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MEETING THE TESTS FOR
THE SOLVENT FARM DEBTOR RULE

— by Neil E. Harl

In 1986, Congress enacted legislation allowing solvent farm debtors to avoid income from the discharge of indebtedness. The statute was amended substantially in 1988 to allow solvent farm debtors to exclude discharge of indebtedness amounts from income only to the extent tax attributes were reduced or the income tax basis of eligible property was reduced. In 1994, the first case to interpret the statute was decided by the Tax Court.

**Facts of the case**

In *Lawinger*, the taxpayer was a widow who had been operating a cow-calf farm with her husband until his death. After he died, she sold the livestock and machinery and rented the land to a tenant under a cash rent lease. The taxpayer was insolvent and was able to negotiate a restructuring with FmHA. An amount of $242,453 in principal was canceled in exchange for a new note of $42,752. Interest totaling $160,916 was also written off. At the time of the cancellation of indebtedness, the taxpayer was insolvent.

The taxpayer did not report any of the canceled debt as income, taking the position that the amount was covered by the insolvent debtor rule and the solvent farm debtor rule. The IRS agreed that the debtor was eligible to make use of the insolvent debtor rule up to the point of solvency but took the position that the debtor was ineligible for the solvent farm debtor rule.

**Solvent farm debtor rule**

Under the solvent farm debtor rule, discharge of indebtedness does not have to be reported as income for solvent farm debtors to the extent the debtor can reduce tax attributes or reduce the basis of property used in the trade or business or held for the production of income. To be eligible, the indebtedness must be "qualified farm indebtedness." To be 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.

In *Lawinger*, the issue was whether the taxpayer's income was properly considered to have come from the trade or business of farming. Specifically, IRS argued that the cash rent income under the lease did not meet the test, nor did the gain on sale of the machinery. Further, IRS took the position that amounts received under the Wisconsin Farmland Preservation Act did not count for purposes of the 50 percent test.

The Tax Court agreed with IRS that the cash rents and the Farmland Preservation Act payments were not gross income from farming but agreed with the taxpayer on the gain from sales of machinery. The court noted that the machinery had been used in the operation of the cow-calf farm and was properly considered part of "gross receipts." The Tax Court rejected the distinction urged by IRS that the sale of inventory (the beef animals) should be considered gross receipts but the sale of capital assets (such as the machinery and equipment) should not count for purposes of the 50 percent test.

Elsewhere, IRS and the Department of the Treasury have drawn a similar distinction successfully. For purposes of deductibility of soil and water conservation expenditures, the regulations state that the term "gross income derived from farming" is calculated under the taxpayer's regular accounting method and includes gains from the disposition of livestock held for draft, dairy, breeding or sporting purposes but does not include gains from other Section 1231 assets such as from farm machinery or land. IRS was unsuccessful without the backing of regulations in drawing much the same line for purposes of the solvent farm debtor rule.

Thus, in *Lawinger*, the taxpayer had income from the discharge of indebtedness after the discharge had made the taxpayer solvent. It should be noted that exempt property is not included in the insolvency calculations. Therefore, a debtor may be solvent by as much as the value of the exempt assets and still be viewed as insolvent for purposes of the insolvent debtor rule.
In conclusion

The Tax Court decision in Lawinger,21 is not surprising. The statute is remedial legislation and should be construed in a manner to enable qualified farm debtors to restructure their debt and to avoid recognition of income to the extent tax attributes and property basis can be reduced. Thus, the decision on gains from farm machinery and equipment represents a reasonable interpretation of the statute. Presumably, gains from the sales of land would be treated in the same manner.

A question remains as to income from a crop or livestock share lease of farmland. While a holding that cash rents are not income from the trade or business of farming is compatible with a long list of court decisions,22 land under crop share and livestock share leases has been held to be an interest in a closely held business for other purposes.23 Presumably, material participation share leases would be deemed to produce income eligible for the 50 percent test under the solvent farm debtor rule but the outcome of income under a non-material participation lease is less clear. Arguably, income from such leases should count for purposes of the 50 percent test but that outcome will await further court decisions.

FOOTNOTES


CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

DISCHARGE. The debtor was convicted, under N.D. Cent. Code § 12.1-23-02, of stealing four horses from a creditor. The creditor brought a civil court action to recover damages from the theft and the debtor filed for bankruptcy. The debtor sought to have the civil action damages declared dischargeable under 11 U.S.C. § 523(a)(6) because the thefts were not made with malice toward the creditor since the debtor did not intend to harm the creditor or the creditor’s property. The court held that Section 12.1-23-02 required proof of the debtor’s intent to deprive another of property; therefore, the first element, intent, of Section 523(a)(6) was met. The court held that the theft of the horses was malicious because the debtor knew or should have known that the theft of the horses would cause harm to the creditor; therefore, the damages awarded in the civil action were nondischargeable. In re Roehrich, 169 B.R. 941 (Bankr. D. N.D. 1994).

EXEMPTIONS

AVOIDABLE LIENS. The debtors sought to avoid a nonpurchase-money security interest in a handgun claimed as an exempt household good. The court held that the pistol was a household good and the lien was avoidable as impairing the exemption. The court adopted the definition of “household good” established in In re McGreeny, 955 F.2d 957 (4th Cir. 1992) as goods typically found around the home and used to facilitate the day-to-day living within the home. Thus, because a pistol is used in the home for protection, a pistol was a household good. Matter of Raines, 170 B.R. 187 (N.D. Ga. 1993), aff’d, 161 B.R. 548 (Bankr. N.D. Ga. 1993).

GROWING CROPS. On the date of the petition, the debtors owned growing crops worth about $14,000. The value of the crops did not exceed the amount of liens against the crops but the debtors claimed an exemption for “41 percent of growing crops” with a listed value of $5,950. The crops were sold post-petition for over $56,400, more than enough to pay the lien, any expenses and the exemption. The debtors claimed 41 percent of that amount as exempt. The court held that the debtors would be allowed an exemption based on the sale value of the crops but that the debtors’ exemption was limited to the dollar amount claimed of $5,950 because the debtor could not benefit from the post-petition appreciation of the crop. Matter of Sherbahn, 170 B.R. 137 (Bankr. N.D. Ind. 1994).

HOMESTEAD. The debtor’s estate included 140 acres of farmland, 60 acres of which was separated from the other acres by a graded road. The debtor claimed the entire 140 acres as an exempt homestead under Fla. Const. Art. X, § 4 which allowed a homestead exemption for up to 160 acres of contiguous farmland. The trustee objected to the

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.