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**The Qualified Farm Indebtedness
Exception to Taxation of Discharged
Debt: Making Hay under TRA**

by

Dirk A. Williams

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THE QUALIFIED FARM INDEBTEDNESS EXCEPTION TO TAXATION OF DISCHARGED DEBT: MAKING HAY UNDER TRA

Dirk A. Williams*

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I. INTRODUCTION

A penny saved is a penny earned.
—Benjamin Franklin

When a party incurs debt and the creditor subsequently forgoes collection of all or a portion of the original debt, the debtor obtains economic benefit by receiving something of value without having to repay the entire amount of the debt. Innumerable scenarios of economic benefit from the discharge of indebtedness exist, ranging from forgiveness of an informal loan between family members to a corporation's repurchase of its own bonds at less than face value. Were Mr. Franklin's words adapted to the forgiveness of debt they might read, a penny borrowed and not repaid is indeed a penny earned.

Shortly after the states ratified the Sixteenth Amendment and Congress adopted the federal income tax, the United States Supreme Court held in *United States v. Kirby Lumber Co.*¹ that a taxpayer must include gains and profits realized by reason of the discharge of indebtedness in the taxpayer's gross income.² The fifty-six intervening years have seen much judicial and Congressional expansion, contraction, and fine tuning of the *Kirby Lumber* doctrine.

The most recent changes to the *Kirby Lumber* doctrine, brought about by the Tax Reform Act of 1986³ (TRA '86), carve a narrow, if not

1. 284 U.S. 1 (1931).

2. *Id.* at 3.

3. Pub. L. No. 99-514, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2085.

clean, exception from the doctrine for discharge of qualified farm indebtedness (QFI). In grossly over-simplified terms, QFI is debt which meets the following criteria: (1) the taxpayer incurred the debt directly "in the trade or business of farming;"⁴ (2) the taxpayer who incurred the debt earns the majority of its gross receipts from "farming;"⁵ and (3) the party discharging the indebtedness is a "qualified person," generally a bank or other lending institution with which the taxpayer has no ownership or familial relationship.⁶

This article explores the new Internal Revenue Code provision of section 108(g), the qualified farm indebtedness exception, in the context of: the continually evolving *Kirby Lumber* doctrine; the gain nonrecognition/deferral provisions of section 108; the basis adjustment provisions of section 1017; the policy goals of TRA '86; and the changes enacted in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).

II. DEVELOPMENT OF THE *Kirby Lumber* DOCTRINE IN GENERAL

History may not repeat itself, but it rhymes.

—Mark Twain

A. Pre-1980 Evolution

The statutory predecessor to section 61 of the Internal Revenue Code defined gross income as "gains or profits and income derived from any source whatever."⁷ In *Kirby Lumber*, the Supreme Court interpreted that statutory definition to include gain from the discharge of indebtedness.⁸

No one has ever challenged seriously the correctness of the *Kirby Lumber* doctrine. Given the subsequent landmark interpretation in *Commissioner v. Glenshaw Glass Co.*⁹ that taxpayers realize gross income when they have "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion,"¹⁰ little doubt remains that the Court reached the correct result in *Kirby Lumber*. When a lender discharges debt, the debtor clearly realizes an accession in an amount equal to the amount of the loan forgiven. With the discharge, the debtor obtains "complete dominion" over funds that it previously had been obligated to repay. Lest there be any doubt about the viability of the *Kirby Lumber* doctrine, Congress has codified the doctrine by stating that gross income includes gains from the "discharge of indebtedness."¹¹

Even before the Court decided *Kirby Lumber*, other courts developed an exception to the doctrine for taxpayers who were insolvent at the time

4. I.R.C. § 108(g)(2)(A) (Supp. V 1987). See *infra* text accompanying note 38.

5. I.R.C. § 108(g)(2)(B) (Supp. V 1987). See *infra* text accompanying note 51.

6. I.R.C. §§ 108(g)(1), (3), 46(c)(8)(D)(iv) (Supp. V 1987). See *infra* text accompanying note 52.

7. Revenue Act of 1921, ch. 136, § 213(a), 42 Stat. 237 (1921).

8. *Kirby Lumber Co.*, 284 U.S. at 3.

9. 348 U.S. 426 (1955).

10. *Id.* at 431.

11. I.R.C. § 61 (a)(12) (1982).

of the discharge. In *Commissioner v. Simmons Gin Co.*,¹² citing a pre-*Kirby Lumber* Supreme Court ruling that a "mere diminution of loss is not gain,"¹³ the Tenth Circuit Court of Appeals held that a discharge of indebtedness which merely reduces a taxpayer's liabilities, without adding to the taxpayer's net worth, is not income.¹⁴

Congress first codified the insolvency exception to the *Kirby Lumber* doctrine when it adopted the first permanent Internal Revenue Code in 1939.¹⁵ The first statutory exception to *Kirby Lumber* applied only to the discharge of corporate debt evidenced by a security. This exception required the taxpayer to: (1) establish to the satisfaction of certain government entities that the taxpayer was in "unsound financial condition" at the time of the discharge, and (2) consent to reduction in the basis of any property the taxpayer held during the year in which the discharge occurred.¹⁶ Reasoning that the "unnecessarily strict"¹⁷ original statutory exception to *Kirby Lumber* denied the benefits of the exception "in many meritorious cases,"¹⁸ the 1942 Congress repealed the requirement that a corporate taxpayer prove its "unsound financial condition."¹⁹

With the insolvency requirement a mere memory for corporations, Congress further liberalized the statutory exception in 1954 by abolishing the requirement that a security evidence the debt and by making the statutory exception available to certain individuals. When the dust settled following adoption of section 108 in 1954, the statutory exception permitted nonrecognition of *Kirby Lumber* gain not only by corporations, but also by individuals who incurred the debt in connection with property used in a trade or business. As a *quid pro quo*, the debtor had to agree to reduce its basis in its property by the amount of gain it otherwise would have recognized.²⁰

Such a basis reduction worked to preserve the debtor's *Kirby Lumber* gain in two steps. First, by reducing the debtor's basis in depreciable property, it reduced the base figure against which the debtor could calculate its future depreciation deductions, thereby reducing those future depreciation deductions. Because of the reduced future depreciation deductions, the debtor's taxable income in future years was increased by an amount up to the sum of *Kirby Lumber* gain previously deferred. Second, if the debtor sold the reduced-basis property before fully depreciating it, such sale forced completion of recapture of any deferred *Kirby Lumber* gain. Having reduced its basis by the amount of deferred *Kirby Lumber*

12. 43 F.2d 327 (10th Cir. 1930).

13. *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 175 (1926).

14. *Simmons Gin Co.*, 43 F.2d at 329.

15. I.R.C. § 22(b)(9) (1940).

16. I.R.C. §§ 22(b)(9), 113(b)(3) (1940).

17. S. REP. NO. 1631, 77th Cong., 2nd Sess. 46 (1942).

18. *Id.*

19. Revenue Act of 1942, Pub. L. No. 77-753, § 114, 56 Stat. 811 (1942).

20. I.R.C. § 108 (1958). The recodification as part of the Internal Revenue Act of 1954 marked the first time the statutory exception to *Kirby Lumber* was known as I.R.C. § 108.

gain, the debtor was forced to recognize gain on the sale by utilizing an adjusted basis which reflected a reduction for the previously deferred gain.

B. BRTA and TRA '86: Coming Full Circle, and Then Some

Two major pieces of legislation in the 1980s affected taxpayers' ability to postpone or avoid the consequences of the *Kirby Lumber* doctrine. The Bankruptcy Tax Act of 1980²¹ (BRTA) generally revised and clarified the Internal Revenue Code's method of forcing eligible parties to preserve their unrecognized *Kirby Lumber* gain, and only indirectly affected taxpayers' eligibility for nonrecognition/deferral of *Kirby Lumber* gain. TRA '86, on the other hand, substantially reformed the eligibility requirements for nonrecognition/deferral of *Kirby Lumber* gain.

1. The Bankruptcy Tax Act of 1980

BRTA was part of a major reform movement that swept the bankruptcy field during the late 1970s and early 1980s. The reform movement represented the first significant revisions to bankruptcy law since 1938.

Although the Department of the Treasury asked Congress in 1979 to repeal the statutory exceptions to the *Kirby Lumber* doctrine for all solvent corporations and individuals,²² BRTA did not alter substantively the roster of taxpayers eligible to benefit from the exception. Rather, it reiterated the original judicially-created exception to *Kirby Lumber* for insolvent taxpayers;²³ foreclosed a possible ambiguity by specifically making the exception available to persons with debts discharged in bankruptcy,²⁴ whether or not such persons were insolvent within the statutory definition of the term;²⁵ preserved, under the new shorthand term "qualified business indebtedness,"²⁶ the statutory exception for discharge of indebtedness of solvent corporations and individuals who incurred the debt in connection with property used in a trade or business;²⁷ required that a taxpayer apply any unrecognized income from the discharge of qualified business indebtedness to offset the taxpayer's basis in depreciable prop-

21. Pub. L. No. 96-589, 94 Stat. 3389 (1980).

22. *Bankruptcy Tax Act of 1979 [sic]: Treasury Statement Before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee on H.R. 5043*, H.R. REP. No. 5043, 96th Cong., 1st Sess. 9 (1979) (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Legislation) [hereinafter cited as *Halperin Oral Statement*].

23. I.R.C. § 108(a)(1)(B) (Supp. IV 1980).

24. I.R.C. § 108(a)(1)(A) (Supp. IV 1980).

25. BRTA provided the first statutory definition of the term "insolvent." "[T]he term 'insolvent' means the excess of the taxpayer's liabilities over the fair market value of its assets, . . . determined on the basis of the taxpayer's assets and liabilities immediately before the discharge. I.R.C. § 108(d)(3) (Supp. IV 1980).

