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# **Tax Implications of Liquidating a Farm Operation After the Tax Reform Act of 1986**

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### Acknowledgments

This publication updates a report that was prepared before Congress enacted the Tax Reform Act of 1986. Numerous changes resulting from that legislation significantly alter the emphasis among tax provisions affecting the liquidation of a farm business and necessitates this revision.

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### Highlights

This publication reviews many of the possible tax consequences of disposing of farm business assets. These tax effects can be significant for owners of farm businesses, both in and out of financial difficulty. Tax planning can reduce the adverse effect.

A tax obligation may result from several situations:

- Taxable gains from the disposal of business assets for more than their tax basis. For example, land that is now worth more than its value at acquisition will produce a taxable gain upon its transfer.
- Partial or total payback (recapture) of investment tax credits on qualified property when those assets have not remained in the business long enough to meet the required holding periods.
- Taxation of forgiven debt. Forgiven (discharged) indebtedness is generally taxable as ordinary income except if 1) paying the debt would have resulted in a deductible expenditure, or 2) the debtor is insolvent or has filed for bankruptcy. There also is an exception for solvent farmers who are discharged from a business debt. Though the exceptions appear to outnumber the rule, some taxpayers may find that they owe tax on forgiven debt.
- Taxes arising from cancellation of a contract for deed. Cancellation of a contract for deed poses potential tax liabilities not only for the indebted farmer but also for the seller of the land who reacquires it.
- Recalculation of estate taxes. Persons who dispose of business property that they inherited from an estate that elected to use the Special Use Valuation or Installment Payment provisions of estate tax law may be required to pay an additional Federal estate tax if the assets have not been held for the required number of years.

There are tax features that can reduce taxes in liquidation situations. The availability of credits, losses, and exclusions may reduce or eliminate a farm operator's tax obligation. Also, there are several strategies for minimizing the amount of tax that needs to be paid by a liquidating farmer. However, without adequate understanding and planning, many farmers have found themselves owing substantial tax bills after all the farm assets have been disposed of to satisfy creditors.

*In this publication, we examine many of the tax liabilities that may arise upon liquidation of the farm business. Options available to reduce these liabilities are also presented. Numerous examples are provided to alert farmers and their tax advisors of the need for serious thinking and planning. Some conclusions from this publication are the following:*

- FARMERS ANTICIPATING LIQUIDATION NEED TO ACT.*
- FINDING AND USING A QUALIFIED TAX ADVISOR PRIOR TO AND DURING LIQUIDATION ARE LIKELY TO BE TWO OF THE MOST IMPORTANT FARM MANAGEMENT DECISIONS MADE DURING THE COURSE OF THE BUSINESS.*
- TIMING IS CRITICAL. THE PRICE OF WAITING, IN TAX MATTERS, CAN BE HIGH.*
- POTENTIAL PAYOFFS FROM GOOD TAX PLANNING COUNT IN BOTH DOLLARS AND PEACE OF MIND.*

TAX IMPLICATIONS OF LIQUIDATING A FARM OPERATION  
AFTER THE TAX REFORM ACT OF 1986

David M. Saxowsky, Philip E. Harris, and W. Allan Tinsley\*

Financial stress among some agricultural operators is pressuring them to adjust or terminate their farm business. A strategy for these farmers is to voluntarily reduce the scale of their operation. This is usually done by selling some equipment, land, or other property used in the farm business. Other times, reduction is involuntary when unpaid creditors attempt to collect payment, either by forcing a sale through foreclosure or pressuring an operator to liquidate. As an alternative, some creditors are willing to accept a transfer of property in exchange for reducing the amount of indebtedness, rather than have the debtor sell it and remit the proceeds.

Reducing scale of operation, whether by voluntary or forced sale or by transferring ownership to a creditor, can lead to an unexpected consequence of taxes. Voluntary and involuntary sales of assets or exchange of property for a reduction of indebtedness are likely to generate taxable income. This report summarizes some Federal income tax implications of partial or complete liquidation of a farm business. Its purpose is to provide an awareness of a problem that often is seen as secondary in comparison to concerns about satisfying unpaid creditors and that receives little or no attention until it is too late. Provisions of tax law discussed in this report generally apply whether the sale is voluntary, involuntary, or the result of foreclosure.

This explanation also clarifies how operators can end up with a tax liability even though they are having financial difficulty, have no cash left over after liquidating some business assets (for example, the proceeds were used to pay creditors or no cash was received), or have deductions and carry-overs of tax credits or losses.

Operators unaware of taxes resulting from liquidation can be frustrated to learn that sale proceeds are insufficient to pay both outstanding debt and resulting income taxes. Lack of awareness may be promoted by balance sheet preparation and interpretation. Balance sheets summarize the value of all assets owned by farmers, all obligations owed by farmers, and their net worth or equity—the difference between asset values and debts. Tax consequences of liquidating are seldom considered in calculating an operator's net worth. Accordingly, balance sheets are likely to overstate a farmer's net worth after liquidation. Similarly, operators liquidating to repay debt often will need to sell property valued in excess of the indebtedness to generate cash sufficient to pay both the debt and accompanying income taxes. Therefore, in determining how much and which assets to liquidate, a farmer needs to consider the after-tax proceeds rather than the anticipated selling price. An example follows.

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Example: A farmer owning land determines that the mortgage and several years of unpaid interest now total the market value of \$450 per acre. It appears that the proceeds from selling the land will be sufficient to meet the debt. However, if the land had been purchased years ago at a low price (\$50 per acre) and the farmer is in the 28- percent tax bracket due to the land sale, Federal income tax may be as much as \$112 per acre. After-tax proceeds per acre would be less than \$350, leaving the farmer unable to fully repay the mortgage.

Income tax liabilities resulting from liquidation after 1986 primarily arise from three features of Federal law. These are (1) capital gains, (2) recapture of investment tax credit, and (3) income from discharge of indebtedness. Liquidation also may trigger recapture of estate tax savings. Cancelling a contract for deed may result in a tax obligation for the seller. Each of these features is explained in more detail in the following sections. Several means of managing taxes upon liquidation are suggested in the final section.

The explanation and examples in this report are in terms of indebted operators. However, these provisions also apply to persons who liquidate for other than financial reasons. For example, a retiring couple who sell their farm business should be aware of potential tax liability as a consequence of capital gains, and recapture of investment tax credit.

Tax law does not distinguish between a forced or foreclosure sale and a voluntary sale. The tax implications are similar regardless of the reason for selling. Likewise, farmers who transfer land or equipment to creditors in exchange for a reduction of indebtedness are likely to encounter many of the same tax ramifications as those who sell. Most examples in this report will illustrate tax implications for operators who were foreclosed or who conveyed property to a creditor rather than selling it and using the proceeds to reduce a debt.

This report updates a publication prepared before enactment of the Tax Reform Act of 1986 in late October of that year. The explanations presented here presume that the sale or conveyance occurred after December 31, 1986 and that most recent statutory changes are in effect. The intent is to introduce possible tax considerations when liquidating a farm after 1986 and to minimize comparing current and past laws (even though some comparisons are made). The earlier report should be referred to for discussion of tax consequences of liquidating before 1987. Single copies are available at no charge by writing Department of Agricultural Economics, P.O. Box 5636, North Dakota State University, Fargo, ND 58105 or calling 701-237-7441. Please specify that the request is for a copy of "Tax Implications of Liquidating A Farm Operation," dated November 1986.

### Capital Gains

Liquidation implies that an operator is selling or otherwise conveying assets used in the farm business. This may be land, equipment, buildings, or livestock used for breeding purposes.<sup>1</sup> Selling this property for more than its basis (cost for tax purposes) will produce a profit or taxable gain according to Federal tax law. That gain—the difference between the amount received from sale of the property and its basis—must be included in taxable income.

Example: A farmer who purchased land in 1975 for \$350 per acre which is sold today for \$425 will realize a taxable gain of \$75 ( $\$425 - \$350$ ) per acre.

