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A FARMER'S TAX LIABILITY IN THE EVENT OF LIQUIDATION IN OR OUT OF BANKRUPTCY

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INTRODUCTION

Since the formation of organized society, taxation has been a stressful force. "Of all debts, men are least willing to pay the taxes."** One of the most difficult results to explain to a farm client who, without proper legal advice, has been foreclosed upon or has voluntarily liquidated, is the outstanding liability for income tax even though that farmer no longer has his source of income or capital. Some or all of the other debts may have been paid or released by the liquidation; however, the tax bill, sometimes large, remains unpaid.

As a segment of our commercialized society, farmers are generally uninformed about the tax consequences of liquidations or foreclosures. The attorney or accountant who becomes involved only after the taxable events have occurred can do very little to remedy the difficulties faced by the liquidated farmer. The use of bankruptcy proceedings, although likely to have been helpful, are now past discussing; any possible benefit having been lost if events have progressed far enough.¹ This article will examine the results of a farm liquidation or foreclosure (in or out of bankruptcy) and the tax planning overview that can be undertaken in order to minimize the consequences of foreclosure or liquidation.

Tax planning is extremely important in farm liquidations. Farmers are usually on the cash method of accounting; thus, the following factors heighten the concern for tax liability: accelerated depreciation is used on machinery and equipment causing basis to be low; raised animals and grain in inventory have no basis; the basis in land is usually low due to inheritance or a low purchase price; and investment credit is subject to recapture. It is essential that tax strategies be reviewed prior to a farm liquidation.

BACKGROUND

Prior to the adoption of the Bankruptcy Tax Act of 1980,² a series of cases and certain statutes determined the treatment of income from the discharge of indebtedness. A leading commentator described the law as "at best

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1. See 11 U.S.C. § 108 (1982); *Johnson v. First Nat'l Bank of Montevideo, Minnesota*, 719 F.2d 270 (8th Cir. 1983); *In re Pridham*, 31 Bankr. 497 (E.D. Cal. 1983); *In re Martinson*, 26 Bankr. 648 (D.N.D. 1983), *reversed in part*, 731 F.2d 543 (8th Cir. 1984).

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

complex and at worst nearly inscrutable."³ The judicial interpretation required an event leading to taxable income which in turn caused a realizable gain.⁴ Over a period of time the courts determined that a taxable event occurs when debt is cancelled or reduced⁵ and that when a debt is forgiven an item is deemed to be restored to income.⁶ Furthermore, a sale of property which included payment of cash and forgiveness of debt resulted in both being included in the computation of income.⁷ Of course, judicial exceptions developed for insolvency,⁸ cancellation of corporate debts by shareholders,⁹ exchanges of stock for debt,¹⁰ reduction in purchase price,¹¹ gifts or bequests¹² and other miscellaneous transactions.¹³

The only statutory scheme involving the treatment of income from discharge of indebtedness was composed of the codification of the Kirby Lumber Rule under IRC Section 61(a)(12),¹⁴ the elective provisions in IRC Sections 108 and 1017¹⁵ and the provisions of the former Bankruptcy Act, Sections 268 and 270.¹⁶ Generally speaking, these statutes allowed some insolvency exception, basis reduction and some recapture.

The adoption of the Bankruptcy Code in 1978¹⁷ repealed provisions of the Bankruptcy Act, thus eliminating some of the statutory rules and creating the need for the Bankruptcy Tax Act. The Bankruptcy Tax Act of 1980 attempted to eliminate tax avoidance while providing tax planning flexibility. However,

the advent and expansion of the alternative minimum tax has severely undermined the taxpayer's ability to achieve this financial and tax planning flexibility due to the fact that any transfer of property in satisfaction of indebtedness, whether inside or outside of the bankruptcy proceedings, is treated as a sale or other disposition having potential capital gains/tax preference ramifications. . . . This result is consistent whether property is transferred by voluntary deed, forfeiture, foreclosure, abandonment, etc. *The taxpayer with substantially appreciated*

3. Eustice, *Cancellation of Indebtedness Redux: The Bankruptcy Tax Act of 1980 Proposals-Corporate Aspects*, 36 TAX. L. REV. 1 (1980); Noffke, *Discharge of Indebtedness Under the Bankruptcy Tax Act of 1980*, 60 TAXES 635 (1982).

4. Eisner v. Macomber, 252 U.S. 189, 199 (1920).

5. United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

6. Helvering v. Jane Holding Corp., 109 F.2d 933, 940 (8th Cir.), cert. denied, 310 U.S. 653 (1940).

7. Crane v. Comm'r, 331 U.S. 1, 14 (1947).

8. Lakeland Grocery Co. v. Comm'r, 36 B.T.A. 289, 291 (1937); Madison Railways Co. v. Comm'r, 36 B.T.A. 1106, 1109 (1937); Astoria Marine Construction Co., 12 T.C. 798 (1949).