26. I.R.C. § 108(a)(1)(C) (Supp. IV 1980).

27. I.R.C. § 108(d)(4) (Supp. IV 1980) defined "qualified business indebtedness" as the term was used in I.R.C. § 108(a)(1)(C) (Supp. IV 1980).

erty;²⁸ and attempted to halt judicial expansion of the doctrine by limiting exceptions to the *Kirby Lumber* doctrine to those taxpayers and situations specifically described in section 108.²⁹

Additionally, BRTA completely changed the nature of section 108 by introducing a nonrecognition/deferral framework for offsetting insolvent and bankrupt taxpayers' unrecognized *Kirby Lumber* gain against certain of their tax attributes. In general, the nonrecognition/deferral framework continued to allow deferral through a reduction of the taxpayer's basis in depreciable property, and added provisions for the offset of *Kirby Lumber* gain against accumulating tax attributes such as net operating loss carryovers, general business credit, and capital loss carryovers.³⁰

2. Eligibility for Deferral of Kirby Lumber Gains After TRA '86

TRA '86 renewed the statutory exception to the *Kirby Lumber* doctrine for taxpayers with debts discharged in bankruptcy or who otherwise are insolvent.³¹ At the same time, Congress finally granted Treasury's wish and repealed the qualified business indebtedness exception.³²

Had Congress stopped with reaffirming the insolvency/bankruptcy exception and repealing the qualified business indebtedness exception, TRA '86 would have placed the *Kirby Lumber* doctrine in statutory *deja vu*. All taxpayers (except those who were bankrupt or insolvent) would have included gains from the discharge of indebtedness in their gross income, just as taxpayers had included such gains under the common law notions of *Kirby Lumber* and *Simmons Gin Co.* prior to Congress' first statutory tinkering with the doctrine in 1939. Congress' adoption of the QFI exception, however, assured that the *Kirby Lumber* doctrine would not make a clean return to its more simple, tax-theory-pure beginnings. The seeds for controversy were sown.

III. MECHANICS OF THE QUALIFIED FARM INDEBTEDNESS EXCEPTION

The QFI exception modifies the *Kirby Lumber* doctrine in a three-step process. Steps one and two set forth sequential tests to determine the general character of the debt. First, the debt must satisfy the two-part qualified farm indebtedness test.³³ Second, the creditor discharging the debt must be a "qualified person."³⁴ Third, assuming satisfaction of

28. I.R.C. § 108(c)(1) (Supp. IV 1980). For purposes of this discussion "depreciable property" includes real property held as inventory. I.R.C. §§ 108(c)(1)(B), 1017(b)(3)(E) (Supp. IV 1980).

29. I.R.C. § 108(e)(1) (Supp. IV 1980).

30. The insolvency and bankruptcy nonrecognition/deferral framework, substantially unchanged by TRA '86, is discussed in more detail in the context of current law. See *infra* text accompanying note 96.

31. I.R.C. § 108(a)(1) (Supp. V 1987).

32. H.R. REP. No. 3838, 99th Cong., 1st Sess. § 323 (1986).

33. I.R.C. § 108(g)(2) (Supp. V 1987).

34. I.R.C. § 108(g)(1) (Supp. V 1987).

the first and second steps of the test, the Code subjects the discharged debt to the nonrecognition/deferral framework available to bankrupt and insolvent taxpayers.³⁵

A. *The Two-Part Qualified Farm Indebtedness Test*

A two-part test governs qualification for the QFI exception.³⁶ Indebtedness will satisfy the definition of qualified farm indebtedness only if the debtor/taxpayer has: (1) incurred the indebtedness "directly in connection with the operation by the taxpayer of the trade or business of farming,"³⁷ and (2) earned fifty percent or more of its aggregate gross receipts for the three tax years preceding the year of discharge from the trade or business of farming.³⁸

1. *What Is the "Trade or Business of Farming?"*

The QFI exception does not define the term "trade or business of farming," either expressly or by reference. Practitioners can anticipate Treasury some day exercising its general rulemaking authority³⁹ to promulgate regulations regarding a definition of this term for purposes of the QFI exception. Until Treasury promulgates QFI regulations⁴⁰ or Congress adopts a statutory definition specifically applicable to the QFI exception, various existing but disparate Code sections defining "the trade or business of farming" and related terms will compete for applicability in identifying the activities that satisfy the first part of the QFI test.

a. *Applying Existing Definitions of "Farm" and "Farming"*

Section 464(e), relating to limits on deductions of certain farming expenses, defines the term "farming" as "the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals."⁴¹ Trees that do not bear fruit or nuts, however, are not "agricultural or horticultural" commodities.⁴² Hence, contract sheep shearers, veterinarians, flower growers and horse trainers arguably are engaged in

35. See *infra* text accompanying note 96.

36. I.R.C. § 108(g)(2) (Supp. V 1987).

37. I.R.C. § 108(g)(2)(A) (Supp. V 1987).

38. I.R.C. § 108(g)(2)(B) (Supp. V 1987).

39. I.R.C. § 7805 (1982) grants the Treasury Department general rulemaking authority to promulgate rules and regulations necessary for enforcement of the Internal Revenue Code.

40. There apparently are no § 108(g) regulations currently in the works at Treasury. The only regulation project relating to § 108 is LR-91-81, begun in 1981 in response to BRTA. Its current official status is "Circulated for Comment at IRS, 10/23/84." *Report by Office of Chief Counsel, Internal Revenue Service, On Regulations Projects Status and Disposition as of April 30, 1988*, 99 DAILY TAX REPORTS SPECIAL SUPPLEMENT 11 (May 23, 1988).

41. I.R.C. § 464(e)(1) (1982).

42. *Id.*

farming within the section 464(e) definition of the term, but Christmas tree growers and owners of ornamental tree nurseries are not.

Although the legislative history of the QFI exception offers no guidance as to how Congress intended to define the term "farmer," the QFI exception clearly is a relief provision. The section 464(e) definition, as part of a statute having the overall purpose of discouraging nonfarmers from utilizing farms as tax shelters,⁴³ is the most restrictive definition of farming in the Code. Because of its inconsistency with the relief purpose of the QFI exception, the section 464(e) definition of "farmer" should be the first one eliminated from application to the QFI exception.

Section 263A(e)(4), the second and newest Code section defining a term relevant to the QFI exception, relates to special rules permitting farmers to deduct expenses that otherwise might require capitalization. It shamelessly provides a circular definition of "farming business" as "the trade or business of farming,"⁴⁴ and makes no reference to section 464(e). Rather than providing any useful general definition of "the trade or business of farming," section 263A, without excluding any other activities, specifically does include nurseries, sod farms, and "the raising or harvesting of trees bearing fruit, nuts or other crops, or ornamental trees" in the definition of "farming business."⁴⁵

The section 263A definition, although more accommodating to Christmas tree growers and nursery operators than section 464(e), yet fails to define the term "farmer" in general terms. Although persons specifically included as farmers under section 263A probably should be eligible for the QFI exception, the definition is inadequate for the general purposes of the QFI exception.

Section 2032A provides the most comprehensive Code definition related to the "trade or business of farming." By its terms, however, the section 2032A definition applies only for purposes of section 2032A, the federal estate tax special use valuation provision.⁴⁶ The section 2032A definition of "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.⁴⁷ The section 2032A definition of farming appears to exclude contract

43. S. REP. No. 938, 94th Cong., 2nd Sess. 53-54 (1976).

44. I.R.C. § 263A(e)(4)(A) (Supp. V 1987).

45. I.R.C. § 263A(e)(4)(B) (Supp. V 1987). However, Christmas tree growers beware: an evergreen tree harvested after it turns seven years old will fail to qualify as an ornamental tree. *Id.* Neither the code nor regulations address the possibility of a grower harvesting some Christmas trees before, and others after, their sixth year of growth.

46. I.R.C. § 2032A (1982 & Supp. V 1987) permits an executor of an estate to elect a special valuation, for federal estate tax purposes, of certain real property used as farm property or in another trade or business. If the executor makes a § 2032A election regarding the decedent's farm land, the property will be valued for federal estate tax purposes at its value as farm land, rather than on the basis of highest and best use. The details of § 2032A are beyond the scope of this article.

47. I.R.C. § 2032A(e)(4) (1982).

sheep shearers, veterinarians, and horse trainers from the ranks of farmers, but includes those who commercially grow flowers, Christmas trees, and timber.⁴⁸

As under the pre-BRTA version of the qualified business indebtedness exception, farmers and owners of small businesses can use section 2032A. Its purpose more closely relates to the QFI purpose of tax relief than does the section 464 purpose of antisheltering, and its definition of farming is more precise than that found in section 263A. Hence, the section 2032A definition of farming is the existing statutory definition most appropriate for application to the QFI exception. However, nothing in the QFI exception precludes either Treasury or the courts from going outside section 2032A for a definition of the phrase "trade or business of farming."

Congress' failure to define the phrase "trade or business of farming" for purposes of the QFI exception, either expressly or by reference, sowed fertile seeds for litigation. Taxpayers are likely to raise creative arguments to establish their debt as incurred in connection with their operation of a trade or business of farming, thereby satisfying the first element of the QFI exception.

b. Suggestions for Defining the Term "Farming"

A 1984 Treasury report bearing the appealing title "Tax Reform for Fairness, Simplicity, and Economic Growth" provided the impetus for TRA '86.⁴⁹ Congress could move to meet two of the tax policy goals articulated in the Treasury report, fairness and simplicity, by adopting one consolidated definition of the term "farming" for use in all contexts from the QFI exception to the estate tax special use valuation.

A concise and consolidated definition of the term "farming" would help attain the goal of simplicity by providing a centralized, understandable definition of the term, adaptable to all tax situations. If Congress found expansion or restriction of the consolidated definition necessary, it could tailor the desired definition merely by specific modification of the consolidated definition.

A concise and consolidated definition of "farming" would work towards the policy goal of fairness by treating all persons described as farmers within the consolidated definition as such for all purposes under the Code. Rather than a confused patchwork of definitions whereby a taxpayer might be a farmer for one purpose and a nonfarmer for another (such as Christmas tree growers),⁵⁰ a consolidated definition would facilitate similar tax treatment for all persons who fit within the consolidated

48. Although the cultivation, growing, and harvesting of timber are considered farming for purposes of § 2032A, the milling of timber into wood products is not considered to be farming. I.R.C. § 2032A(e)(5)(C) (1982).

49. DEPARTMENT OF THE TREASURY, 1 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, TREASURY DEPARTMENT REPORT TO THE PRESIDENT (1984).

50. See *supra* text accompanying note 45.

definition of "farmer." The section 2032A definition of "farming" provides a good starting point for such a consolidated and concise definition.

2. *The Fifty Percent of Gross Receipts Requirement*

The second element of QFI requires that "50 percent or more of the average annual gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs [must have been] attributable to the trade or business of farming."⁵¹

Other than the uncertainty resulting from Congress' failure to define the phrase "trade or business of farming," the requirements for satisfying the longevity element of the QFI test appear straightforward. By requiring the taxpayer to look back three years, the Code apparently attempts to assure that a taxpayer seeking benefit under the QFI exception has established farming as its primary business, at least during the prior three years.