Taxable gain can be burdensome for property with low basis relative to its current value. Basis is a way of measuring one's cost in property for tax purposes. For example, breeding livestock has a low basis (often zero dollars) if it was raised by a farmer who uses the cash method of accounting. Similarly, sale of land acquired years ago at a low cost can result in a rather substantial taxable gain. Equipment, machinery, and purchased breeding livestock also may have a low basis because it was adjusted downward as depreciation was claimed over the years. Business property received as gifts from parents or others also tend to have a low basis because a donor's cost (basis) is carried over to the donee regardless of the asset's value at time of the gift. Therefore, liquidation of a major portion of a farm operation may dramatically increase a debtor's taxable income.

Example: Land which was purchased for \$50 in 1960 and sold for \$400 in 1985 produces a gain of \$350 ( $\$400 - \$50$ ) per acre. Sale of a quarter-section (160 acres) of farmland would increase taxable income by \$56,000 ( $160 \times \$350$ ).

### Assumption of Debt

A common practice is for a buyer to assume responsibility for repaying a seller's debts, rather than paying cash for the property. This alternative is especially desirable when the creditor is willing to accept the buyer as the debtor while releasing the seller from any further

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<sup>1</sup> Proceeds from sale of grain, livestock held for resale, or other items of inventory held for resale are ordinary income, and the entire amount realized is generally subject to taxation. The level of ordinary income will be substantial for operators who have stored several years of production and are now totally liquidating. Similarly, operators who acquired Commodity Credit Corporation loans but did not report the proceeds as income may be forced to report income from several years of production in a single tax year. This report, however, emphasizes the consequence of liquidating assets used in operation of a farm rather than sale of inventory.

personal liability. This alternative, however, will not reduce a seller's tax liability because the amount realized from sale of property includes debt assumed by a purchaser. Consequently, there can be a tax liability even though no cash is received.

Example: Land purchased for \$50 but subject to a mortgage of \$450 per acre will be considered for tax purposes as sold for \$450 per acre if a buyer acquires the land by assuming the entire debt. The operator will have realized a gain of \$400 per acre even though the transaction did not involve a cash payment.

### Marginal Rate on Long-Term Capital Gains

Prior to 1987, the long-term capital gain exclusion permitted a tax reduction for taxpayers who owned business assets for a minimum length of time. The savings arose when a portion of the gain was excluded from taxable income; that is, a seller was required to pay tax on only a portion of the gain rather than the total gain. The Tax Reform Act of 1986 removed this tax savings by reducing the percent of gain that can be excluded to zero. For many practical purposes, there no longer exists a difference between gain that is considered long-term capital and other income. All taxable income is subject to the same tax rates.

Removal of the exclusion increased the tax liability for persons with substantial amounts of capital gain. Prior to 1987, the maximum tax bracket was 50 percent and long-term capital gain treatment excluded 60 percent of the gain. Accordingly, the maximum tax rate for long-term capital gain was 20 percent ( $.50 \times (1 - .6)$ ). The new tax rate structure specifies two marginal tax rates; 15 percent and 28 percent. The law, however, mandates that beginning in 1988, a surtax of 5 percent will be imposed on persons with relatively high taxable income. The surtax effectively establishes a third tax bracket of 33 percent. Therefore, the maximum rate for long-term capital gains after 1987 is 33 percent; a transition rule sets 28 percent as the maximum rate for long-term capital gains in 1987.

Generally, individuals who began farming several decades ago (and purchased their land at that time) are more likely to encounter the higher tax rates than persons who bought land during the past decade. This outcome is due to higher land prices during the late 1970s which means a higher basis and less gain if it sells for the same price as land purchased years earlier at a lower cost.

Technically, long-term capital gain remains part of federal income tax law; the 1986 Act only eliminated the exclusion. Legislative history indicates that Congress retained the statutory structure so a favorable long-term capital gain treatment could be reinstated with relative ease. Consequently, several important distinctions exist between long-term capital gain and other income. These are briefly explained in the following paragraphs.

### Installment Sale of Depreciable Property

Current tax law offers a seller an opportunity to reduce the impact of capital gains from sale of property by reporting the income under the installment sale method. This method allows a seller who is willing to receive sale proceeds over several years, to report a portion of the total gain each year as payments are received rather than reporting all of the gain in the year of sale.

Two potential drawbacks may limit application of this strategy, however. First, financially distressed farmers may not be able to accept being paid in installments since they usually need the proceeds immediately to pay outstanding obligations.

A second disadvantage arises when the sale involves depreciable property such as equipment, machinery, and purchased breeding livestock. Sellers are required to report in the year of sale any income that is considered recaptured depreciation even if the payment will not be received until a later year. This requirement is best understood by briefly reviewing the concept of recapturing depreciation.

Prior to 1987, recapture of depreciation converted apparent long-term capital gain from the sale of depreciable property to ordinary income. The purpose of recapture was to adjust for depreciation deducted in past years that reduced ordinary income. The adjustment was made by treating gain from the sale of the property (to the extent depreciation had been claimed) as ordinary income. Without recapture, tax law would have permitted a taxpayer to reduce ordinary income with depreciation deductions and benefit from long-term capital gain. Recapturing "plugged a loophole" in Federal tax law.

Elimination of the long-term capital exclusion de-emphasizes the tax consequence of recapturing depreciation; that is, as long as there is no long-term capital gain exclusion, a farmer's tax liability will be the same whether income from the sale of depreciable property is considered recaptured depreciation or capital gain. Accordingly, this publication does not detail the rules for recapturing depreciation and for simplicity, discusses it as if it were capital gain.<sup>2</sup> The concept of recapturing depreciation, however, remains part of federal income tax law and has some limited practical implications. First, recaptured depreciation will continue to be identified and reported on IRS Form 4797. More importantly, it affects the taxation of gain resulting from the installment sale of depreciable property.

Congress recognized that a person who sells on an installment basis would not report the income for several years while the buyer would be deducting depreciation on the property. Therefore, Congress amended the law in 1984 to require taxpayers to recapture depreciation in the year of the

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<sup>2</sup> A more complete explanation of depreciation recapture is presented in the earlier version of this report which is available as explained on page 2.

sale even though payment may not be received that year. That rule is still in effect. Consequently, treating gain as ordinary income rather than capital gains causes the gain realized on an installment sale to be recognized in the year of the sale rather than as the payments are received. This may not only cause a substantial amount of income to be taxed in a single year and possibly trigger the surtax, but it also can be detrimental to a taxpayer who must pay the tax even though the cash income has not yet been received.

### Self-Employment Taxes

Repeal of long-term capital gain exclusion did not alter the characterization of the income. It remains "unearned" income and not subject to self-employment tax.

### Section 1231 Property

Repeal of the long-term capital gain exclusion did not alter the definition of capital assets nor the fact that most farm assets fit within the definition of Section 1231. This can be advantageous for a taxpayer when disposition results in a loss; that is, the selling price is less than the property's basis.

Section 1231 property includes farm machinery, equipment, buildings, and land. Technically, these items are not capital assets according to Federal income tax law; examples of capital assets would be shares in a corporation or precious metals held for investment. The primary distinction between capital assets and Section 1231 property is the tax treatment of losses that arise from their disposition.

Loss on disposition of a capital asset is offset against capital gain. The remaining loss is then deducted from other taxable income but no more than \$3,000 per year. Capital loss in excess of \$3,000 is carried forward to other tax years. Gain and loss from disposition of Section 1231 property, like capital assets, are offset against one another. However, the deductibility limit does not apply to a net Section 1231 loss as it does to a capital loss; an entire Section 1231 loss may be deducted. This beneficial treatment is important to farmers since most assets used in a farm operation are defined as section 1231 property.

Example: Land purchased for \$450 per acre in 1981 is sold for \$300 per acre. The farmer incurred a \$150 loss per acre. If the tract encompassed 160 acres, the farmer would be entitled to a deduction of \$24,000 ( $\$150 \times 160$ ) against ordinary income.

Example: Land purchased for \$450 per acre is sold for \$600 per acre. The farmer realizes a gain of \$150 per acre. This gain, like income from a capital asset, is not subject to self-employment tax and can be offset by capital losses.

Example: A pickup truck was purchased in January 1985 for \$10,000. After depreciation is deducted for years 1985 through 1987, its adjusted basis is \$4,100. Selling it for \$3,800 in 1988 will result in a loss of \$300. The farmer can deduct the full amount. Recapture of investment credit (discussed in the next section) must be addressed whether the disposition produces a gain or a loss.

