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Recourse and Non-recourse Debt: Differences in Loan Forgiveness

by Neil E. Harl

With farm commodity prices receding from the unusually high levels of 2012 and 2013, concerns are being voiced about loan forgiveness. We examined that issue in the May 27, 2016 issue. Another dimension of loan forgiveness that puzzles many is the difference in treatment between recourse and non-recourse loans.

What is the difference between recourse and non-recourse loans?

The difference, of course, is whether the creditor is limited to the property given as collateral (a non-recourse loan) or is free to seek satisfaction from other assets of the debtor (a recourse loan).

Recourse debt treatment. A taxpayer in 2016 transferred to a creditor an asset with a fair market value of $60,000 and the creditor discharged $75,000 of recourse indebtedness for which the taxpayer was personally liable. The taxpayer's income tax basis was $40,000. The $40,000 return of basis would be without income tax consequences. The difference between income tax basis and fair market value ($20,000) would be taxed as though the property were sold and may produce ordinary income or capital gain depending upon the nature of the asset involved. The transaction could trigger recapture consequences. As discussed in the May 27, 2016 issue of the Digest, an eligible farmer or rancher might be eligible to reduce tax attributes and defer taxability. Otherwise, the difference between the income tax basis and fair market value would be taxable at that time.

Non-recourse debt. As noted, non-recourse debt involves transactions where the creditor is limited to the property given as collateral and cannot seek satisfaction from other assets owned by the debtor. While non-recourse debt gained popularity in the 1970s, the inability of creditors to obtain satisfaction from other property caused a marked decline in its use. Nonetheless, non-recourse debt treatment may be encountered in farm and ranch debt workouts.

A contract of sale for farmland with the remedy limited to forfeiture of the land in question and with no rights to pursue other assets, would be a non-recourse debt.

Commodity loans from the Commodity Credit Corporation are non-recourse loans to the extent that the debtor may pay off the loan with a sufficient amount of an eligible

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commodity having a price support value equal to the outstanding value of the loan. If insufficient commodity of acceptable quality is transferred, the debtor is still personally liable for any deficiency.

A debtor in bankruptcy may encounter non-recourse treatment where property subject to recourse debt has been abandoned back to the debtor. The bankruptcy process strips off the recourse debt character and the obligation becomes non-recourse.

**Special attention to LLC debt**

Under the regulations, the debt of a limited liability company (an LLC) is generally characterized as non-recourse for purposes of the partnership regulations. That is because no member of the LLC bears the economic risk of loss for the debt, thanks to limited liability. Four exceptions are recognized for purposes of the partnership regulations.

Although it is not completely clear, it appears that the partnership regulations may not apply to the handling of non-recourse debt under I.R.C. § 108 and 1001. This is discussed in more detail in the July 10, 2015, issue of the Digest.

However, even more importantly, although it is not completely clear, it appears that the partnership regulations do not apply to the handling of non-recourse debt under I.R.C. § 108 (income from discharge of indebtedness) and § 1001 (determination of the amount of recognition of gain or loss). That was discussed in some detail in the July 10, 2015 issue of the Digest.

**ENDNOTES**


4  See Treas. Reg. § 1.1001-2(c), Example 8.


6  7 C.F.R. § 1421.19(a).

7  7 C.F.R. § 1421.23(d).

8  Ltr. Rul. 8918016, Jan. 31, 1989 (real property was abandoned back to the debtor with the unsecured portion of the mortgage discharged in bankruptcy; the mortgage, however, survived the bankruptcy).

9  Treas. Reg. § 1.752-1, -2.

10  Treas. Reg. § 1.752-2(c)(1).