B. Requirement that the Creditor Be a Qualified Person

As a prerequisite to a taxpayer's eligibility for the QFI exception, TRA '86 required that the creditor be a "qualified person" within the preexisting statutory definition of section 46(c)(8)(D)(iv).⁵² Although the legislative history gives no insight into why Congress so restricted the creditors whose lending could qualify as QFI, Congress apparently intended to preclude QFI treatment of seller-financed debt and credit extended to a taxpayer by a party who theoretically controls the taxpayer, is controlled by the taxpayer, or is controlled by the same party that controls the taxpayer.

The convenience Congress apparently saw in adopting the preexisting definition was illusory. The circuitous route to a definition of "qualified person" results in confusing statutory contortions at best. More importantly, a critical reading of the statutory chain definition reveals gaps that Congress probably did not intend to create.

To be a qualified person within the statutory definition, one first must be "actively and regularly engaged in the business of lending money."⁵³ A creditor is not a qualified person, however, if it is "a person from which the taxpayer acquired the property,"⁵⁴ "a person who receives a fee with respect to the taxpayer's investment in the property,"⁵⁵ or "a related person with respect to the taxpayer."⁵⁶

TAMRA '88 added to the preexisting definition of qualified persons by specifically providing that all federal, state, and local government agencies and instrumentalities are qualified persons for purposes of ap-

51. I.R.C. § 108(g)(2)(B) (Supp. V 1987).

52. I.R.C. § 108(g)(3) (Supp. V 1987).

53. I.R.C. § 46(c)(8)(D)(iv) (Supp. V 1987).

54. I.R.C. § 46(c)(8)(D)(iv)(II) (Supp. V 1987).

55. I.R.C. § 46(c)(8)(D)(iv)(III) (Supp. V 1987).

56. I.R.C. § 46(c)(8)(D)(iv)(I) (Supp. V 1987).

plying the QFI exception.⁵⁷ Rather than settling any confusion, the TAMRA '88 amendments created an apparent boon to relatively few farmers.⁵⁸

1. *Non-Governmental Creditors as Qualified Persons*

a. *Active and Regular Engagement in the Business of Lending Money*

A creditor's status as "actively and regularly engaged in the business of lending money" is critical to the definition of "qualified person," which in turn is critical to a discharged debt's eligibility for nonrecognition/deferral under the QFI exception. However, neither the Code nor regulations define the term "actively and regularly engaged in the business of lending money" for purposes of the qualified person definition. Consequently, because of the dearth of authority defining the term "actively engaged in the business of lending money," interpretations from other contexts may be helpful.

Though by its terms applicable only to the limited statutory exclusion from gross income of interest on loans used to acquire employer securities,⁵⁹ one Treasury regulation concisely states that a person "is actively engaged in the business of lending money if it lends money to the public on a regular and continuing basis (other than in connection with the purchase by the public of goods and services from the lender or a related party)."⁶⁰ In the context of business deductions, courts consistently have held that whether a taxpayer is engaged in the trade or business of lending money depends on the facts and circumstances in each case.⁶¹ Relevant factors include: the number and frequency of loans made by the taxpayer; the time period over which the taxpayer made the loans; the adequacy and nature of the taxpayer's records; the extent of separation between the taxpayer's lending business and its other businesses; the extent to which the taxpayer solicited lending business; the amount of time the taxpayer devoted to the lending business; and the taxpayer's general reputation in the community as a lender.⁶²

b. *Persons from Whom the Taxpayer Acquired the Property*

The rule that a taxpayer seeking to utilize the QFI exception may not have "acquired the property" from the creditor⁶³ seems, at first blush, straightforward. It appears to preclude QFI treatment of all seller-fi-

57. I.R.C. § 108(g)(1)(B) (as amended by TAMRA § 1004(a)(4) (1988)).

58. See *infra* text accompanying note 173.

59. I.R.C. § 133 (Supp. V 1987) provides statutory authority for the exclusion.

60. Treas. Reg. § 1.133-1T (A-2) (1986).

61. *Gustin v. Commissioner*, 27 T.C.M. 186, 190 (CCH 1968).

62. *United States v. Henderson*, 375 F.2d 36, 41 (5th Cir. 1967), *cert. denied*, 389 U.S. 953 (1967).

63. I.R.C. § 46(c)(8)(D)(iv)(II) (Supp. V 1987).

nanced debt, ranging from credit sales of fuel and supplies to owner-financed land sale contracts. Upon closer scrutiny, however, the rule illustrates the unnecessary confusion which often results when Congress adopts a definition from one area of the Code to serve a marginally related purpose in another area.

The stated purpose of treating creditors from whom the debtor acquired the property as nonqualified persons⁶⁴ is to guard against sheltering of income through the "overvaluation of assets or transfer of tax benefits to a party with no real equity in the property."⁶⁵ The term "the property" refers to property used in connection with an activity subject to the at-risk rules,⁶⁶ which generally limit a taxpayer's losses to the amount of its investment,⁶⁷ and placed in service during the taxable year by an individual or a personal holding company.⁶⁸

Farming is one of the activities subject to the at-risk rules.⁶⁹ Nothing in the language or legislative history of the QFI exception, however, indicates that Congress intended to discriminate in favor of farmers who are individuals or personal holding companies. Nonetheless, a strict construction of the operative definition of property results in QFI treatment of debt associated with farm property placed in service during the taxable year by an individual or personal holding company, while QFI treatment does not extend to debt associated with farm property placed in service during the taxable year by, for example, a "C" corporation.

Congress conceivably may have intended the rule precluding QFI treatment of debt when the creditor is "a person from which the taxpayer acquired the property" to refer, in the context of the QFI exception, to any property acquired, in whole or in part, through the discharge of debt.⁷⁰ By prohibiting all debtors in seller-financed transactions from enjoying the benefits of the QFI exception, the statute could preclude collusion between the buyer and seller to inflate the purchase price of property (thereby establishing an artificially high basis against which the buyer could depreciate the property and calculate tax credits), and then agreeing to discharge all or a portion of the debt, with the debtor benefiting from the QFI exception and the creditor acquiring a bad debt deduction.⁷¹

The seeds of failure of such reasoning lie in the nature of the QFI

64. *Id.*

65. H.R. REP. No. 432, 98th Cong., 2nd Sess. 1509 (1984).

66. I.R.C. § 46(c)(8)(B) (Supp. V 1987).

67. I.R.C. § 465(a) (Supp. V 1987).

68. I.R.C. §§ 46(c)(8)(B)(i), 465(a)(1) (Supp. V 1987). A personal holding company is, in general, a corporation having: (1) at some time during the taxable year, more than 50% of its stock owned, directly or indirectly, by five or fewer shareholders; and (2) at least 60% of its income (from sources other than the sale or exchange of capital assets) in the form of passive-type income or income from personal service contracts. I.R.C. § 542(a)(1), (2) (1982).

69. I.R.C. § 465(c)(1)(B) (1982).

70. The plain language of the statute, however, could never support such an interpretation.

71. I.R.C. § 166 (1982 & Supp. V 1987) permits bad debt deductions.

exception, however. A taxpayers' propensity to plan tax sheltering activities in advance, thereby possibly creating the collusion scenario, justify the restrictions against seller financing in the tax shelter arena. The QFI exception, on the other hand, will not likely give rise to advance planning, much less collusion. Few sellers would agree to inflate the sale price in a seller-financed transaction with an eye toward subsequent discharge, because the installment sales provision⁷² requires the seller to recognize a ratable portion of the anticipated gain under the installment sale in the pre-discharge years. Such recognition of gain based on an inflated sale price would cause the seller to recognize a disproportionate share of its "true" gain⁷³ in the early years of the installment contract, thereby denying the seller full use of the deferral opportunity afforded by the installment sales method. By the same token, the seller's bad debt deduction would be deferred to the year of discharge. Such up-front recognition and deferred deductions are the antithesis of tax shelter activities, and to expect such behavior from sellers in arms' length transactions is unrealistic.

On an even more basic level, buyers in a nonshelter, arms' length transaction, whether seller-financed or not, realistically are not likely to practice collusion with the buyer. If the installment sales contract named a purchase price and provided for a subsequent discharge of debt, and the buyer attempted to use the pre-discharge price as its basis, the buyer would hand Treasury perhaps its easiest tax fraud case in history. If, on the other hand, the written agreement between the parties made no mention of the prearranged discharge, the parol evidence rule would constantly stand between the buyer and discharge of a portion of the debt. If the seller did acknowledge a prearranged discharge of a portion of the original debt, Treasury would have its second easiest tax fraud case in history.

Finally, the potential exists for a purchase price reduction if a seller in a seller-financed transaction discharges all or a portion of the debt and the debtor is neither insolvent nor a debtor in bankruptcy.⁷⁴ The practical effect of reducing the purchase price in the event of such a discharge is that the gain will be deferred and preserved in the form of the taxpayer's reduced basis. Such preservation of gain through reduced basis is the same general result that would occur if seller-financed debt were eligible for QFI treatment.⁷⁵

The only reference in the legislative history of the QFI exception to qualified persons, either direct or indirect, is the statement that the QFI exception would be available if a solvent farmer and "an unrelated person" agreed to discharge QFI.⁷⁶ Legislative history does not mention Congress' intent in precluding, through the qualified person requirement, QFI

72. I.R.C. § 453 (1982 & Supp. V 1987).

73. The "true" gain is calculated after taking into consideration the prearranged discharge of debt.

74. I.R.C. § 108(e)(5) (1982).

75. See *infra* text accompanying note 128.

76. S. REP. No. 313, 99th Cong., 2d Sess. 272 (1986).

treatment when the creditor is "a person from which the taxpayer acquired the property."