Example: A farmer sold a farm operation during 1988. One tract of land resulted in a gain of \$25,000 while a second tract resulted in a loss of \$30,000. A combine was sold at a loss of \$2,000 while several other pieces of equipment and breeding livestock that had been purchased generated a gain of \$3,000. For purposes of section 1231 for 1988, this operator would have an overall loss of \$4,000, which can be used to offset other income.

|                             | <u>Dollars</u> |
|-----------------------------|----------------|
| Tract 1                     | 25,000         |
| Tract 2                     | -30,000        |
| Combine                     | -2,000         |
| Other section 1231 property | <u>3,000</u>   |
|                             | - 4,000        |

Should Section 1231 losses exceed a farmer's other taxable income and thereby result in a negative adjusted gross income, the taxpayer may carry the loss over to other tax years as a net operating loss.

If a taxpayer had Section 1231 losses in the previous five years, a net Section 1231 gain will be treated like ordinary income rather than as capital gains. However, this requirement is of little practical relevance as long as the long-term capital gain exclusion remains at zero.

### Sale of a Residence

The tax burden resulting from capital gains may be somewhat reduced by taking advantage of several tax law provisions pertaining to the sale of a residence. Taxpayers may postpone recognizing gain on sale of a principal residence if another is purchased within 2 years. Also, taxpayers over the age of 55 years may obtain a one-time exclusion of up to \$125,000 of gain on the sale of a personal residence if certain other requirements are met. The law is rather clear that a house on a farm will qualify for these provisions. It is important to recognize, however, that for tax purposes a residence is not the same as a homestead under State law exemptions. A residence is limited to the house and yard immediately surrounding it, whereas a homestead may encompass many acres, depending on State law. The tax provisions apply only to the residence.

### Recently Converted Wetlands and Erodible Cropland

The Tax Reform Act supplements the Food Security Act of 1985 (the 1985 Farm Bill) by discouraging drainage of wetlands and cultivation of highly erodible cropland. Congress accomplished this with a new provision that defines gain on sale of recently converted wetlands and erodible cropland as ordinary income and the loss as capital. Thus, the \$3,000 loss limit applies in this narrow case and even if Congress re-instates a long-term capital gain exclusion in the future, the gain from these lands will be ordinary (100 percent taxable). Land must have been first used for farming after March 1, 1986 to meet the definition of being recently converted.

### Recapture of Investment Credit

Disposing of machinery, breeding livestock, and single purpose agricultural structures purchased before 1986 can trigger an additional tax liability in the form of investment tax credit recapture. Although not available since the end of 1985 (except under some transitional rules), investment tax credit claimed before its repeal must be recaptured if the property is not held the requisite period of time. Consequently, the potential for recapture of investment tax credit will survive until the end of 1990 (except for property under the transition rules). To better understand investment tax credit recapture, it may be helpful to review its basic provisions.

Before its repeal as part of the Tax Reform Act, investment tax credit was available to taxpayers who purchased certain property for business use before 1986. It offered an incentive for business owners to expand their operation by granting a tax break for having purchased depreciable property. Items that qualified for the credit included equipment, machinery, purchased breeding livestock, and single-purpose agricultural buildings such as grain bins and confinement barns.

Investment tax credit directly reduced an operator's tax liability. The reduction was computed as a percentage of the property's cost. For depreciable property purchased before 1981, the rate was 10 percent if a taxpayer intended to own the property for at least 7 years. After 1980 (and until the credit was repealed effective at the end of 1985), the rate was 6 percent for breeding swine, pickup trucks, and cars (3-year ACRS property), and 10 percent for all other qualified property (most frequently, 5-year ACRS property).

The law continues to require taxpayers to repay some of the tax savings due to the credit if the property is disposed of before it has been held a minimum length of time. Dispositions that trigger recapture of investment tax credit include sale (whether voluntary or forced), gift, or conveyance to a creditor. Neither filing bankruptcy nor reducing tax attributes (as a result of excluding income from debt discharge as explained in a later section) is a disposition that will trigger recapture of investment credit.

The required time period for investment credit claimed prior to 1981 is generally 7 years from date of acquisition. Consequently, only property purchased during 1980 remains subject to the 7 year requirement; and at the end of 1987, the pre-1981 rules will no longer apply. Disposition during 1987, however, will trigger recapture of one-third of the amount claimed as investment tax credit in 1980.

Example: Jones acquired a tractor in late December 1980 for \$25,000 cash and claimed investment tax credit of \$2,500 ( $\$25,000 \times 0.10$ ). Recapture of investment tax credit will be triggered if the tractor is sold or otherwise disposed of during 1987. Rules for recapturing credit claimed before 1981 require 33.3 percent to be repaid; that is, the farmer's tax liability will increase by \$833 ( $\$2,500 \times 0.333$ ).

The requisite time period for property acquired after 1980 is 3 years for property in the 3-year ACRS classification and 5 years for property in the other ACRS classifications. The amount that must be recaptured is less for each year investment tax credit property is held and under present law, will cease to be a consideration after 1990. Table 1 summarizes recapture of investment tax credit for 3- and 5-year properties. The period of time from date of acquisition to the date of disposition determines the number of years investment credit property has been held by the taxpayer; a fraction of a year is disregarded. For example, a tractor purchased in April 1985 but sold in August 1988 will be considered held for 3 years when computing recapture of investment tax credit.

TABLE 1. PERCENTAGE OF CLAIMED INVESTMENT TAX CREDIT THAT MUST BE RECAPTURED FOR PROPERTY PLACED IN SERVICE AFTER 1980

| Year Property<br>Was Acquired | Year of Disposition* |      |      |      |                 |      |
|-------------------------------|----------------------|------|------|------|-----------------|------|
|                               | 5-Year Property      |      |      |      | 3-Year Property |      |
|                               | 1987                 | 1988 | 1989 | 1990 | 1987            | 1988 |
|                               | ----- percent -----  |      |      |      |                 |      |
| 1982                          | 20                   | 0    | 0    | 0    | 0               | 0    |
| 1983                          | 40                   | 20   | 0    | 0    | 0               | 0    |
| 1984                          | 60                   | 40   | 20   | 0    | 33              | 0    |
| 1985                          | 80                   | 60   | 40   | 20   | 66              | 33   |

\*Assumes property is disposed of earlier in the calendar year than it was acquired; otherwise, property should be considered disposed of during the subsequent year.

SOURCE: Internal Revenue Code, Section 47(a)(5).

Example: Fred acquired a combine (property to be owned at least 5 years) during the summer of 1984 for \$40,000 cash and claimed a credit of \$4,000 ( $\$40,000 \times 0.10$ ). Disposition of the combine in January 1988 will trigger recapture of 40 percent of the claimed credit, \$1,600 in this example.

Recapture of investment tax credit can result in a major, and sometimes unexpected, tax obligation. It is a direct increase in tax liability, not merely an increase in taxable income. A farmer who has within the past several years purchased a substantial dollar amount of machinery may encounter a burdensome tax liability should the business be liquidated.

Example: Farmer A spent \$150,000 during 1984 and 1985 acquiring machinery for the business. Disposition of this equipment during 1988 may trigger more than \$6,000 in taxes as a result of recapture of investment tax credit.

#### Discharge of Indebtedness

Some creditors, when it is obvious that they are not likely to be paid, inform their debtor that the obligation has been cancelled or forgiven. By discharging an obligation, a creditor relieves a debtor of any legal responsibility for the amount owed. The creditor is admitting that no further attempts will be made to collect payment and that the obligation is no longer legally enforceable.

Although such action terminates an agreement between the parties, it does not end the matter for a debtor. Forgiveness of a financial obligation results in taxable income for a debtor unless one of several exceptions apply.

Example: The local bank is owed \$10,000 by a farm operator who is experiencing financial difficulty. The bank agrees to accept \$8,000 in full satisfaction of the loan. The forgiven debt of \$2,000 represents taxable income to the farm operator.

Justification for this treatment is that discharge of an obligation increases a debtor's net worth, an increase that should be subject to income taxation. Numerous court decisions over several decades made some exceptions to this general rule, and in 1980 Congress enacted legislation which codified these exceptions with some changes. The Tax Reform Act of 1986 provided further amendments to the rules for taxation of discharged indebtedness.

