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Forgiveness of Debt: Different Rules for Some Farmers and Ranchers

by Neil E. Harl*

The downturn in farm commodity prices has focused attention once again on forgiveness of debt or “discharge of indebtedness income.” For many practitioners (and many debtors and lenders) it is the first time since the 1980s to face significant problems in repaying debt on farm or ranch loans. The rules have remained largely unchanged over the past 25 years.

It is important to note that the rules on forgiveness of debt (or discharge of indebtedness) for farm or ranch taxpayers are significantly different from the rules applicable to other types of businesses. In general, if indebtedness is cancelled or forgiven, the amount cancelled or forgiven must be included in gross income as ordinary income. However, relief provisions are available, even for solvent taxpayers, under some circumstances.

Discharge of indebtedness for a solvent farm (or ranch) taxpayer

Under legislation enacted toward the end of the farm debt crisis of the 1980s, effective for discharges after April 9, 1986, discharges of indebtedness arising from an agreement between a person engaged in the trade or business of farming and a “qualified person” as lender to discharge “qualified farm indebtedness” is treated for federal income tax purposes under a special provision (if specified conditions are met). That “special provision” allows eligible taxpayers to reduce the income tax basis of certain types of property instead of reporting the amount as income which amounts to deferring the day of reckoning (which is the date of disposal of the property for which the income tax basis had been reduced).

Who is a “qualified person”? The “qualified person” requirement focuses on the lender involved. The “qualified person” is defined as someone, including state and federal agencies, who is “actively and regularly engaged in the business of lending money” and who is not (1) related to the taxpayer, (2) a person from whom the taxpayer acquired the property (or a related person) or (3) a person who receives a fee with respect to the taxpayer’s investment in the property (or a related person). The definition of “related person” is determined at the end of the taxable year and includes brothers, sisters, spouses and lineal descendants; an individual and a corporation more than 10 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the individual and various combinations of controlled or related entities. Also it includes a partnership and a person owning, directly or indirectly, more than 10 percent of the capital or profits.

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interest in the partnership or two partnerships in which the same persons own, directly or indirectly, more than 10 percent of the capital or profits interest and persons who are engaged in trades or businesses under common control.

What is “qualified farm indebtedness”? To be eligible to be treated as “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 gross receipts of the taxpayer for the three preceding taxable years must be attributable to the trade or business of farming. Note that the same Internal Revenue Code Section in extending the provision to other types of businesses, in defining “qualified property,” refers to property which is used or held for use “in a trade or business or for the production of income.” That broadens the scope of the provision to include cash rent landowners but that is not included in the subsection providing the rules for “qualified farm indebtedness” which is not extended to cash rent landowners.

How gain is avoided

Reduction of tax attributes. The 1986 provision assures avoidance of taxation on discharge of indebtedness (or forgiveness of indebtedness) by requiring a reduction of “tax attributes” (such as net operating losses for the year and any carryover of losses to that year) and by reduction of income tax basis on eligible property.

Reduction of income tax basis. After the tax attributes have been reduced, any remaining discharge of indebtedness is used to reduce the income tax basis of “qualified property” of the debtor. The term “qualified property” means any property which is used or is held for use in a trade or business or for the production of income for business and investment entities but the more narrow provision (trade or business of farming) applies elsewhere to farm indebtedness.

Order of basis reduction. The order of income tax basis reduction is (1) depreciable property, (2) land used or held for use in the trade or business of farming and (3) other qualified property. The rules under I.R.C. § 1017 state that the basis reduction is to apply the language in I.R.C. § 108(g)(3)(C) which states that the test is held for use in a trade or business or held for the production of income. That apparently includes cash rent landowners.

ENDNOTES

3 I.R.C. § 61(a)(12). See, e.g., Vukasovich, Inc. v. Comm’r, 790 F. 2d 1409 (9th Cir. 1986), aff’g in part, rev’g in part, T.C. Memo. 1984-611 (cancellation of indebtedness for less than amount owed resulted in ordinary income to debtor).
4 See I.R.C. § 108(g) (eligible farm and ranch taxpayers).
6 I.R.C. § 108(g).
7 I.R.C. § 108(g).
9 I.R.C. §§ 108(g)(1)(B).
16 I.R.C. § 108(g)(3).
17 I.R.C. § 108(g)(3).
18 I.R.C. § 108(g)(2).
22 I.R.C. § 108(g)(3)(C).
24 I.R.C. § 1017(b)(4).
25 I.R.C. § 1017(b)(4).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ADVERSE POSSESSION

EXCLUSIVE USE. The parties were neighbors who both engaged in crop farming on their land. Although the case originally involved five parcels of land between the farms, only two were in issue on appeal. The evidence included aerial photos of the disputed parcels showing the defendant’s planting of crops continuously from the defendant’s land onto the disputed parcels.

The defendant also testified as to the use of the disputed parcels and the trial court gave the defendant’s testimony more credibility than the plaintiff’s testimony. Although the plaintiff testified that the plaintiff used one parcel to turn around equipment, the court held that this occasional use was not sufficient to overcome the defendant’s continuous use of the parcel for raising crops. Therefore, the defendant was granted title to both parcels based on exclusive use of the parcels for crop farming. Johnson v. Fischer, 2016 Minn. App. Unpub. LEXIS 433 (Minn. Ct. App. 2016).