Given the nature of the QFI exception, the dearth of legislative history surrounding the roundabout preclusion of QFI treatment when the creditor is "a person from which the taxpayer acquired the property," and the potential for a purchase price adjustment if the debt fails to qualify as QFI, no apparent reason exists for any restriction against seller-financed debt qualifying as QFI. Indeed, the restriction and corresponding chain definitions may be mere statutory baggage that tagged along when Congress tapped the preexisting definition of qualified person as a means to preclude QFI treatment of debt discharged by related persons. The prohibition against QFI treatment of debt owed to related persons sufficiently protects against any significant abuses by taxpayers otherwise eligible for the QFI exception.

c. Persons Who Receive a Fee

In requiring that only qualified persons' credit could qualify as QFI,⁷⁷ Congress provided that a creditor will not be a "qualified person" if it is "a person who receives a fee with respect to the taxpayer's investment in the property"⁷⁸ At first glance it appears Congress intended the "person who receives a fee" prohibition to exclude brokers from the list of persons whose extension of credit would qualify for the QFI exception. However, the legislative history of the qualified person definition reveals that the original purpose of the "person who receives a fee" provision was to remove taxpayer debt owed to tax shelter promoters from the amount considered at risk.⁷⁹

No apparent need exists to restrict debt incurred to promoters of tax shelters from qualifying for QFI treatment, because the QFI exception is not likely to be used as a tax shelter. Like the restriction on seller-financed sales of property, the rule denying qualified person status for those who receive a fee from the debtor appears to be mere excess statutory baggage picked up when Congress incorporated the definition in the QFI exception as a shortcut to prohibiting QFI treatment of debt owed to related persons. The phantom appearance of the "person who receives a fee" prohibition in the QFI chain definition again points out the need to revise the definition of qualified person in the QFI context.

d. Related Persons

The tortuous definition of the term "qualified person" includes a requirement that the creditor not be a "related person."⁸⁰ The Code consid-

77. I.R.C. § 108(g)(3) (Supp. V 1987).

78. I.R.C. § 46(c)(8)(iv)(III) (Supp. V 1987).

79. H.R. REP. No. 432, 98th Cong., 2nd Sess. 1510 (1984).

80. I.R.C. § 46(c)(8)(D)(v) (Supp. V 1987) defines the term "related persons" by reference to § 465(b)(3)(C).

ers a creditor related to the taxpayer, and the taxpayer's indebtedness ineligible for the QFI exception if: (1) the lender and the taxpayer bear any of the relationships described in section 267(b) or section 707(b)(1),⁸¹ or (2) the taxpayer and the creditor are engaged in trades or businesses under common control.⁸²

Those who are "related persons" because of their description under section 267(b) or section 707(b)(1) generally consist of members of the same family;⁸³ a corporation⁸⁴ or a partnership,⁸⁵ and any single majority shareholder or partner; two corporations,⁸⁶ or two partnerships,⁸⁷ or a corporation and a partnership,⁸⁸ where the same person owns a majority interest in each such entity; two or more corporations, where the corporations have a parent-subsidiary or a brother-sister relationship, or a combination thereof;⁸⁹ grantors, beneficiaries, and fiduciaries of a common trust;⁹⁰ and fiduciaries and beneficiaries of trusts having a common grantor.⁹¹ The Code deems a taxpayer and its creditor as engaged in trades or businesses under common control if they are members of a group of trades or businesses that is either a parent-subsidiary group under common control, a brother-sister group under common control, or a combined group under common control, within the meaning given to such terms by section 1563.⁹²

The legislative history of the QFI exception gives no insight into why Congress adopted the prohibition against related persons' credit qualifying as QFI. However, Congress apparently wanted to foreclose the opportunity for debtors and creditors to manipulate the QFI exception through the use of loans that were not truly at risk. The prohibition against loans between related persons is sufficient to foreclose any reasonably antici-

81. I.R.C. § 465(b)(3)(C) (Supp. V 1987).

82. I.R.C. § 465(b)(3)(C)(ii) (Supp. V 1987). I.R.C. § 52 (Supp. V 1987) describes which trades or businesses are deemed to be under common control.

83. I.R.C. § 267(b)(1) (1982). For this purpose, "family" includes brothers, sisters, spouses, ancestors and lineal descendants. I.R.C. § 267(c)(4) (1982).

84. I.R.C. § 267(b)(2) (1982).

85. I.R.C. § 707(b)(1)(A) (Supp. V 1987).

86. I.R.C. § 267(b)(11), (12) (1982 & Supp. V 1987).

87. I.R.C. § 707(b)(1)(B) (1982).

88. I.R.C. § 267(b)(10) (1982 & Supp. V 1987).

89. See I.R.C. § 267(b)(3) (Supp. V 1987), which refers to "corporations which are members of the same controlled group (as defined in [§ 267(f)]." Subsection 267(f) in turn refers to the definition of "controlled group" found in § 1563(a), and alters the threshold percentage of ownership for controlled group status (for purposes of § 267) from 80% to 50%. I.R.C. § 267(f)(1)(A) (Supp. V 1987).

The statutory definition of controlled groups of corporations is beyond the scope of this article. For a discussion of the arcane world of § 1563(a) controlled groups of corporations, see Note, *The Brother-Sister Controlled Group Under I.R.C. § 1563(a)(2)*, 67 VA. L. REV. 751 (1981).

90. I.R.C. § 267(b)(4), (6) (1982).

91. I.R.C. § 267(b)(5), (7) (1982).

92. I.R.C. § 52(a), (b) (1982 & Supp. V 1987), which in turn refer to I.R.C. § 1563 (1982 & Supp. V 1987). See also Treas. Reg. § 1.52-1(b) (1988).

pated collusion between lenders and creditors, and should be the only provision in the QFI exception restricting whose credit qualifies as QFI.

2. Governmental Agencies as Qualified Persons

Congress could have moved a long way toward the TRA '86 ideal of simplicity by scrapping the maze of cross-references used to identify qualified persons⁹³ and by replacing it with a single statute that describes clearly the persons whose extension of credit qualifies as QFI. Rather than simplifying the definition of qualified persons, TAMRA '88 added to the existing group of qualified persons by designating all federal, state, and local government agencies and instrumentalities as qualified persons for purposes of applying the QFI exception.⁹⁴ However, understanding the mechanics of the QFI exception is essential to appreciate the impact of the expanded definition of qualified persons.⁹⁵

C. The Section 108 Nonrecognition/Deferral Framework

If discharged debt is QFI and the creditor discharging it is a qualified person, the Code⁹⁶ subjects the discharged amount to the tax attribute offset framework of section 108. Section 108 generally is available only to bankrupt and insolvent taxpayers.⁹⁷

The purpose of the section 108(b) tax attribute offset framework is to preserve deferred *Kirby Lumber* gain by reducing the value of certain assets, called tax attributes, which the taxpayer might otherwise use to reduce its current or future tax liability. If the Code allowed a taxpayer to exclude *Kirby Lumber* gain, but retain tax attributes which in the future might reduce its tax liability, the taxpayer would have realized, but not recognized, *Kirby Lumber* gain, and nothing would require that the taxpayer recognize the *Kirby Lumber* gain in a later tax year. Because *Kirby Lumber* gain fits within the *Glenshaw Glass* definition of gross income,⁹⁸ it is critical that the Code require taxpayers to recognize any *Kirby Lumber* income they might have.

This subsection discusses the tax attribute offset framework Congress has adopted to assure recognition of any deferred *Kirby Lumber* gain, including tax attributes which the taxpayer must reduce to preserve its *Kirby Lumber* gain, the order of their reduction, and other factors relevant to the tax attribute offset framework.

93. See *supra* text accompanying note 52, for discussion of the definition of qualified persons under current law.

94. I.R.C. § 108(g)(1)(B) (P-H) (1988).

95. The impact of the inclusion of governmental agencies as qualified persons is discussed *infra* at text accompanying note 173.

96. I.R.C. § 108(b)(1) (P-H) (1988).

97. I.R.C. § 108(g)(1) (P-H) (1988).

98. "Undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

1. Net Operating Losses

The taxpayer first must offset *Kirby Lumber* gain against the net operating loss⁹⁹ (NOL) deduction "for the taxable year of discharge, and any net operating loss carryover to such taxable year."¹⁰⁰

The Code defines a NOL generally as the excess of allowable business deductions over the taxpayer's gross income for the tax year.¹⁰¹ If a NOL arises for a tax year, the taxpayer may either carry the NOL back to the earliest year in the three preceding that was not a loss year¹⁰² or carry it over to each of the fifteen tax years following the year of the NOL.¹⁰³ Excluded *Kirby Lumber* gain offsets only the NOL for the current year and any carryover to the current year. Congress wisely avoided an amendment-of-return quagmire by not requiring an offset against future years' NOL which might be carried back to the year of discharge of indebtedness. The offset of excluded *Kirby Lumber* gain against NOL is on a dollar-for-dollar basis.¹⁰⁴

2. General Business Credit

The second tax attribute against which a taxpayer must offset excluded *Kirby Lumber* gain is the section 38 general business credit.¹⁰⁵ The general business credit is an umbrella¹⁰⁶ for the investment credit,¹⁰⁷ the targeted jobs credit,¹⁰⁸ the alcohol fuels credit,¹⁰⁹ the increased research activities credit,¹¹⁰ and the low income housing credit.¹¹¹ Because credits allow direct reductions in tax, rather than deductions against gross income, excluded *Kirby Lumber* gain offsets the general business credit on a three-to-one basis.¹¹²

3. Capital Loss Carryovers

The third tax attribute against which a taxpayer must offset ex-

99. I.R.C. § 172 (1982 & Supp. V 1987) provides the net operating loss deduction, carryover, and carryback framework.

100. I.R.C. § 108(b)(2)(A) (1982).

101. I.R.C. § 172(c) (1982).

102. I.R.C. § 172(b)(1)(A) (Supp. V 1987).

103. I.R.C. § 172(b)(1)(B) (Supp. V 1987).

104. I.R.C. § 108(b)(3)(A) (1982).

105. I.R.C. § 108(b)(2)(B) (Supp. V 1987).

106. See I.R.C. § 38(b) (Supp. V 1987).

107. I.R.C. § 46(a) (Supp. V 1987).

108. I.R.C. § 51(a) (Supp. V 1987).

109. I.R.C. § 40(a) (Supp. V 1987).

110. I.R.C. § 41(a) (Supp. V 1987).

111. I.R.C. § 42(a) (Supp. V 1987).

112. I.R.C. § 108(b)(3)(B) (Supp. V 1987). If, for example, a taxpayer has 100x of deferrable *Kirby Lumber* gain, and the tax attribute being offset is the general business credit, deferral of the *Kirby Lumber* gain will trigger a reduction of the taxpayer's general business credit by 33 1/3x.

cluded *Kirby Lumber* gain is the capital loss carryover.¹¹³ In general, capital losses are deductible only to the extent of capital gains.¹¹⁴ Noncorporate taxpayers may also deduct the excess of capital losses over capital gains, but only up to a maximum of \$3,000 per year.¹¹⁵ A taxpayer having capital losses in excess of the deductible amount for a taxable year may carry those excess capital losses over to subsequent years.¹¹⁶ Excluded *Kirby Lumber* income offsets capital loss carryovers on a dollar-for-dollar basis.¹¹⁷

4. Basis Reduction

Next, a taxpayer must offset excluded *Kirby Lumber* income against its basis in its property. The basis reduction provision plays a central role in the QFI exception, as it permits the offset of excluded *Kirby Lumber* gain against the basis in both depreciable and nondepreciable property on a dollar-for-dollar basis.¹¹⁸

Prior to TRA '86, solvent farmers, like all other solvent taxpayers incurring debt in connection with trade or business property, were eligible for the qualified business indebtedness exception, which permitted solvent taxpayers to offset *Kirby Lumber* gain against their basis only in depreciable property.¹¹⁹ The cornerstone of justification for the QFI exception was to afford farmers, whose principal asset is nondepreciable farmland, the same opportunity as taxpayers owning depreciable property to defer recognition of *Kirby Lumber* gain and simultaneously preserve that gain by reducing their basis in business property.¹²⁰

A taxpayer may offset excluded *Kirby Lumber* gain against its basis only in "qualified property;" that is, property used or held for use in a trade or business or for the production of income.¹²¹ The taxpayer must offset excluded *Kirby Lumber* gain from discharge of QFI first against its basis in depreciable qualified property.¹²² Next, it must offset such ex-

113. I.R.C. § 108(b)(2)(C) (1982). I.R.C. § 1212 (1982 & Supp. V 1987) provides the statutory framework for the capital loss carryover.