### Discharge of a Deductible Debt

One exception to the general rule for taxation of a forgiven debt is that no taxable income is realized when the forgiven indebtedness would have resulted in a tax deduction had the obligation been paid rather than being discharged.

Example: Fred borrowed \$10,000 from a local bank. The note had a 6-month repayment period. At the note's maturity, Fred was unable to repay the principal plus the interest of \$500. If the bank forgave the interest obligation, Fred has been discharged from a debt, but he did not realize income because payment of the \$500 would have been a deductible expenditure. If the bank forgave any portion of the principal, Fred would have realized income from debt discharge, since payment on the principal portion of a loan is not a tax-deductible expenditure.

What about the case of refinancing an obligation? Creditors often, at maturity of a loan that will not be paid, refinance the obligation by adding any unpaid interest to the unpaid principal and treating the total debt as the principal for a new loan. If this practice is continued for several years and the obligation is never repaid, a creditor may be forced to forgive a portion of the debt. A problem that arises for the debtor is determining how much of the discharged debt is not taxable because it is an interest obligation that has been forgiven.

The answer probably depends on the debtor's tax treatment of the interest obligation during the years of refinancing. The general rule is that taxpayers may not deduct unpaid interest when a loan is refinanced with the same lender. In such a case, a portion of the forgiven debt is an interest expense that, when discharged, should not result in realized income. Consequently, careful attention must be given to assure that the appropriate amount of discharged debt is excluded from taxation because the debt would have resulted in a deduction had it been paid.

Taxpayers who use the accrual method of accounting deduct their interest obligations as they arise. These operators will have to treat almost the entire forgiven obligation as realized income. However, this realized income will be considered discharged indebtedness and excludable, as explained in the next section.

### Excluding Income from Discharge of Indebtedness

A second exception from the rule that discharged debt is income allows taxation of that income to be postponed. Postponement is accomplished by excluding the amount of discharged indebtedness from taxable income, and then requiring the farmer to reduce tax attributes such as net operating losses, credit carry-overs, and basis of retained property. The tax is paid in a later year when attributes otherwise would have been

available to decrease tax liability had they not been reduced as a consequence of excluding discharged debt.

The tax also is paid upon disposition of property that had its basis reduced as a result of the discharged debt. The amount by which the basis of property is reduced due to the exclusion of income from debt discharge must be reported as ordinary income at disposition of the property. Accordingly, a debtor who had an obligation cancelled has two questions for tax purposes: 1) What amount of discharged indebtedness can be excluded from income? and 2) To what extent must attributes be reduced?

The law specifies three categories for discharged indebtedness.<sup>3</sup> They are when discharge 1) is part of a bankruptcy proceeding, 2) occurs outside of bankruptcy but the debtor is insolvent, or 3) occurs outside of bankruptcy and reduces farm debt for a solvent farmer. Solvency is determined immediately before discharge and is based on the debtor's assets at their fair market value and the debtor's liabilities.

In general, there are only two sets of rules for these three categories because the first two categories are treated similarly. The primary distinction between the sets of rules is that the exclusion available to solvent farmers is limited to institutional debt (for example, loans from banks, insurance companies, FCS, FmHA, or GMAC).

There is a situation in which both sets of rules apply. It is when an insolvent farmer is rendered solvent by discharge outside of bankruptcy. In that case, income from discharged indebtedness equal to the debtor's insolvency will be treated as arising during insolvency. The amount of discharged indebtedness in excess of the debtor's insolvency, however, will be treated as if discharged when the farmer was solvent. This continues a principle established by earlier court decisions in which it was reasoned that nonbankrupt debtors who are insolvent before and after discharge have no assets free of creditors' claims. However, nonbankrupt debtors who are rendered solvent had some assets freed of creditors' claims and to that extent should be treated similar to solvent debtors.

Example: A farmer outside of bankruptcy has debt of \$125,000 and assets valued at \$100,000. This person is insolvent by \$25,000. Discharge of \$30,000 of debt would render the person solvent by \$5,000. Therefore, \$25,000 of the discharge will be treated as if the debtor was insolvent whereas the last \$5,000 will be taxed as if the person was solvent.

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<sup>3</sup> There is a limited exception for solvent non-farmers that applies only to debt arising from purchase of property.

### Discharge in Bankruptcy or During Insolvency

A person in bankruptcy (that is, Chapter 7 Liquidation, Chapter 11 Reorganization, or Chapter 12 Farm Reorganization--all in Title 11 of the U. S. Code) is permitted to exclude all discharged indebtedness to preserve bankruptcy's "fresh start." Likewise, nonbankrupt debtors who remain insolvent after discharge may exclude all discharged indebtedness, since there still are no assets free of creditors' claims. Nonbankrupt farmers who are rendered solvent by discharge can exclude an amount equal to their pre-discharge insolvency, and any remaining income from debt discharge will be subject to the rules for solvent farmers.

Bankrupt and insolvent taxpayers who exclude income from debt discharge must reduce their tax attributes in the following order:

1. Net operating loss,
2. Certain credit carry-overs (including investment tax credit),
3. Capital loss carry-over,
4. Basis of property retained by taxpayer (except exempt property under Federal bankruptcy law), and
5. Foreign tax credit carry-overs.

The law is clear that attributes are adjusted after the tax year during which the discharge occurs. Accordingly, a farmer who is forgiven an obligation will be allowed to deduct net operating loss carried over to that year and the full year's depreciation allowance before having to reduce these attributes because the discharged debt was excluded. Furthermore, the amount of exclusion is not limited by the amount of attributes.

Example: A debtor with \$60,000 of tax attributes is discharged from \$100,000 of obligations. The entire amount of discharged indebtedness will be excluded (even though it exceeds the amount of attributes) if the discharge was part of a bankruptcy proceeding or the debtor was insolvent both before and after discharge.

Attributes are reduced by \$1 for each \$1 of excluded income, except credits are decreased 33 1/3 cents for each \$1 excluded. A category of attributes is reduced to zero before the next one is decreased, except that basis of property will not be decreased below the amount of indebtedness that remains after discharge.

Example: An insolvent debtor is discharged from obligations worth \$100,000. The debtor's attributes are a net operating loss of \$25,000, an investment tax credit carry-over of \$10,000, and a basis of \$30,000 in retained property. These will absorb only \$85,000 of excluded income ( $\$25,000 + (3 \times \$10,000) + \$30,000$ ). Consequently, they will be adjusted to zero if the debtor has no outstanding obligations after discharge. By comparison, basis of the property will not be reduced below \$7,000 if the debtor is discharged from only \$93,000 of the \$100,000 in liabilities.

As an alternative, bankrupt and insolvent debtors may elect to first reduce the basis of depreciable property. By choosing this option, these debtors preserve tax attributes that otherwise would be decreased (such as net operating loss and credit carry-over), but the reduction in basis diminishes the amount of depreciation that can be deducted in future years.

Example: An insolvent taxpayer has \$100,000 in assets, \$120,000 in liabilities, a net operating loss of \$12,000, investment tax credit carry-over of \$8,000, and depreciable property with a basis of \$42,000. Income from a creditor forgiving \$15,000 of debt will be entirely excluded, but the taxpayer will have to reduce attributes by that amount. If done in the order specified by statute, the net operating loss would be eliminated and the investment tax credit carry-over would be reduced by \$1,000. The basis of the depreciable property would remain at \$42,000. If the taxpayer elects to reduce the basis of depreciable property instead, the basis would then be \$27,000. The net operating loss and investment tax credit carry-over would remain unchanged.

Use of this election should be based on the time value of tax savings and the attribute that will save the most taxes. These differ for each taxpayer and will depend in large part on the expected level of income in future years. Frequently, taxpayers will benefit by using this election and thereby preserve their tax credits but forsake future depreciation deductions. This election also removes the limit on how far a property's basis can be reduced, thereby allowing the basis of the property to be adjusted downward to zero.

#### Debt Discharge for Solvent Farmers

Solvent farmers and insolvent farmers, to the extent that they are rendered solvent, may exclude income from debt discharge only if

1. the obligation was incurred in connection with operation of the farm,
2. 50 percent or more of the average annual gross receipts of the farmer for the previous 3 years was attributable to farming, and
3. the discharging creditor is
  - a. in the business of lending money, and
  - b. is not related to the farmer, did not sell property to the farmer, nor received a fee for the farmer's investment in the property.