9. Putoma Corp. v. Comm'r, 66 T.C. 652 (1976); aff'd, 79-2 USTC ¶9557, 601 F.2d 734 (5th Cir. 1979); Comm'r. v. Fender, 338 F.2d 924, (9th Cir. 1964), cert. denied, 382 U.S. 813 (1965).

10. Motor Mart v. United States, 156 F.2d 122, 127 (1st Cir. 1946); Alacazar Hotel, Inc. v. Comm'r, 1 T.C. 872, 879 (1943); Rev. Rul. 222, 1959-1 C.B. 8082; Rev. Rul. 98, 1959-1 C.B. 76, 77.

11. Hextel v. Huston, 28 F. Supp. 521, 523 (S.D. Iowa 1939).

12. Helvering v. Am. Dental Co., 318 U.S. 322, 331 (1943).

13. Bradford v. Comm'r., 233 F.2d 935, 939 (6th Cir. 1956); Hotel Astoria, Inc. v. Comm'r, 42 B.T.A. 759, 764 (1940); Walker v. Comm'r., 88 F.2d 170, 171 (5th Cir. 1937).

14. 26 U.S.C. § 61(a)(12) (1982).

15. *Id.* at §§ 108, 1017.

16. 11 U.S.C. §§ 346(J)(1)(5) (1982) (former 11 U.S.C. §§ 668, 670).

17. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

*property who could otherwise avoid bankruptcy by voluntary transfer of property in satisfaction of indebtedness may have to take bankruptcy to avoid federal and state alternative minimum tax on capital gain preferences.*¹⁸

According to the legislative history, the "income tax treatment of debt discharge income in bankruptcy is intended to accommodate both bankruptcy policy and tax policy."¹⁹ The enactment of the Bankruptcy Tax Act was an attempt to cure the confusing scheme of case and statutory law and provide a clarification of when discharge of indebtedness income would be excluded from the reportable income of the taxpayer.²⁰ The purpose was to govern bankrupt, insolvent and solvent debtors who received discharge of indebtedness income and accommodate the aforementioned legislative purposes of both bankruptcy and taxation.²¹ The policy behind bankruptcy law is to provide the debtor with a fresh start.²² The tax policy is to defer (but eventually collect) the tax within a reasonable period.²³

STATUTORY SCHEME FOR TAXATION OF INCOME FROM DISCHARGE OF INDEBTEDNESS

"Gross income" is defined to include, *inter alia*, both the gain from dealings in property (if used in a trade or business) and income from discharge of indebtedness.²⁴ This is further extended in the regulations, wherein it is stated that when an individual performs services for a creditor in return for debt cancellation, income is realized by the debtor.²⁵ Capital gain income results under IRC Section 1001(b) when the amount realized exceeds the basis in the property.²⁶ The "amount realized" includes either the dollars received, debt assumed or debt discharged or the value of property received,²⁷ whereas the "basis" is the cost adjusted for depreciation and improvements.²⁸

IRC Section 108(a)(1), as part of the Bankruptcy Tax Act of 1980, excludes from gross income the amount realized from discharge of indebtedness in three situations:

- (a) If the discharge is in a case under Title 11 U.S.C.,²⁹
- (b) If the discharge occurs when the taxpayer is insolvent;³⁰ or
- (c) If the indebtedness discharge is from a qualified business

18. Bibler, Discharge of Indebtedness Tax Planning Alternatives, Iowa Continuing Legal Education (1984) (available at the University of Iowa College of Law). See Treas. Reg. § 1001-2(a) (1980).

19. H.R. REP. NO. 833, 96th Cong., 2d Sess. (1980).

20. *Id.*

21. *Id.*

22. *Id.*

23. S. REP. NO. 1035, 96th Cong., 2d Sess. (1980), reprinted in U.S. CODE CONG. & AD. NEWS 7017.

24. 26 U.S.C. §§ 61(a)(3), (12) (1982).

25. Treas. Reg. § 1.61-12(a) (1960).

26. 26 U.S.C. § 1001(a) (1982).

27. *Id.* at § 1001(b).

28. *Id.* at § 1011.

29. *Id.* at § 108(a)(1)(A).

30. *Id.* at § 108(a)(1)(B).

indebtedness.³¹

It is the final three situations which must be discussed in detail after the basic information necessary for an evaluation is gathered. Situations outside of the Bankruptcy Code shall be discussed first.

TAXABLE EVENTS NOT OCCURRING WITHIN THE PROTECTION OF THE BANKRUPTCY TAX ACT

Before a farmer or a rancher enters into a voluntary sale or allows a mortgage to be foreclosed outside of a bankruptcy proceeding, a review of the tax status of such a debtor is necessary. The Bankruptcy Tax Act does not define the distinction between discharge of indebtedness income and the income resulting from other transactions. Thus, the Bankruptcy Tax Act will not apply to a debtor who suffers a mortgage foreclosure or a debtor who transfers property other than money in satisfaction of debt unless one of the three exceptions is applicable. These foreclosures or transfers result in capital gain from the sale of depreciable property or other long term property.³² The proceeds from such a transaction are not only subject to the capital gain provisions of the Internal Revenue Code, but also trigger recapture of investment credit and the alternative minimum tax.³³ A review of the issues and possible tax results will help to clearly define the scope of the taxpayer's status.