114. I.R.C. § 1212 (1982).

115. I.R.C. § 1211(b) (Supp. V 1987).

116. I.R.C. § 1212(b) (P-H) (1988).

117. I.R.C. § 108(b)(3)(A) (1982).

118. I.R.C. § 108(b)(3)(A) (1982).

119. I.R.C. § 108(c)(1)(A) (1982) (repealed by Pub. L. No. 99-514, § 822(b)(2), 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2373).

120. 132 CONG. REC. S7827 (daily ed. June 18, 1986) (statement of Sen. Kassebaum, R-Kansas).

121. I.R.C. § 1017(b)(4)(A)(i) (P-H) (1988). The basis reduction rules provide a classic statutory trapeze act. I.R.C. § 108(b)(2)(D)(ii) cross-references to I.R.C. § 1017 for a basis reduction framework. I.R.C. § 1017(b)(4) provides special rules for QFI, including a requirement that a taxpayer may offset *Kirby Lumber* gain excluded under the QFI exception only against its basis in "qualified property." I.R.C. § 1017(b)(4)(B) then cross-references back to I.R.C. § 108(g)(3)(C) for the definition of qualified property cited in the text accompanying this footnote.

122. I.R.C. § 1017(b)(4)(A)(ii)(I) (P-H) (1988).

cluded gain against its basis in land used or held for use in the trade or business of farming.¹²³

If any *Kirby Lumber* gain from discharged QFI remains excluded after offsetting it against the taxpayer's basis in farmland, the taxpayer must offset it against its basis in other qualified property.¹²⁴ Consequently, taxpayers with *Kirby Lumber* gain from the discharge of QFI may offset such gain against their basis in nonfarm, nondepreciable property, while solvent, nonfarming taxpayers who realize *Kirby Lumber* gain from discharge of debt other than QFI must recognize such gain immediately. Such dissimilar treatment of similarly situated taxpayers is the antithesis of sound tax policy.¹²⁵

5. Foreign Tax Credit Carryover

The fifth tax attribute against which a taxpayer must offset *Kirby Lumber* gain is the section 27 foreign tax credit carryover.¹²⁶ Excluded *Kirby Lumber* gains reduce the foreign tax credit carryover on a three-to-one basis.¹²⁷

6. Election to First Reduce Basis in Depreciable Property

A taxpayer allowed to exclude *Kirby Lumber* gain may elect to offset all or a portion of its excluded gain against its basis in depreciable property, outside of the scheme for tax attribute offsets described above.¹²⁸ Any such offset against basis in depreciable property is on a dollar-for-dollar basis.¹²⁹ The taxpayer must make the election on its return for the year of discharge, and may revoke the election only with consent of the Treasury.¹³⁰

The election adds significant flexibility to a taxpayer's planning options. For example, a bankrupt or insolvent taxpayer may wish to preserve its NOL carryover for future years by electing in the year of discharge to reduce its basis in depreciable property.¹³¹ A taxpayer having an expiring NOL, on the other hand, might wish to first offset the NOL, then reduce its basis in depreciable property, thereby preserving its capital loss carryover.

D. Tax Treatment of Discharge of Purchase-Money Debt

If a solvent debtor having *Kirby Lumber* gain is not eligible to utilize the bankruptcy or insolvency exception, and the discharged debt arose in

123. I.R.C. § 1017(b)(4)(A)(ii)(II) (P-H) (1988).

124. I.R.C. § 1017(b)(4)(A)(ii)(III) (P-H) (1988).

125. See *infra* discussion following note 169.

126. I.R.C. § 108(b)(2)(E) (Supp. V 1987).

127. I.R.C. § 108(b)(3)(B) (Supp. V 1987).

128. I.R.C. § 108(b)(5) (1982).

129. I.R.C. § 108(b)(3) (1982 & Supp. V 1987).

130. I.R.C. § 108(d)(9) (Supp. V 1987).

131. H.R. REP. No. 833, 96th Cong., 2nd Sess. 9 (1980).

a seller-financed transaction, the debtor nonetheless may defer recognition of the gain by treating the amount of gain "as a purchase price adjustment."¹³² Neither the Code nor the regulations define the term "purchase price adjustment," but the term apparently refers¹³³ to a book-keeping entry reducing the purchase price of the property by the amount of debt discharged. Such a reduction in the purchase price automatically reduces the debtor's basis in its property,¹³⁴ and thereby preserves any *Kirby Lumber* gain the debtor would have recognized if not for the purchase price adjustment provision.

Following the purchase price adjustment, the tax benefit rule forces the debtor to include in its gross income for the year of discharge an amount equal to the excess depreciation, if any, allowed in prior tax years as a result of the taxpayer's use of the "overstated" purchase price to determine basis.¹³⁵ The tax benefit rule also requires the debtor to include in its gross income for the year of discharge an amount equal to the credits, if any, attributable in the prior year to the amount of the purchase price reduction.¹³⁶

On the other hand, the seller/creditor who discharged the debt, under the claim of right doctrine,¹³⁷ adjusts its tax liability in the year of discharge to take into account the amount of the purchase price adjustment which it previously reported as gross income. The seller/creditor may either: (1) deduct in the year of discharge an amount equal to the purchase price reduction,¹³⁸ or (2) compute the amount of tax in the prior year of inclusion attributable to the purchase price reduction, and reduce its tax liability in the year of discharge by that amount.¹³⁹

IV. GENERAL POLICY CONSIDERATIONS REGARDING THE QFI EXCEPTION

Constant change in the tax law causes confusion. Confusion creates distrust. And ultimately, distrust leads to disrespect of our tax law. . . . Disrespect increases as people feel that similarly situated taxpayers are not paying the same amount of tax.

—Former IRS Commissioner Lawrence Gibbs

A 1984 Treasury Report bearing a title that reflected the overall

132. I.R.C. § 108(e)(5) (1982).

133. See *Halperin Oral Statement* at 9.

134. I.R.C. § 1012 (1982 & Supp. V 1987).

135. *Alice Phelan Sullivan Corp. v. Commissioner*, 381 F.2d 399, 402-03 (Ct. Cl. 1967).

136. I.R.C. § 111(b)(1) (Supp. V 1987). *But see* I.R.C. § 111(b)(3) (1982).

137. The claim of right doctrine is a remedy for those situations where a taxpayer included an item in its gross income for a previous year because the taxpayer appeared at the time to have had unrestricted right to such item, and after the close of such year it is established that the taxpayer did not have unrestricted right to such item. I.R.C. § 1341(a) (1982 & Supp. V 1987). The doctrine requires the adjustment, in the form of a deduction, to be made in the year the taxpayer discovers that its "claim of right" to the item in the prior year was, in retrospect, erroneous. *Id.*

138. I.R.C. § 1341(a)(4) (1982 & Supp. V 1987).

139. I.R.C. § 1341(a)(5) (1982 & Supp. V 1987).

goals of the reform movement, "Tax Reform for Fairness, Simplicity, and Economic Growth,"¹⁴⁰ provided the catalyst for TRA '86. In more technical terms, the report described the two general principles of good tax policy as: (1) similar taxation of similarly situated taxpayers¹⁴¹ and (2) neutrality with respect to the tax law's effect on allocation of resources in a free market economy.¹⁴²

Whether the QFI exception fosters *economic growth* is a question better left to politicians and economists. Earlier discussion in this article regarding the mechanics of the QFI exception pointed out the deceptive complexity, rather than *simplicity*, which the exception contributed to the Code. The issue of *fairness* of the QFI exception is perhaps the most intriguing of the three policy issues, both for its result and for the route Congress took to adoption of the QFI exception.

A. Denial of Kirby Lumber Offset Against Nondepreciable Property

When introducing the QFI exception on the Senate floor, Senator Nancy Kassebaum touted it as a "noncontroversial" remedy of an inequity inherent in the then-existing qualified business indebtedness exception.¹⁴³ The QFI exception, Senator Kassebaum said, would cure the *de facto* discrimination against farmers under the qualified business indebtedness exception. That exception allowed business taxpayers to offset *Kirby Lumber* gain against their basis in depreciable property, but did not allow such offset against basis in nondepreciable assets, such as farmers' major asset, farm land. Although the QFI exception generated little controversy as it passed through Congress, the exception should not escape critical analysis.

1. The Inequity of the Qualified Business Indebtedness Exception

Why, Senator Kassebaum and a throng of farm state senators asked, should the Code allow most solvent businesses to defer recognition of *Kirby Lumber* gain by an offset against their basis in depreciable assets,¹⁴⁴ while effectively precluding farmers from deferring *Kirby Lumber* gain merely because their primary asset, farmland, is nondepreciable, noninventory real property?¹⁴⁵

140. DEPARTMENT OF THE TREASURY, 1 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, TREASURY DEPARTMENT REPORT TO THE PRESIDENT (1984).

141. *Id.* at 14.

142. *Id.* at 13.

143. 132 CONG. REC. S7827 (daily ed. June 18, 1986) (statement of Sen. Kassebaum).

144. I.R.C. § 108(c)(1)(A) (1982) (repealed by Pub. L. No. 99-514, § 822(b)(2), 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2373). This question applies equally to basis in real property that was inventory if the taxpayer was a dealer in real property. I.R.C. § 108(d)(5) (Supp. V 1987) defines "depreciable property" by reference to I.R.C. § 1017. I.R.C. § 1017(b)(3)(E) (Supp. V 1987) allows taxpayers to elect, for purposes of § 1017 and § 108, to treat as "depreciable property" any real property includible in inventory of dealers in real property under § 1221(1).