Apparently Congress wants this exclusion limited to farmers for debt discharged by regular lending institutions such as banks, credit unions, Farm Credit Services, Farmers Home Administration, or credit subsidiaries of manufacturing companies. Stated conversely, solvent non-farm debtors cannot exclude income from discharge of debt nor can solvent farmers exclude income from debt discharged by relatives or occasional creditors (such as sellers on contracts for deed).

Solvent farmers who exclude income from discharged farm debt must reduce their tax attributes. The order of reduction is somewhat different than for insolvent debtors:

1. Net operating loss,
2. Certain credit carry-overs (including investment tax credit),
3. Capital loss carry-over,
4. Foreign tax credit carry-overs.
5. Basis of property other than farmland retained by farmer, and
6. Basis of farmland retained by farmer.

Legislative history indicates that the amount of income from discharge of farm debt that farmers may exclude is limited to their amount of tax attributes. This limitation is not specified in the statute but a footnote to the legislative history indicates that a technical correction is necessary to clarify the intent to impose this limit.

Example: a solvent farmer is discharged from a \$25,000 FmHA farm ownership loan and a \$2,000 personal debt. The farmer's tax attributes total \$22,000. That amount of the discharged FmHA debt (\$22,000) can be excluded as the attributes are reduced to zero. Neither the remaining \$3,000 nor the \$2,000 personal debt can be excluded.

The limitation on reducing the basis below the remaining debt does not apply to solvent debtors. Therefore, solvent debtors, as with insolvent or bankrupt debtors who make the election described in the preceding section, must reduce the basis of depreciable property to zero even though some debt remains after discharge.

The requirement that the discharging creditor did not sell property to the solvent farmer may not, for practical purposes, limit exclusion of income from debt discharge. The reason for this outcome is that the debt should be excludable under another provision. For example, two businesses that may sell to farmers on credit are implement dealers and suppliers of operating inputs such as fuel, fertilizer, or repairs. Debt discharged by the fuel and fertilizer supplier should be excludable under the first exception explained above; that is, the discharged debt, had it been paid, would have been a deductible expenditure. Likewise, discharge of a debt by an implement dealer who sold equipment to a solvent farmer on credit should be excludable as a purchase price adjustment; which is explained next.

#### Purchase Price Adjustment

The statute does provide a limited exception for all solvent debtors (farmers as well as nonfarmers). A discharged debt will not be considered income if the debt arose from a sale of property by the creditor to the debtor. In this case, debt discharge will be treated as a price adjustment; that is, the tax basis of the property will be the renegotiated purchase price rather than the originally agreed upon sale price. Renegotiated contracts for deed wherein the principal owed is reduced fall within this

provision. Application of this provision is not limited to a particular type of debt nor a particular type of creditor. This is the only exception available for nonfarm debt when the discharged debtor is solvent.

### Discharge Coupled with a Partial Noncash Payment

Few creditors are willing to discharge a debt without at least attempting to collect some or all of the obligation. This is especially true for secured creditors who have already taken steps to assure payment by securing a lien or mortgage upon property of the debtor. Creditors may be willing, however, to forgive the remainder of an obligation if a debtor sells some property using the proceeds for a partial payment or transfers property to the creditor in full satisfaction of an obligation.

A debtor who uses proceeds from sale of property as partial payment and then has the remaining debt discharged will encounter tax consequences as already described. There may be capital gains, recapture of investment tax credit, and income from discharge of indebtedness. But more significantly, the sale establishes a disposition price for the property and the amount of debt discharge.

Example: A farmer owes a financial institution \$28,000. The parties agree that a tractor which secures the loan will be sold by the farmer and the proceeds paid to the institution in full satisfaction of the debt. It sells for \$22,000. The farmer will treat the \$22,000 as proceeds from disposition and use it in computing capital gains. The remaining \$6,000 is income from discharge of indebtedness.

Tax law treats agreements to transfer property in full satisfaction of an obligation in the same manner; that is, as if the property had been sold and some debt discharged. Examples of such arrangements are deeding land to a mortgage holder, and returning farm machinery to an unpaid seller or creditor holding a security interest in the property. The difficulty in such situations is that there is no sale to establish the disposition price or the amount of discharged debt. The question is how much of the forgiven obligation should be considered proceeds from disposition of property (and taxed as explained in the first section) and how much is discharged indebtedness which may be excludable (as described in the preceding section)?

The answer, according to Federal tax law, depends on whether the obligation was recourse or nonrecourse and whether the property's fair market value exceeds the amount of indebtedness. A recourse debt entitles a creditor to seek payment from the debtor should the mortgaged property be insufficient to fully satisfy the obligation. With a nonrecourse debt, creditors are allowed to seek payment only from the mortgaged property and, even though it is insufficient to pay the entire obligation, may not attempt to collect additional remuneration from the debtor. An excellent example of nonrecourse financing in agriculture is the loan program of the Commodity Credit Corporation (CCC). Recourse financing is used in most farm financing

arrangements. The value of the property is significant for tax purposes when the obligation is a recourse debt.

The entire outstanding obligation on a nonrecourse debt is considered proceeds from the disposition of property regardless of its value. No portion of the obligation can be excluded since none is considered income from discharge of indebtedness.

Example: A farmer owes \$28,000 to a financial institution on a nonrecourse note. Transferring to the institution the tractor which secures the note will relieve the debtor of any further obligation on the debt regardless of the asset's value. For tax purposes, the farmer will be treated as having sold the tractor for the amount of indebtedness (\$28,000). This amount will be considered return of basis and gain. No portion of the debt will be income from discharge of indebtedness and therefore will not be excludable.

A recourse note where fair market value of the property exceeds the debt also results in no income from debt discharge. The entire obligation will be treated as proceeds from disposition of the property and subject to capital gain as explained previously.

Example: A farmer is personally liable for repayment of a loan of \$28,000 which is secured by a mortgage on a tractor. The farmer transfers the tractor (currently valued at \$29,000) to the creditor in full satisfaction of the debt. The farmer will be taxed as if the tractor had been sold for \$28,000. There will be some return of basis and capital gains. There will be no income from debt discharge, so none will be excludable.

When fair market value of property transferred to a creditor in full satisfaction of a recourse obligation is less than the outstanding debt, there are both proceeds from disposition and income from debt discharge. The fair market value of the property and the amount of debt determine these amounts. First, the fair market value is considered the amount for which the property was disposed; that is, the debtor is treated as having sold the property for its fair market value. Second, the debtor realizes income from discharge of indebtedness to the extent that the debt exceeds the property's fair market value. This amount is excludable according to the rules described above.

Example: A farmer is personally liable for a debt of \$64,000 secured by a mortgage on 80 acres (for example, a debt of \$800 per acre). The land, although it may have sold for \$850 per acre several years ago, would probably sell for \$600 today. By transferring the land to the creditor in full satisfaction of the debt, the farmer would be treated as having sold the land for \$600 per acre and as having been discharged from debt of \$200 per acre. The \$600 would be used to determine gain or

loss from ownership while the \$200 would be taxed according to whether the debtor was in bankruptcy, insolvent, or solvent.

Establishing fair market value is somewhat subjective and may offer debtors an opportunity to reduce tax liabilities by adjusting the fair market value of property either up or down within the range of reasonable values. For example, taxpayers who can exclude income from debt discharge will want a lower fair market value. In all cases, an appraisal by a competent professional will be necessary to establish fair market value of the property.

A related question is the time the income is realized. Will it be realized at the time of the foreclosure sale, when the creditor no longer has a legal remedy against the debtor, or at expiration of the redemption period? The discussion thus far suggests that two transactions are occurring, a transfer of property and a discharge of indebtedness. Since there are two transactions, there may be two taxable events arising at different times.

Property is considered disposed of when the burdens and benefits of ownership are transferred from the debtor. Accordingly, timing of the taxable event for capital gains, recapture, and related provisions are determined by State law and the type of transaction. For example, the burdens and benefits of property that has been foreclosed cannot be transferred until expiration of the redemption period, which in some States may be a year after the sale. A deed in lieu of foreclosure, by comparison, can transfer the burdens and benefits of ownership when the debtor signs and delivers a deed to the creditor.

