sought an administrative expense claim in the Chapter 7 case for the lease payments incurred during the post-petition period of the Chapter 11 case. The trustee argued that the lease payments could not receive administrative claim priority because the estate did not benefit from the use of the equipment. The court held that, under Section 365(d)(10), the debtor was required to perform under the lease; therefore, the post-petition lease

*Agricultural Law Manual (ALM).