145. 132 CONG. REC. S7827 (daily ed. June 18, 1986) (statement of Sen. Kassebaum).

The sponsors of the QFI exception pointed out that because farmers' primary asset is nondepreciable farm land, the BRTA revisions to the *Kirby Lumber* doctrine denied farmers the same treatment as similarly situated business taxpayers holding depreciable property. Senator Kas-sebaum noted that the *de facto* discrimination caused a "well-advised farmer with cash flow problems [to] consider filing for bankruptcy" and utilize the bankruptcy exception to *Kirby Lumber*, rather than restructuring the debt.¹⁴⁶ Marginally solvent farmers who restructured their debt and had insufficient depreciable property to offset their *Kirby Lumber* gain could be forced into bankruptcy by increased tax liability due to such gain. Taxpayers receiving discharge of qualified business indebtedness, on the other hand, could defer recognition simply by reducing their basis by the amount of the unrecognized *Kirby Lumber* gain, at least to the extent of their basis in depreciable property. A sound tax policy would not encourage taxpayers with only nondepreciable property to file for bankruptcy merely to obtain the same tax treatment as similarly situated solvent taxpayers with depreciable property.

In addition to the dissimilar treatment of similarly situated taxpayers, the qualified business indebtedness exception presumably interfered with the allocation of resources in a free-market economy.¹⁴⁷ First, the discrimination against solvent taxpayers who held primarily nondepreciable property discouraged investment in nondepreciable property such as farmland. The discrimination also discouraged renegotiation of farm debt, as creditors justifiably feared that tax liability created by recognition of *Kirby Lumber* income might push marginally solvent farmers into bankruptcy, possibly jeopardizing the renegotiating creditor's collection priority and certainly reducing the amount of its claim in bankruptcy.

2. Discrimination Against Nondepreciable Farmland

Compelling as they were, the arguments in favor of the QFI exception were not as one-sided as the debate precipitating its approval. In the rush to adopt TRA '86, few appear to have articulated the significant policy arguments against the QFI exception. Although a few senators at the committee hearing on the QFI exception questioned the fairness of applying the QFI exception only to farmers,¹⁴⁸ no one spoke against the provision on the Senate floor.¹⁴⁹

When Congress voted in 1980 to prohibit solvent taxpayers from offsetting *Kirby Lumber* gain by reducing their basis in nondepreciable as-

146. *Id.*

147. Discussion on the Senate floor focussed on the issue of similar treatment of similarly-situated taxpayers, and only tangentially addressed the allocation of resources issue. An empirical study of the resource allocation issue is beyond the scope of this article.

148. Sen. Long, D-Louisiana, and Sen. Chafee, R-Rhode Island, questioned why farmers should be treated differently than other taxpayers. 31 TAX NOTES No. 2 at 105-06 (April 14, 1986).

149. 132 CONG. REC. S7827-29 (daily ed. June 18, 1986).

sets, it intended to preclude taxpayers from indefinitely deferring *Kirby Lumber* gain by reducing basis in nondepreciable assets which the taxpayer planned never to sell, such as stock in subsidiaries or land on which the business was headquartered.¹⁵⁰ The potential for indefinite deferral likewise should have been a concern surrounding the QFI exception. Farmers typically hold significant depreciable farm assets, such as machinery and buildings, the basis of which was eligible to offset *Kirby Lumber* gain under the pre-TRA '86 qualified business indebtedness exception. The reduction in the basis of those depreciable assets assured recapture of deferred *Kirby Lumber* gain, but only to the extent of the reduction of basis in depreciable property, by reducing the taxpayer's depreciation base and causing the forfeiture of future depreciation deductions.

Although farmers typically have significant depreciable assets, most farmers' primary asset is nondepreciable land. Under the QFI exception farmers allowed to offset *Kirby Lumber* gain against nondepreciable assets will not sacrifice any right to take future depreciation deductions related to those nondepreciable assets. The QFI exception fails to provide any mechanism for rapid recapture of deferred *Kirby Lumber* gain, unlike the qualified business indebtedness exception which forced recapture of deferred *Kirby Lumber* gain via the taxpayer's near-term sacrifice of depreciation deductions.

Furthermore, dealers in real property, who were allowed under the qualified business indebtedness exception to offset *Kirby Lumber* gain against their basis in land held as inventory,¹⁵¹ by definition could be expected to sell their real property in the near future, facilitating rapid recapture of deferred *Kirby Lumber* gain. Farmers, on the other hand, are not likely to sell their land promptly and trigger recapture. Indeed, one express long-term goal of the QFI exception is to help family farmers keep ancestral lands.¹⁵² The QFI exception therefore provides an opportunity for tax planning for farmers. Many farmers who defer *Kirby Lumber* gain and "preserve" it by reducing basis in nondepreciable farmland will keep the farm, then transfer it at death to the next generation. The successors will receive a stepped-up fair market value basis,¹⁵³ and any *Kirby Lumber* gain theoretically "preserved" in the farm land basis will be permanently excluded.

Finally, dealers in real property who elected under the qualified business indebtedness exception to offset *Kirby Lumber* gain against their basis in real property held as inventory¹⁵⁴ were estopped from denying their

150. *Halperin Oral Statement* at 9.

151. I.R.C. §§ 108(d)(5), 1017(b)(3)(E) (1982).

152. 132 CONG. REC. S7828 (daily ed. June 18, 1986) (statement of Sen. Boren).

153. I.R.C. § 1014 (1982).

154. I.R.C. § 1017(b)(3)(E) (1982) permits this election, although repeal of the qualified business indebtedness exception has neutralized its effect. Unlike the old qualified business indebtedness basis offset, the now-exclusive § 108(b) tax attribute offset framework does not discriminate between depreciable assets and nondepreciable assets regarding the

dealer status and seeking capital gain treatment upon sale of the property.¹⁵⁵ On the other hand, farmers who preserve *Kirby Lumber* gain by reducing their basis in nondepreciable assets may treat any gain from sale of their land as capital gain, rather than as ordinary income.¹⁵⁶

Without ever seriously considering the policy considerations against the QFI exception and sailing proudly under the banner of "Tax Reform For Fairness, Simplicity, and Economic Growth," the Senate passed the QFI exception on voice vote.¹⁵⁷ With adoption of the QFI exception, solvent farmers' *Kirby Lumber* gain seemingly would be treated the same as those of taxpayers eligible for the qualified business indebtedness exception.

B. *Legislative Ships in the Night*

The similarity in names between the qualified farm indebtedness exception and the qualified business indebtedness exception is not coincidental. In theory, the two exceptions should have given equal deferral opportunity to similarly situated taxpayers. The QFI's sponsors' pursuit of equitable tax treatment for farmers is, however, a case study in irony.

The QFI exception and the qualified business indebtedness exception passed through tax reform like ships in the night. While Congress enacted the QFI exception allowing farmers to defer *Kirby Lumber* gain, as their nonfarming neighbors had done since 1980, it simultaneously repealed the qualified business indebtedness exception for all other taxpayers. Nothing in the legislative history of either the QFI exception or the qualified business indebtedness exception repeal shows any evidence of coordination between the two provisions of TRA '86. While Senator Kassebaum's "noncontroversial" QFI amendment sailed through tax reform unscathed, the qualified business indebtedness exception, which caused inequitable treatment to farmers in the first place, sailed in the opposite direction, into oblivion.

1. *The Case Against the Qualified Business Indebtedness Exception*

TRA '86 was not the first attempt to repeal the qualified business indebtedness exception. Treasury urged Congress to repeal the qualified business indebtedness exception as part of BRTA in 1980,¹⁵⁸ following up on the Justice Department's similar request in 1978.¹⁵⁹

offset against basis. Following repeal of the qualified business indebtedness exception, a dealer in real property will use the § 1017(b)(3)(E) election only if it is eligible for the bankruptcy or insolvency exception to *Kirby Lumber* and wishes to preserve its NOL and general business credit at the cost of decreased basis.

155. See I.R.C. § 1221(1) (1982 & Supp. V 1987).

156. The differentiation between capital gains and ordinary income is not critical when, as now, there is no preferential tax rate for capital gains.

157. 132 CONG. REC. S7827 (daily ed. June 18, 1986).

158. *Halperin Oral Statement* at 9.

159. *Bankruptcy Tax Act of 1979 [sic], Written Comments on Certain Aspects of*

To support its drive to repeal the qualified business indebtedness exception in BRTA, Treasury pointed out that the purpose of the original *Kirby Lumber* exception was to "aid corporations in financial distress that wished to reduce their yearly interest payments by repurchasing their debt on the open market."¹⁶⁰ Extensive review of returns, however, revealed that taxpayers utilizing the exclusion typically were not distressed.¹⁶¹ Rather, almost all had taxable income for the year of discharge and the immediate preceding years, and over half had at least \$250 million in assets.¹⁶²

Focusing on the intricacies of the tax policy principle of similar treatment of similarly situated taxpayers,¹⁶³ at least one commentator breaks the principle into two subparts: (1) "horizontal equity," providing similar treatment for similarly situated taxpayers;¹⁶⁴ and (2) "vertical equity," exemplified by progressive rate structures allocating the burden of supporting government "with an eye toward the taxpayer's ability to pay."¹⁶⁵

A provision designed for relief of distressed taxpayers, but used almost exclusively by large, healthy corporations to defer taxation of income, does not allocate the tax burden "with an eye toward the taxpayer's ability to pay." Treasury correctly concluded the exception was a relief measure for those who least needed it.¹⁶⁶ Such vertical inequity alone might have been sufficient grounds for BRTA's repeal of the provision allowing deferral of *Kirby Lumber* gain for solvent business taxpayers.

In the spirit of compromise, however, Treasury quietly agreed to forego its battle for outright repeal of the qualified business indebtedness exception.¹⁶⁷ Congress instead restricted the exception to taxpayers able to offset *Kirby Lumber* income against basis in depreciable property, and officially named the provision the "qualified business indebtedness" exception.

In the fallout of BRTA, solvent farmers and other taxpayers having *Kirby Lumber* income but insufficient depreciable property against which to offset it, were left in a second-class tax position. The Code limited their use of the qualified business indebtedness exception severely, while large solvent corporations with a variety of depreciable property, and no critical need for the exclusion, used the exception with near impunity. From 1980 until 1986, the inequitable version of the qualified business

H.R. 5043, 96th Cong., 2nd Sess. 2 (statement of D. Halperin, Deputy Assistant Secretary of the Treasury for Tax Policy) (1980) [hereinafter cited as *Halperin Written Statement*].