Debt discharge arises when the creditor no longer has a legal right to seek a deficiency judgment. This right expires according to State law. In some states, this may be several months after a foreclosure sale. In other states, debt discharge may occur as soon as a creditor is permitted to foreclose, if the State law prohibits a deficiency judgment. On the other hand, a creditor who agrees to accept property from a debtor in satisfaction of a debt is discharging the indebtedness (to the extent the debt exceeds the property's fair market value) when the agreement becomes binding.

Complete documentation is needed to substantiate information on tax returns reporting income from a discharged debt, its exclusion, and adjustments to tax attributes. Needed information includes the taxpayer's net worth before discharge; net worth after discharge; fair market value of transferred property; amount of debt discharge; amount of discharged debt that is not income because the debt, had it been paid, would have been a deductible expenditure; date of the transactions; and record of adjustments to tax attributes. Tax Form 982 must be completed to document basis adjustments. It may be beneficial for a debtor to anticipate what information will be needed so it can be collected as an arrangement transpires, rather than having to reconstruct it from memory. Appraisals by competent professionals should be obtained when it is likely that they will be necessary to substantiate property valuations. Similarly, creditors must

file a Tax Form 1099-A, reporting any foreclosure or other acquisition of property in full or partial satisfaction of a debt.

Several observations may be beneficial in concluding this section. First, a liquidating farmer may have both a Section 1231 loss and discharged indebtedness as the result of a single transaction. This outcome can be very beneficial from a tax perspective. The loss could be used to reduce the level of taxable income from other sources whereas the discharged debt would be excluded from taxation. Persons who purchased land in the late 1970s and now deed it to a creditor in satisfaction of a mortgage may fit this description. In that case, both the basis and the debt would exceed the land's current fair market value (which likely declined during the 1980s). Second, a solvent farmer who borrowed operating capital from a relative does not fit within any of the exceptions if the loan is forgiven; the discharged amount would be taxable.

#### Cancellation of a Contract for Deed

Cancellation of a contract for deed, as with a deed-back and voluntary or involuntary sale, is considered a disposition for tax purposes which could result in a tax liability. Cancellation of a contract for deed, however, poses a potential tax liability not only for the indebted farmer but also for the seller of the land who reacquires it. Let us now look at possible tax consequences for a seller who has reacquired land, and then briefly review the buyer's tax implications.

The requirement that a seller recognize gain upon cancellation of a contract for deed and reacquisition of the land relates to how the seller initially reported the gain from the sale for tax purposes. A contract for deed implies that the buyer will make payments to the seller over a period of time, often several years. Federal tax law, recognizing that all the income from the sale is not realized at the time of the sale, permits a seller to report the gain from the sale over the same period of time instead of at the time of the sale. As each payment is made by the buyer, it is allocated to interest and principal. The amount applied to reduce principal is apportioned to return of basis (with no tax liability) and gain. Consequently, at any time during the contract, a seller will have applied a greater amount to reduction of principal than has been subjected to taxation as gain.

Example: This example uses two cases to illustrate how to compute the portion of each payment to be reported as gain. A seller sold two tracts of land to a buyer in 1983. The seller had purchased tract 1 in 1965 for \$48,000 and tract 2 in 1975 for \$90,000. The sale to the buyer was two separate contracts and each tract sold for \$120,000.

| <u>Item</u>  | <u>Tract 1</u> | <u>Tract 2</u> |
|--|----------------|----------------|
|  | (Dollars)      |                |
| Buyer's purchase price   | 120,000        | 120,000        |
| Seller's basis   | 48,000         | 90,000         |
| Seller's gain  | <u>72,000</u>  | <u>30,000</u>  |
| Percentage of principal payment that is reported as gain (seller's gain divided by buyer's purchase price times 100) | (Percent)      |                |
|  | 60             | 25             |
|  | (Dollars)      |                |
| Downpayment in 1983  | 30,000         | 30,000         |
| 1984 principal payment   | 5,000          | 5,000          |
| 1985 principal payment   | <u>5,000</u>   | <u>5,000</u>   |
| Total principal payments   | <u>40,000</u>  | <u>40,000</u>  |
| Previously reported gain (total principal times percentage to be reported as gain)                                   | <u>24,000</u>  | <u>10,000</u>  |
| Principal payment not reported as gain   | <u>16,000</u>  | <u>30,000</u>  |

Section 1038 of the Internal Revenue Code requires a seller upon reacquisition of property in full or partial satisfaction of an obligation that arose from sale of the property to recognize gain to the extent that principal payments received from the buyer exceed the amount of gain previously recognized by the seller. That requires a seller to report the untaxed portion of principal payments as taxable gain upon reacquisition of the property. The seller consequently pays tax on income received in the past, perhaps several years earlier. The amount of gain that needs to be recognized by the seller at time of reacquisition, however, is limited to the amount of gain that has not yet been reported for the sale.

Example: In 1987, seller cancels the contracts due to buyer's missed payments. The maximum amount of gain that seller must report is determined as follows:

| <u>Item</u>  | <u>Tract 1</u> | <u>Tract 2</u> |
|--|----------------|----------------|
|  | (Dollars)      |                |
| Principal payment not reported as gain   | 16,000         | 30,000         |
| Seller's gain  | 72,000         | 30,000         |
| Previously reported gain   | <u>24,000</u>  | <u>10,000</u>  |
| Amount of gain not yet reported  | <u>48,000</u>  | <u>20,000</u>  |
| Amount of gain seller must report (the lesser of principal payment not reported and amount of gain not yet reported) | 16,000         | 20,000         |

The seller's basis in the property that has been reacquired is the adjusted basis of the indebtedness plus the amount of gain that must be reported at time of reacquisition. Basis in the indebtedness equals the basis in the property that was sold minus the portion of principal payments received but not reported because it was considered return of basis.

Example. Seller's basis in the land after reacquisition would be \$48,000 for tract 1 and \$80,000 for tract 2. These amounts were computed in the following manner.

| <u>Item</u>                                | <u>Tract 1</u> | <u>Tract 2</u> |
|--|----------------|----------------|
|  | (Dollars)      |                |
| Basis of indebtedness                      |                |                |
| Basis of sold real estate                  | 48,000         | 90,000         |
| Principal payment not reported as gain     | 16,000         | 30,000         |
|  | <u>32,000</u>  | <u>60,000</u>  |
| Amount of gain reported upon reacquisition | 16,000         | 20,000         |
| Seller's basis after reacquisition         | <u>48,000</u>  | <u>80,000</u>  |

Tax consequences to a buyer upon cancellation of a contract for deed are similar to those experienced with a deed-back, a sale where the creditor accepts the proceeds in full satisfaction, or when the creditor's legal remedies expire. The buyer is considered to have sold the land for the amount of outstanding debt if the contract is determined to be a nonrecourse arrangement. In these instances, the buyer will have a loss. For contracts that provide the seller recourse, the buyer (for tax purposes) is considered to have sold the property for either its fair market value or the amount of indebtedness, whichever is less. Land treated as sold for its market value will result in a loss (to the extent fair market value is less than basis) and income from debt discharge (to the extent that the debt exceeds the market value).

#### Recapture of Estate Tax Savings

Federal law allows farm families to reduce the amount of estate tax by valuing farmland at its current earning capacity rather than its market value. Known as Special Use Valuation, this practice imposes numerous requirements upon the family. One requirement is that the land be owned and operated by family members for 10 years after the death of the family member whose estate benefited from this provision. If the land is disposed of before the 10 years have passed, the estate taxes saved must be paid. Liquidating farmland that has been valued for estate tax purposes at its earning capacity, within the past 10 years, can result in recapture of substantial estate taxes.

Similarly, taxes upon an estate which is comprised, at least in part, of a closely held business (such as most farms are) may be paid in installments extending over 15 years. However, if assets of the closely held business are disposed of, the privilege to pay over time terminates and the tax obligation is due. Consequently, disposition of land, equipment, or livestock could trigger an immediate tax liability that was expected to be paid over several years.

Estimating tax consequences of liquidating should include a determination of whether recapture of estate tax savings will be triggered.

