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Neil E. Harl

Iowa State University, harl@iastate.edu

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NEW RULES FOR SOLVENT FARM DEBTORS

— by Neil E. Harl*

The Revenue Reconciliation Act of 199320 made major changes in the handling of discharge of indebtedness income.2 The legislation repealed (effective in 1995) the stock-for-debt provision allowing insolvent debtors to issue stock in satisfaction of debt without creating discharge of indebtedness income,3 created a provision for discharge of real property business debt4 and added additional tax attributes to the list of those reduced from discharge of indebtedness.5 The latter provision applies to debtors in bankruptcy, those insolvent but not in bankruptcy and solvent farm debtors.6 The legislation continues the pattern established in 1986 of a different system of ordering the reduction of tax attributes and the reduction of basis of property for solvent farm debtors,7

Solvent farm debtor rule

For farm and ranch taxpayers, a major concern is how the tax attributes added to the list of those adjusted for discharge of indebtedness income affect solvent farm debtors.8 As a general rule, discharge of indebtedness is to be reported as ordinary income.9 However, exceptions are provided for debtors in bankruptcy,10 those insolvent but not in bankruptcy,11 solvent farm debtors,12 taxpayers receiving a discharge of qualified real property business indebtedness13 and discharge of indebtedness in connection with purchase price reduction.14

Under the solvent farm debtor rule, discharge of indebtedness arising from an agreement between a person engaged in the trade or business of farming15 and a qualified person16 to discharge "qualified farm indebtedness"17 is eligible for a special procedure for reduction of tax attributes and reduction of basis.18 The amount excluded from income is limited to the amount covered by the tax attributes reduced and the income tax basis of business and investment assets.19

Tax attributes added

The Revenue Reconciliation Act of 199320 added two tax attributes to the list of those eligible for reduction to offset discharge of indebtedness income.21 The new tax attributes are — (1) minimum tax credits as of the beginning of the taxable year immediately after the taxable year of the discharge and (2) passive activity loss and credit carryovers from the taxable year of the discharge.22

The minimum tax credit is allowed against a taxpayer's regular tax for the taxable year, for taxpayers who paid alternative minimum tax in a prior year.23 The minimum tax credit is generally the excess of (1) the sum of the minimum tax imposed for all prior taxable years following 1986 over (2) the amount allowed as a minimum tax credit for those prior taxable years.24 The Revenue Reconciliation Act of 1993 added minimum tax credits to the list of those eligible for reduction effective for discharges in taxable years beginning after December 31, 1993.25

The passive loss rules26 limit deductions and credits from passive trade or business activities.27 Deductions and credits suspended under these rules are carried forward to the next taxable year;28 suspended losses may be deducted when the taxpayer disposes of the entire interest in the passive activity to an unrelated person.29 The Revenue Reconciliation Act of 1993 added passive activity loss and credit carryovers to the list of those eligible for reduction from discharge of indebtedness income effective for discharges in taxable years beginning after December 31, 1993.30

New order of basis reduction

For qualified farm indebtedness, the new order of reduction of tax attributes is —

- Net operating losses for the taxable year and any carryover of losses to that year.31
- General business credits.32
- Minimum tax credits.33
- Capital losses for the taxable year and any carryover of capital losses to that year.34
- Passive activity loss and credit carryovers.35
- Foreign tax credits.36

Basis reduction

For purposes of basis reduction, property is limited to that used in a trade or business or held for the production of income.37 The order of basis reduction is specified —

- Depreciable property,
- Land used or held for use in the trade or business of farming,
- Other qualified property.38

The basis of property is reduced to zero under the solvent farm debtor rule.39

FOOTNOTES

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* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
In re determination of the IRS; therefore, because the debtor did not return after the debtor's net income is changed by a Code § 48-7-82(e)(1), clearly required the debtor to file a bankruptcy petition. The court held that the statute, Ga. 1987 state income tax return but the state filed a claim for federal income tax return. The debtor did not amend the resulting from understatement of income on the debtor's assessment against the debtor for additional 1987 taxes sum for the leasehold.

The court denied the claim because the son produced no competent evidence of the leasehold value, the lease had been breached and the son had already received a substantial payment of any rent and the court held that the lease had been breached by the son. The trustee had sold the property liquidated the business prior to the bankruptcy filing. The son operated a nursery on the land for several years but 7.7 acres of land to the debtor's son for rent of $10 per year. The IRS had issued a deficiency CLAIMS. The debtor had leased, under a 50 year lease, 7.7 acres of land to the debtor’s son for rent of $10 per year. The son sought further claims for the leasehold interest. The bank had leased, under a 50 year lease, 7.7 acres of land to the debtor's son for rent of $10 per year. The debtor stated that the homestead was to be sold with the proceeds divided between the parties. The house remained unsold at the time of the bankruptcy. The debtor moved out of the house and used the proceeds to pay off the mortgage on the property and to purchase some exempt annuities. The debtor tested that the purpose for purchasing the annuities was to provide income and to shield the proceeds from creditors. The court held that the conversion was impermissible pre-bankruptcy planning and disallowed the exemptions because the debtor had no idea when the annuities would provide income, the debtor consulted with an attorney before making the conversion and the debtor knew the bankruptcy consequences of the transactions. The court held that the conversion was impermissible pre-bankruptcy planning and disallowed the exemptions because the debtor had no idea when the annuities would provide income, the debtor consulted with an attorney before making the conversion and the debtor knew the bankruptcy consequences of the transactions. In re Aube, 158 B.R. 567 (Bankr. D. R.I. 1993).

DISCHARGE. The IRS had issued a deficiency assessment against the debtor for additional 1987 taxes resulting from understatement of income on the debtor’s federal income tax return. The debtor did not amend the 1987 state income tax return but the state filed a claim for additional taxes based upon the IRS assessment. The debtor argued that the state taxes were dischargeable because no return was required to be filed within three years before the bankruptcy filing. The court held that the statute, Ga. Code § 48-7-82(e)(1), clearly required the debtor to file a return after the debtor’s net income is changed by a determination of the IRS; therefore, because the debtor did not file an amended return, the taxes were nondischargeable. In re Mackey, 158 B.R. 509 (Bankr. M.D. Fla. 1993).

EXEMPTIONS-ALM § 13.03[3].*

AVOIDABLE LIENS. The court held that the debtor could not avoid a judgment lien on the debtor’s homestead because, under Colorado law, judgment liens cannot attach to homesteads. In re Shaff, 158 B.R. 224 (Bankr. D. Colo. 1993).

CONVERSION OF ASSETS. Prior to filing for bankruptcy, the debtor sold some non-exempt real property and used the proceeds to pay off the mortgage on the property and to purchase some exempt annuities. The debtor testified that the purpose for purchasing the annuities was to provide income and to shield the proceeds from creditors. The court held that the conversion was impermissible pre-bankruptcy planning and disallowed the exemptions because the debtor had no idea when the annuities would provide income, the debtor consulted with an attorney before making the conversion and the debtor knew the bankruptcy consequences of the transactions. In re Mackey, 158 B.R. 509 (Bankr. M.D. Fla. 1993).

HOMESTEAD. Under a divorce decree, the debtor’s homestead was to be sold with the proceeds divided between the parties. The house remained unsold at the time of the bankruptcy. The debtor moved out of the house and into an apartment in another city just prior to filing bankruptcy but the debtor’s son lived in the house at the time of the bankruptcy filing. The debtor stated that the debtor would return to the house only if the debtor could find a job in that city. The court denied the homestead exemption because the debtor had abandoned the house without intent to return. In re Mackey, 158 B.R. 509 (Bankr. M.D. Fla. 1993).