160. *Halperin Oral Statement* at 9.

161. *Halperin Written Comments* at 1.

162. *Id.*

163. See *supra* text accompanying note 140, for discussion of the general tax policy goals of TRA '86, and a more technical breakdown of those goals.

164. Hudson, *Tax Policy and the Federal Taxation of the Transfer of Wealth*, 19 WILLAMETTE L. REV. 1, 3 (1983).

165. *Id.* at 4.

166. *Halperin Written Statement* at 2.

167. *Halperin Oral Statement* at 8.

indebtedness exception remained in the Code.

As enacted in BRTA, the qualified business indebtedness exception completed its contradiction of the tax policy goal of similar tax treatment of similarly situated taxpayers. It violated horizontal equity by denying the exclusion of *Kirby Lumber* gain for solvent taxpayers holding little or no depreciable property, while allowing the exclusion for solvent taxpayers who held substantial depreciable property. It violated vertical equity by allowing higher-bracket taxpayers with many depreciable assets to use the exclusion and thereby reduce their tax liability, while lower-bracket taxpayers with smaller portfolios of depreciable assets were less able to use the exclusion, and saw immediate taxation of their *Kirby Lumber* gain. Meanwhile, Treasury reloaded for another assault against the qualified business indebtedness exception. A Senate amendment to TRA '86 called for repeal of the qualified business indebtedness exception, the Conference Committee concurred,¹⁶⁸ and with little fanfare Congress handed Treasury a victory in its long war against the exception. Congress astutely cited sound policy reasons for its repeal of the qualified business indebtedness exception. The exception was "too generous" to those able to pay, and it produced "disparate results among taxpayers depending upon the makeup of their depreciable assets."¹⁶⁹

Congress' repeal of the qualified business indebtedness exception was strong tax legislation. Standing alone, it would have solved the inequity the sponsors of the QFI exception were attempting to cure.

2. I.R.C. Section 108 Exceptions After TRA '86: Reshuffled Inequity

At this point, the conflict inherent in the QFI exception is obvious: solvent farmers now may defer, or even exclude, *Kirby Lumber* gain, but all other solvent taxpayers must recognize such gain in the year the debt is discharged. The inequity of the old qualified business indebtedness exception still exists, but the name and beneficiaries of the exception have changed.

The flip-flop of discrimination caused by the repeal in TRA '86 of the qualified business indebtedness exception and the simultaneous enactment of the QFI exception defeat the policy goal of similar tax treatment of similarly situated taxpayers at multiple levels.

First, the QFI exception discriminates against all solvent, nonfarming taxpayers, including those previously eligible for the qualified business indebtedness exception, by denying them the QFI exception simply because they are not farmers. Neither the 1984 Treasury Report nor the legislative history of either the QFI exception or repeal of the qualified business indebtedness exception mention congressional intent to let farmers "get even." On the contrary, a stated goal of both TRA '86 amendments to section 108, clearly in harmony with the policy goals articulated

168. H.R. REP. No. 841, 99th Cong., 2nd Sess. II-325 (1986).

169. S. REP. No. 313, 99th Cong., 2d Sess. 161 (1986).

in the Treasury Report, was to treat all solvent taxpayers having *Kirby Lumber* gain in a similar manner.

Although Treasury's arguments against the qualified business indebtedness exception were compelling, and farmers were forced to endure six years of inequity because of a quirk in the BRTA amendments to the exceptions from *Kirby Lumber*, vengeance of past inequities does not justify dissimilar treatment of similarly situated taxpayers. Denying taxpayers the opportunity to defer *Kirby Lumber* gain solely because they are not farmers is as inequitable as was the denial of the same opportunity to farmers merely because their only asset was nondepreciable property.

Second, solvent farmers may now defer recognition of *Kirby Lumber* gain by offsetting it against their basis in nondepreciable property,¹⁷⁰ while the pre-TRA '86 Code required those eligible for a *Kirby Lumber* exception to preserve their deferred gain by offsetting their basis in depreciable property.¹⁷¹ Concerns about indefinite deferral of *Kirby Lumber* gain by allowing an offset against nondepreciable property are equally critical with regard to farmers and nonfarming taxpayers. Congress failed to address those concerns as they relate to farmers, and created a significant estate planning tool for agricultural families. The regularity with which farmers restructure their debt, the nondepreciable nature of their primary asset, and their tradition of passing the farm at death to the next generation will assure that farmers will permanently defer significant *Kirby Lumber* gain under the QFI exception.

Simultaneously with providing the QFI break to farmers, Congress altogether precluded solvent nonfarmers from deferring *Kirby Lumber* gain, even though nonfarmers preserved significant gain through basis reductions in depreciable property. Such uneven treatment of similarly situated taxpayers is *prima facie* horizontal inequity.

In addition to violating the principle of similar treatment of similarly situated taxpayers, the QFI exception defeats the tax policy goal of economic neutrality. By allowing deferral of *Kirby Lumber* gain only to the farmer-taxpayer, the provision encourages investment in farming at the expense of nonfarm investment. By allowing farmers to offset *Kirby Lumber* gain against nondepreciable farmland, thereby indefinitely deferring such gain, the QFI provision encourages investment in farmland at the expense of depreciable property such as machinery and storage facilities. Furthermore, the provision permitting farmers, but no others, to offset *Kirby Lumber* gain against their basis in nondepreciable assets other than farmland¹⁷² likely will encourage farmers to invest in nondepreciable property used in a trade or business other than farming. The QFI exception therefore diametrically contradicts the TRA '86 goal of removing ar-

170. I.R.C. § 1017(b)(4)(A)(ii)(II) (Supp. V 1987).

171. See *supra* text accompanying note 96, for discussion of justification for the BRTA requirement that *Kirby Lumber* gain be preserved against the taxpayers' basis in depreciable property.

172. I.R.C. § 1017(b)(4)(A)(ii)(III) (P-H) (1988).

tificial influence of tax considerations from investment decisions.

The changes TRA '86 brought to the statutory exceptions to the *Kirby Lumber* doctrine defeat all stated goals of tax reform. Standing alone, both the repeal of the qualified business indebtedness exception and adoption of the QFI exception had merit. Their operation in tandem, however, brought about inequity antithetical to sound tax policy.

3. *Problems with Making the Government a Qualified Person*

The provision in TAMRA '88 which included governmental entities as qualified persons for purposes of the QFI exception immediately multiplied the effects of the QFI exception. Many farmers' federal, state, and local tax bills instantaneously became QFI, and any compromise between a solvent farmer and the taxing authority now gives rise to deferral of *Kirby Lumber* gain under the QFI exception.

The big shock of the proposed redefinition of qualified persons, however, appears indirect. Although the many arcane consequences of TRA, ACA, and TAMRA are beyond the scope of this article, a cursory analysis indicates Congress concocted a volatile blend of tax and debt relief for farmers.

The Agricultural Credit Act of 1987 (ACA '87)¹⁷³ laid the groundwork for discharge of a large portion of the huge debt America's farmers owe to their lender of last resort, the Farmers Home Administration (FmHA). FmHA has released proposed regulations for implementing ACA '87 that reveal some staggering statistics about the loan discharge, which ACA '87 and the proposed regulations refer to as a "write-down":

About 118,000 FmHA borrowers were delinquent or in some other default status in early 1988, including 16,000 borrowers who have been accelerated. FmHA estimates that about 37,000 of these borrowers are able to resolve repayment problems through normal servicing procedures, including subordination, rescheduling, and deferral. The remaining 81,000 borrowers would be eligible for consideration of restructuring with write-down of debt.¹⁷⁴

FmHA estimates that 65,000 of the 81,000 borrowers eligible for consideration will be unable to show repayment potential, and therefore will not qualify for the write-down program.¹⁷⁵ FmHA further estimates losses on nonqualifying borrowers' loans at six billion dollars.¹⁷⁶ The remaining 16,000 borrowers with repayment potential could participate in the write-down program.¹⁷⁷ For those 16,000 borrowers, FmHA will discharge ap-

173. Pub. L. No. 100-233, 1987 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 1568.

174. *Certain Provisions of the Agricultural Credit Act of 1987 and Additional Amendments of Portions of Farmer Program Regulations*, 53 Fed. Reg. 18,392 (May 23, 1988).

175. *Id.*

176. *Id.*

177. *Id.*

proximately two billion dollars in debt.¹⁷⁸ Neither ACA '87 nor the proposed FmHA regulations implementing it give any apparent consideration to the significant income tax consequences of the write-down.

FmHA apparently considers the 65,000 farmers without repayment potential insolvent. Consequently, the insolvency and bankruptcy exceptions to *Kirby Lumber* will exclude from gross income the six billion dollars of the insolvent farmers' debt that FmHA has forgiven, and the tax attribute offset will apply.¹⁷⁹ Such exclusion is appropriate in light of the long-standing judicial¹⁸⁰ and statutory¹⁸¹ exclusion of *Kirby Lumber* gain of insolvent and bankrupt taxpayers.

The 16,000 farmers who show repayment potential apparently are solvent. Although those solvent farmers will be ineligible for the insolvency exception to *Kirby Lumber*, the redefinition of qualified persons to include the federal government generally brought those solvent taxpayers' debt within the QFI definition. Assuming the taxpayers meet the two part QFI test,¹⁸² that portion of the two billion dollars' worth of discharged indebtedness that represents principle will be taxed under the QFI non-recognition/deferral framework. That portion of the write-down representing accrued but unpaid interest would be realized income, as the interest, if paid, would have given rise to a deduction.¹⁸³ Even if only half the write-down to solvent farmers represents principle, those 16,000 solvent farmers benefiting simultaneously from the QFI exception and the FmHA write-down could defer an average of \$62,500 of *Kirby Lumber* gain. Given the potential for permanent deferral of gain from the discharge of QFI,¹⁸⁴ many of those sixteen thousand solvent farmers likely will realize a portion of their *Kirby Lumber* gain from the FmHA write-down tax free.

Treasury estimated that the QFI exception, in its original intended usage, would result in a total revenue reduction of thirty-nine million dollars for fiscal years 1987 through 1991.¹⁸⁵ Assuming that one billion of the two billion dollars of FmHA loan write-down for solvent farmers is QFI, a marginal tax rate of fifteen percent, and full use of the QFI exception by eligible taxpayers, \$150 million of additional tax revenue will be deferred

178. *Id.*

179. See *supra* text accompanying note 96.

180. See *supra* text accompanying note 10.

181. I.R.C. § 108(a)(1) (Supp. V 1987).

182. See *supra* text accompanying note 36.

183. I.R.C. § 108(e)(2) (1982) precludes realization of income from the discharge of debt that if paid would have given rise to a deduction. I.R.C. § 163 (1982 & Supp. V 1987) allows a deduction for interest paid as an expense of a trade or business. The rationale for § 108(e)(2) is sound. If a taxpayer were deemed to have realized income to the extent of discharged of accrued but unpaid interest, they would then be eligible to deduct the amount of that deemed interest, and a tax "wash" would result. Section 108(e)(2) recognizes the likelihood of such a wash at the outset, and limits its effect.