### Possible Tax Savings and Pitfalls

Part of the tax problem resulting from liquidation is that more than one of these features can increase tax liability as the result of a single transaction. Sale or transfer of real estate can produce capital gains and result in income from discharge of indebtedness. Sale of farmland may also trigger recapture of estate taxes. Disposition of depreciable personal property (equipment, machinery, and purchased breeding livestock) and single-purpose agricultural buildings is likely to trigger recapture of investment credit as well as result in taxable gain. Sale of livestock and crops also will generate taxable income.

The discussion thus far has been a description of Federal tax law (primarily income tax law) that imposes an obligation upon farm operators who liquidate their business. To best understand the overall implications, however, it is necessary to review features that can ameliorate the situation. Losses from operating a farm or disposing of business assets as well as unused investment tax credit carried over from 1985 can reduce a tax liability. It is equally important to recognize that some of the tax savings are limited in certain situations. Availability and limitations for each of these provisions are addressed in the following sections.

#### Deductibility of Losses

A loss is incurred when land, equipment, machinery, or breeding livestock (Section 1231 property) is sold for less than its basis. A loss also results from conveying property to a creditor in exchange for discharge from a recourse note if the property's fair market value is less than its basis. Such losses can be deducted from other taxable income, as discussed in a preceding section.

#### Net Operating Losses

An operating loss results when business deductions for a year exceed business income. The operating loss is deducted from income received from other sources such as off-farm wages. If there is no other income, the loss (after adjustments) is carried over as a Net Operating Loss to other tax years to reduce the amount of taxable income for those years. These adjustments reduce the amount of Net Operating Loss carry-over by disallowing some tax benefits such as the taxpayer's personal exemptions and nonbusiness losses. A Net Operating Loss must be carried back to the three preceding tax years unless a timely election is made to forego the carryback period. Regardless of the taxpayer's election, Net Operating Losses may be carried forward up to 15 years.

## Hobby Losses

Recognizing that some taxpayers were offsetting significant amounts of income with losses from investments, Congress imposed limits on the deductibility of certain losses. One rule limits the deductibility of losses incurred in activities "not engaged in for profit." The rule is that such losses may be deducted only to the extent of gross income from the activity. The law will not presume that the activity was engaged in for profit if income does not exceed deductions for at least three years of a five year period. Most farmers who experience a loss for more than two years are able to avoid the limit, however, by demonstrating that they conducted their business intending to earn a profit.

## Losses From Passive Activities

Congress imposed, as part of the Tax Reform Act, an additional limitation upon the deductibility of losses arising from passive activities. Renting land for cash will be considered a passive activity and subject the indebted owner to this limitation. The limitation is that a loss resulting from a passive activity may be deducted only from passive activity income. Consequently, losses from passive activities may not be used to reduce taxable income from other sources. Any loss that is not deducted may be used to reduce passive activity income earned in subsequent years.

The intent of the law is to discourage tax-sheltering activities, including tax-sheltered farming. Accordingly, most farmers will not be affected because they are involved in operating their farm and will not be leasing out the land or other assets. However, families who are liquidating their farm business may fall within the reach of the statute. For example, an operator who has sold equipment and livestock to satisfy creditors, may have no alternative but to lease out the land. Wages from a non-farm job can not be reduced (for income tax purposes) by the farm loss even though the owner pays more interest on the land debt than is received as rent income.

The statute includes two exceptions that mitigate the adverse impact of this rule. One, taxpayers are allowed to deduct up to \$25,000 as losses from rental activities as long as the taxpayer actively participates in the rental activity and has no more than \$100,000 adjusted gross income for the year. Apparently, a share-crop arrangement will be needed for the landlord to actively participate; a cash rent will not suffice. A second exception permits taxpayers who totally dispose of their passive activity to deduct the full loss (even losses from passive activities that have been carried forward from past years).

## Alternative Minimum Tax

The advantage of some tax saving provisions is so beneficial that Congress has included a requirement to reduce their preferential treatment. This provision, the Alternative Minimum Tax, requires taxpayers who benefit from tax preferences to pay at least a minimum amount of taxes. Some tax preferences are rapid depreciation of business assets, certain itemized deductions, and certain farm losses (including Net Operating and Passive Activity Losses).<sup>4</sup> Consequently, liquidating farmers who are intending to reduce their income tax liability will a significant amount of loss must understand that the deduction may trigger the Alternative Minimum Tax and thereby, eliminate the anticipated savings.

Taxpayers determine whether they are subject to the Alternative Minimum Tax by using two methods to compute their Federal income tax liability. The first method is the regular income tax used by all taxpayers. The second method employs a different approach. If the tax liability computed by the alternative method exceeds the amount owed according to the regular method, the farm operator must pay the greater amount. The second method will produce a greater liability for taxpayers with substantial amounts of tax preferences.

The amount of taxable income for the Alternative Minimum Tax is determined by adding a taxpayer's tax preferences to that person's adjusted gross income. This amount is then reduced according to the taxpayer's filing status. A married couple filing jointly is allowed a \$40,000 deduction; an unmarried individual may deduct \$30,000, whereas a married person filing separately is permitted a \$20,000 deduction. The remaining amount is subject to a flat rate of 21 percent. Farm owners can find themselves owing more taxes than they expected as a result of the alternative tax. Accordingly, the effect of the Alternative Minimum Tax must be included in tax planning for liquidating a farm.

## Investment Tax Credit Carried-Over from 1985

Although investment tax credit has not been available since the end of 1985 (except for transitional rules), unused credit can be carried forward to future years to offset taxes at that time. The amount of credit carried forward must be reduced to adjust for lower tax rates in 1987 and thereafter. The reduction for 1987 is 17.5 percent; credit carried forward

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<sup>4</sup> Prior to the Tax Reform Act of 1986, a major tax preference item encountered by liquidating farm operators was the long-term capital gain exclusion. The earlier version of this report (see page 2) included a description of the Alternative Minimum Tax prior to 1987 and a statute enacted in April 1986 which allows insolvent farmers to disregard some of the long-term capital gain exclusion in computing their Alternative Minimum Tax.

to later years must be reduced by 35 percent. Credit that is carried forward may not be claimed by the taxpayer if the asset that generated the credit is no longer used in the farm business.

### Other Provisions

Another approach is to liquidate over time so that no one tax year is burdened with an extraordinary level of income. This usually requires cooperation from a creditor. Perhaps the parties can agree to convey some property during the current year and more property shortly after the start of the following tax year. Creditors may be willing to cooperate if they find that proceeds they were hoping to receive would otherwise be needed to satisfy an income tax liability. Liquidation over time will not only reduce bunching of income but will also decrease the amount of investment tax credit recapture for assets conveyed during the later years.

Farm operators who agree to liquidate over time must be careful to avoid constructive receipts; that is, having sufficient control over the proceeds to require reporting the income the first year. For example, if the seller has the right to receive all the proceeds of the sale but asks the buyer to wait to pay part of it, the seller will be taxed as if the full proceeds were received during that year. A related question is whether a plan to convey property over time will result in the farmer having to report the income in the year of the agreement even though he or she will not complete the transaction until a later year. It could be argued that the theory of constructive receipts does not apply to such agreements because the plan 1) has a business purpose of extending the time an operator may continue in farming and 2) was not devised solely for tax purposes.

An alternative is to enter into a tax-free trade (an exchange of the same kind of property), but this is not meaningful in terms of paying a creditor. It can be a useful approach, however, to convert assets into exempt property so as to shield them from claims of creditors. Trades generally are practical only if no creditor has a lien on the property being traded away.

As discussed in a preceding section, taxpayers may defer or exclude gain from disposition of their residence if they purchase another home within two years or if they are over the age of 55. These provisions are available to farmers and should not be overlooked.

A final alternative to reduce the tax burden upon liquidation is to seek relief under bankruptcy. Although it may not be desired for personal reasons, bankruptcy is available and could be beneficial. In the following paragraphs, some aspects of taxation and bankruptcy are introduced.

### Declaration of Bankruptcy

Farmers must recognize that tax consequences of filing bankruptcy will vary depending on which chapter they use when filing for protection. Declaring bankruptcy under either Chapter 7 Liquidation or Chapter 11 Reorganization creates a new legal entity--the bankrupt estate. By comparison filing for protection under Chapter 12 (Farm Reorganization) does not create a new taxable entity; instead the taxpayer is responsible for any tax liability. This difference has been identified by some as a major disadvantage for using Chapter 12.

Another major difference among the types of bankruptcies is the timing of the debtor's discharge; that is, when the debt is no longer a legally enforceable obligation. Discharge often occurs within several months after filing a Chapter 7. By comparison, discharge occurs in a Chapter 11 bankruptcy when the plan of reorganization is confirmed, which may be as long as two or three years after filing. Debt is discharged in a Chapter 12 after the terms and payments set forth in the reorganization plan have been fulfilled; that may be three to five years after filing bankruptcy. Consequently, the timing of income from debt discharge for tax purposes will vary depending on the type of bankruptcy filed. Changes in the solvency of the debtor between time of filing and discharge may also impact whether the discharged debt can be excluded (as explained in a preceding section). Most of the discussion in this section will focus upon Chapter 7 and Chapter 11 filings and the resulting taxable entity.

Upon filing bankruptcy, all property of the debtor, along with all debts and obligations against the debtor transfer to the bankruptcy estate. Filing bankruptcy, although it transfers property from the debtor to the estate, does not result in taxes. It is not clear whether transfer of assets from a debtor to a bankruptcy estate results in acceleration of Federal estate taxes or the recapture of Special Use Valuation. It could be argued that language of the Federal tax code is sufficiently broad to apply also to estate tax provisions and thereby prevent acceleration or recapture. Farmers must realize, however, that the transfer of property from the estate to creditors or the sale of it to others is taxable and subject to the numerous provisions described in the preceding sections.

The estate receives all income that is generated after bankruptcy by property of the estate such as from land rent or sale of commodities. Income earned by the debtor after bankruptcy (such as wages) belongs to the debtor.

There are two taxpayers after a Chapter 7 or Chapter 11 bankruptcy is filed; the debtor and the estate. The estate is responsible for all income tax liabilities that arise from the estate's income. The debtor is responsible for all taxes on income that arose before bankruptcy and for income that belongs to the debtor after bankruptcy. Persons who file for a Chapter 11 Reorganization must be certain that two tax returns are filed, a fiduciary return for the estate and an individual return for the debtor.

Example: The debtor receives taxable income of \$20,000 on March 1, 1988. Debtor declares bankruptcy on June 1, 1988, and all property of the debtor (including the \$20,000) is transferred to the estate on that date. The estate realizes income of \$15,000 in October, while the debtor earns \$11,000 in wages between June 1 and December 31, 1988. The debtor would have taxable income of \$31,000 whereas the estate's taxable income would be \$15,000

After bankruptcy has been filed, the estate also assumes the debtor's tax attributes, such as net operating loss carry-over, investment credit carry-over, and capital loss carry-over. However, these attributes are not determined as of the date of bankruptcy. Instead, they are determined as of the first day of the tax year during which bankruptcy is filed. Accordingly, these attributes are not available to the debtor to offset tax liabilities that arise after bankruptcy.

Although taxes on income earned before bankruptcy are the responsibility of the debtor, they can be paid from property of the estate only if they are an obligation at the time bankruptcy is filed. However, an income tax obligation does not arise until the end of the tax year. Therefore, income earned during the year but before bankruptcy is declared is not an obligation of the debtor until the end of the year. This obligation, consequently, is not payable by the estate. Furthermore, the debtor's attributes are not available to offset this liability as they were transferred to the estate. The income received before bankruptcy is not available to pay the tax because it was property of the debtor on the day bankruptcy was filed and was also transferred to the estate on the same day. The debtor is left without the income and without attributes, but with the tax obligation that results from the income.

Example: The debtor in the previous example had a Net Operating Loss carry-over of \$10,000 on January 1, 1988. The estate uses the carry-over to reduce its taxable income, while debtor has no tax attributes with which to reduce the level of taxable income. The proceeds with which to pay the taxes on the \$31,000 of income must come from wages earned after June 1, which would be the \$11,000 in this example.

Debtors who could postpone filing bankruptcy until the first day of a tax year could force the estate to pay the income taxes for the preceding year (as they are now due). Furthermore, a debtor would likely have little income or resulting tax liability, since bankruptcy was filed on the first day of a new tax year and before much income could be earned. This would appear to encourage postponing bankruptcy filings until January 1.

### Two Short Tax Years

The Congress enacted an exception to permit debtors to end the tax year the day before filing and to start a new individual tax year on the day of bankruptcy is filed. Thus, the debtor can have two short tax years for

individual income tax purposes in the year bankruptcy is filed. (The income must be annualized in calculating the tax for each short year.) Tax on income during the first part of the year becomes an obligation on the day before bankruptcy is filed, and consequently is payable from the estate's property. Also, tax attributes would not be transferred until the day of filing, as that is now the first day of the tax year during which bankruptcy begins. Accordingly, the farmer's attributes would be available to offset his or her tax liability from the first short tax year. A debtor with taxable income before filing bankruptcy should benefit by splitting the tax year into 2 short years.

Example: Let us suppose that the taxpayer referred to in the prior example elects 2 short tax years. Taxable income for the first portion of year is \$20,000 which is partially offset by the \$10,000 net operating loss carry-over. This attribute was insufficient to offset the tax liability for the first short year so property of the estate, if any, will be used to pay it. The estate now receives no net operating loss with which to reduce its \$15,000 of taxable income. The debtor remains responsible for the taxes on the income earned during the second short year (\$11,000).

A debtor is not relieved of responsibility (discharged) from income taxes on earnings before bankruptcy, even though property of the estate can be used to pay them.<sup>5</sup> Unpaid taxes would again be an obligation of the debtor after bankruptcy is completed. By comparison, taxes on the estate's income cannot be collected from the individual debtor, even though there are insufficient monies or property in the estate to pay them. Accordingly, debtors may benefit by postponing taxable income until bankruptcy has been filed so that the tax liability (along with the income) belongs to the estate and will be discharged if not paid. Bankrupt farm operators must be mindful, however, that tax obligations which arise during a Chapter 11 Reorganization remain the responsibility of the estate as long as the plan is being implemented and the estate is in existence. In some instances, only a Chapter 7 Liquidation will successfully relieve the debtor or farm business of the income tax liability.

#### Abandonment

One feature of bankruptcy law may have serious tax implications for debtors. This feature is the trustee's authority under Federal bankruptcy law to abandon property that is of no value to the estate. Property is generally considered of no value to the bankruptcy estate when the outstanding liens or mortgages exceed the property's value. With depressed asset values and substantial debt obligations, a trustee in a very common practice, may decide to abandon the property because it is of no value to the estate.

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<sup>5</sup> An exception is provided by Federal bankruptcy law in that unpaid taxes that arose more than 3 years before bankruptcy is filed are dischargeable.

The consequence of abandonment is that the lienholders may proceed under State law to foreclosure or otherwise seize the property in satisfaction of the debt owed to them. Once property is abandoned it is no longer part of the estate nor protected from creditors.

The law is not clear at this time, but a possible tax consequence of abandonment is that when creditors foreclose or otherwise seize the property, any income from disposition is realized by (that is, taxed to) the individual debtor rather than the bankruptcy estate. Consequently, any resulting tax obligation is owed by the debtor as an individual rather than the estate. Accordingly, debtors who file bankruptcy in an attempt to minimize individual tax liability may not be successful if property is abandoned. The likelihood of abandonment and its potential tax consequences must be recognized and addressed before final decisions are made, otherwise a reason for filing bankruptcy could be impaired by the trustee or the court.

At this writing, the Internal Revenue Service is studying the tax consequences of abandonment and may issue a Revenue Ruling to address this topic.

#### Conclusion

Farm operators need to realize that liquidation usually generates taxable income but that repayment of loan principal and other obligations are not deductible expenditures for tax purposes. It is this combination that leaves farmers with little or no cash (because creditors were paid) but with a substantial tax liability (due to high level of taxable income). Discovering that a tax liability exists when little or no cash remains can only aggravate an already emotional situation.

Each farm business is different and the incidence of taxation will vary. Persons contemplating liquidation must be mindful of the tax ramifications and should consult with their professional advisers about their situation.

TAX IMPLICATIONS OF LIQUIDATING A FARM OPERATION  
AFTER THE TAX REFORM ACT OF 1986

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