184. See *supra* text accompanying note 153.

185. DEPARTMENT OF THE TREASURY, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, Appendix of Estimated Revenue Effects of the Act 1362 (1986).

by operation of the QFI exception, as applied to principle forgiven under the FmHA write-down. The portion of such deferred revenue that Treasury would permanently forego through the offsetting of the *Kirby Lumber* gain against basis in nondepreciable property, followed by a date-of-death basis step up, is susceptible only to speculation. Clearly, however, what once was an innocuous relief provision will become, in light of ACA '87, a major forfeiture of tax revenue if Congress fails to ensure recapture of *Kirby Lumber* gain deferred by an offset against taxpayers' basis in nondepreciable assets.

Regardless of the farm policy virtues of the FmHA write-down¹⁸⁶ the federal government's lending of two billion dollars to solvent taxpayers, followed by forgiveness of the debt even though the debtors show ability to repay, in turn followed by a potentially indefinite deferral¹⁸⁷ of those solvent taxpayers' *Kirby Lumber* gain under the QFI exception, is nothing short of a giveaway of taxpayer money.

Out of fairness to the taxpaying public generally unable to defer its *Kirby Lumber* gain, Congress must adopt some mechanism, such as the five-year recapture system proposed below,¹⁸⁸ to assure that taxpayers who are allowed to defer *Kirby Lumber* gain by offsetting their basis in nondepreciable property will be forced to recognize such gain within a reasonable time from the date the creditor discharges the debt.

4. Suggested Changes for Greater Equity Under the QFI Exception

The statutory exceptions to the *Kirby Lumber* doctrine and the Internal Revenue Code in general do not operate in a pure tax-theory vacuum. If they did, this article would call for immediate repeal of the QFI exception because it discriminates in favor of a narrow group of farming taxpayers by allowing them to defer recognition of substantial amounts of taxable income.

Instead of a vacuum, the Code operates in an imperfect market economy. Through tax incentives, Congress regularly attempts to encourage economic behavior which it deems beneficial to the public well-being, but which needs some economic assistance. For example, since the energy crisis of the mid-1970s, the Code has provided a series of tax credits to encourage conservation of existing resources and development of new sources of energy.¹⁸⁹ In the corporate tax area, Congress designed Subchapter S of the Code to facilitate the economic success of the American Dream by allowing small business owners to enjoy the limited liability of the corporate entity, yet avoid the double taxation imposed by the Code

186. The wisdom of the write-down itself is beyond the scope of this article.

187. See *supra* text accompanying note 153, for discussion of the potential for indefinite deferral of *Kirby Lumber* gain under the QFI exception.

188. See *infra* discussion following note 197.

189. See, e.g., the Alcohol Fuels Credit, I.R.C. §§ 40, 87 (Supp. V 1987); the Residential Energy Credit, I.R.C. § 23 (Supp. V 1987); and the Business Energy Property Credit, I.R.C. § 48(l) (1982 & Supp. V 1987).

upon larger corporations and their shareholders.¹⁹⁰ To assist farmers, who grow our food and are prominent in our heritage, the Code is replete with special provisions, ranging from the estate tax special use valuation¹⁹¹ to special accounting rules for crop insurance proceeds and disaster payments.¹⁹²

Such Congressional influence of market decisions by its nature defeats the tax policy goal of economic neutrality. While tax purists might urge repeal of any provision violating the principle of neutrality, reality shows that such provisions have always played an integral role in tax policy. A provision that violates neutrality principles need not, however, violate the principles of vertical and horizontal equity.¹⁹³

This subsection discusses some changes Congress could make in the statutory exceptions to the *Kirby Lumber* doctrine to facilitate equity, assist taxpayers in need, and assure eventual taxation of solvent taxpayers' deferred *Kirby Lumber* gain.

a. Extension of the Exception to Solvent Small Business Taxpayers

The striking fault of the QFI exception is not that it appears in the Code, but that it benefits only farmers, while other solvent small business owners who renegotiate debt to ameliorate cash flow problems are forced to recognize their *Kirby Lumber* gain in the year of discharge. Rather than repealing the QFI exception to bring theoretical equity to the Code, Congress should consider a limited reinstatement of the qualified business exception. Such a reinstatement for business taxpayers with less than ten million dollars in assets would allow marginally solvent, relatively small businesses, which might otherwise be financially unable to renegotiate burdensome debt because of lurking *Kirby Lumber* gain, to renegotiate their debt without having to take bankruptcy merely to avoid devastating tax liability. Such a provision would afford small businesses the same general opportunity to defer *Kirby Lumber* gain that farmers now enjoy under the QFI exception, thereby curing the patent horizontal inequity that currently plagues the QFI exception.

The top-end asset limit, which initially appears to discriminate arbitrarily against larger businesses, is justified by the fact that larger, solvent businesses generally have more financial ability than small businesses to absorb the added tax burden of recognizing *Kirby Lumber* gain. The pre-TRA '86 qualified business indebtedness exception was not utilized primarily by marginally solvent taxpayers, but by large, profitable corporations to defer recognition of *Kirby Lumber* gain at a time when their cash

190. S. REP. No. 640, 97th Cong., 2nd Sess. 3 (1982).

191. I.R.C. § 2032A (1982 & Supp. V 1987). See *supra* note 46, for a brief discussion of the estate tax special use valuation.

192. I.R.C. § 451(d) (1982).

193. See *supra* text accompanying note 163, for a discussion of vertical and horizontal equity.

flow made recognition affordable.¹⁹⁴ To remove some of the arbitrariness from the asset limits of such an exception, the Code could provide for a phase-out of the exception for businesses having between ten and fifteen million dollars in assets.

Such a top-end asset limit for access to a tax relief provision would have parallels in the Code. For example, the estate tax special use valuation¹⁹⁵ allows qualified estates to reduce the taxable value of qualified property, but limits the amount of the reduction to \$750,000.¹⁹⁶ The allowance of a deduction for unreimbursed medical expenses only to the extent they exceed seven and one-half percent of adjusted gross income¹⁹⁷ is designed to give lower-income taxpayers, who typically spend a disproportionately high percentage of their income on medical expenses, a deduction that higher-income taxpayers could use in only extreme circumstances. Too, on a more basic level, the graduated tax rates, to the limited extent they continue to exist after TRA '86, theoretically give preference to those taxpayers least able to afford to pay taxes.

b. Requiring Recapture of Deferred Gain Previously Offset Against Basis in Nondepreciable Property

Limiting the exceptions from the *Kirby Lumber* doctrine to small businesses and farmers would not arrest the concerns about the long-term, potentially permanent deferral of *Kirby Lumber* gain which result from allowing taxpayers to offset such gain against basis in nondepreciable assets.

Congress could foreclose the possibility of permanent deferral by individuals simply by requiring that any *Kirby Lumber* gain previously offset against a taxpayer's basis in nondepreciable property, and not recaptured at the time of the taxpayer's death, be included as gross income on the decedent's final return. Such recapture at death nonetheless would permit deferral of the *Kirby Lumber* gain for extended lengths of time in many cases. However, such recapture at death would compound the estate liquidity problems already all too common.

A more equitable and efficient means of recapturing *Kirby Lumber* gain previously offset against taxpayers' basis in nondepreciable property would be to require taxpayers to recognize such *Kirby Lumber* gain ratably over the five tax years following the year of discharge. Such a provision would assure recapture within a reasonably short period of time, yet afford the taxpayer the luxury of both deferring taxation of such gain and spreading the gain over a number of years, possibly reducing the marginal rate at which such gain is taxed.

194. See *supra* text accompanying note 160.

195. I.R.C. § 2032A (1982 & Supp. V 1987).

196. I.R.C. § 2032A(a)(2) (1982).

197. I.R.C. § 213(a) (Supp. V 1987).

VI. CONCLUSION

The QFI exception has not cured the pre-TRA '86 inequity of the qualified business indebtedness exception, but merely reversed its operation. Solvent farmers, who in 1985 were on the outside of the *Kirby Lumber* exceptions looking in, are now on the inside, looking out. Where farmers were effectively precluded from using the statutory mechanisms for deferring *Kirby Lumber* gain prior to TRA '86, they now are the only solvent taxpayers eligible to defer *Kirby Lumber* gain. Nonfarmers, on the other hand, may defer *Kirby Lumber* gain only if they are bankrupt or insolvent.

Furthermore, farmers may defer *Kirby Lumber* gain by offsetting such gain against their basis in all business property, whether depreciable or nondepreciable. Solvent business taxpayers who were eligible to defer *Kirby Lumber* gain prior to TRA '86, on the other hand, could offset deferred *Kirby Lumber* gain only against depreciable property. By offsetting deferred *Kirby Lumber* gain against their basis in nondepreciable property, farmers may defer recognition of such gain indefinitely. In the event a noncorporate farmer dies before selling his nondepreciable property, or his stock in the family farm corporation that owns nondepreciable property, his heirs will take a fair market value basis, thereby permanently excluding the gain from taxation.

Although providing an inequitable result in a variety of ways, the premise of the QFI exception is attractive. Congress attempted to provide relief for a segment of the economy that the economic recovery has left behind. By making the QFI exception applicable only to certain farming taxpayers, simultaneously repealing a similar provision that previously provided relief to similarly situated nonfarming taxpayers, and allowing for permanent deferral, however, Congress has not provided farmers merely with relief, but has made them a privileged class of taxpayers.

Small businesses of all sorts regularly have cash flow problems, and could benefit from deferral of their *Kirby Lumber* gain without such deferral rising to a level of abuse. Congress could cure the inequity of affording only farmers the QFI deferral by making such deferral available to all small business taxpayers. Congress could mitigate the problem of indefinite, and sometimes permanent, deferral of *Kirby Lumber* gain, moreover, by requiring recognition of such gain ratably over the five tax years following discharge of the indebtedness.

In its current state, the QFI exception is inequitable and provides an unnecessary opportunity for permanent exclusion of income. With some vision and revision, however, it could become a proud example of how Congress might use the Internal Revenue Code to assist needy taxpayers, while protecting the federal fisc.