If a substantial liquidation or foreclosure is under consideration, there is basic information necessary to determine the debtor's ability to transfer (or suffer a transfer) with a minimum of tax consequence. An appraisal of the assets in question is necessary for a determination of fair market value. A review of liabilities is necessary to determine the extent of solvency or insolvency. A depreciation schedule updated to include recently acquired assets must be examined. Past tax returns must be analyzed for net operating loss carryovers, net capital loss carryovers and other tax attributes.

It is necessary to review the statutory scheme in general rules. One general rule is that when property is exchanged for a debt satisfaction, such as a deed in lieu of foreclosure, the taxpayer realizes (1) a capital gain to the extent that the fair market value of the property surrendered exceeds the basis in the property and (2) debt discharge income to the extent that the amount of the debt discharge exceeds the fair market value of the property.³⁴ For example, if the debtor's basis in the property is \$100, fair market value is \$200, the debt against the property is \$300 and the property is transferred to the creditor in satisfaction of the debt, the debtor will have capital gain in the amount of \$100. This is the difference between the basis and the fair market value. The debtor will also have debt discharge income in the amount of \$100—the difference between the debt and the fair market value of the property. Thus, the

31. *Id.* at § 108(a)(1)(C).

32. *Id.* at § 1001(c).

33. *Id.* at §§ 1001, 1202, 55-58, 1017(c)(2).

34. Pinney, Problems of the Insolvent Farmer, ALI-ABA 1983, Tax Planning For Agriculture.

taxpayer will not necessarily benefit by an artificially low market value since the balance will become debt discharge income.

Excessive debt discharge income could create an intolerable tax burden. The Supreme Court has held in *Commissioner v. Tufts*³⁵ that the fair market value of property which is encumbered is irrelevant in calculating the amount realized on the sale or disposition of property, if the fair market value is less than the debt.³⁶ In *Tufts* the sale was for a very nominal consideration on property worth \$1.4 million³⁷—the goal being to show a loss. Since the debt was cancelled, the court found the total gain to be the full amount of the debt.³⁸ Since in most farm loans the farmer is liable for any deficiency after the liquidation and application of the collateral, the debt of the farmer is “recourse.” If there was no liability for the deficiency the debt would be non-recourse. *Tufts* has resulted in the Internal Revenue Service taking the position that the excess of nonrecourse debt over the debtor’s basis in the property is gain even when the debt exceeds the fair market value of the property.³⁹

The alternative minimum tax under IRC Sections 55 through 58 would also apply to determine the tax consequences for the debtor.⁴⁰ If there is gain recognized under IRC Section 1001, then a capital gain deduction follows under IRC Section 1202, which in turn is a tax preference item.⁴¹ It is presently apparent that the alternative minimum tax is applicable whether or not there is a bankruptcy involved.⁴² Furthermore, where accelerated depreciation or investment credit has been taken, it is subject to recapture upon conveyance of the property in satisfaction of debt.⁴³ Thus some authors conclude that the Bankruptcy Tax Act of 1980 has not contributed substantially to a revision or a clarification of tax law governing exchanges of property for debt.⁴⁴

The debtor may also attempt to avoid the repayment of debt by having a third party assume the indebtedness to the creditor. If the party assuming the debt is a related party to the taxpayer there is debt discharge income under IRC Section 108(e)(4).⁴⁵ A related party is defined in IRC Section 267(b) to include a brother, sister, spouse, parent, child, grandchild or any spouse of a child or grandchild.⁴⁶

This author believes most farm debt to be recourse debt and all conclusions herein are reached upon that assumption. The only liquidation situation which from the beginning escapes the debt discharge income question is where

35. 103 S. Ct. 1826 (1983) (this case involved non-recourse debt).

36. *Id.* at 1831.

37. 70 T.C. 756, 757-61 (1978).

38. *Id.* at 770.

39. Treas. Reg. § 1.1001-2(b) (1980).

40. 26 U.S.C. §§ 55-58 (1982).

41. *Id.*

42. S. 3095, 98th Cong., 2d Sess., — CONG. REC. 14,443 (1984) (introduced but not enacted).

43. 26 U.S.C. § 1017(d) (1982).

44. See McQUEEN & CRESTOL, FEDERAL TAX ASPECTS OF BANKRUPTCY (1984).

45. 26 U.S.C. § 108(e)(4) (1982).

46. *Id.* §§ 267(b), 707(b)(1).

fair market value is equal in amount to the debt. Capital gain will almost always result because of high debt and low basis. This gain is recognized regardless of solvency or insolvency.⁴⁷ Where capital gain results, the alternative minimum tax will follow.⁴⁸ Although the use of bankruptcy will avoid discharge of indebtedness income for the debtor due to the interaction of IRC Sections 61 and 108,⁴⁹ further planning is necessary with regard to the bankruptcy estate's capital gain.

SPECIAL RULES APPLICABLE TO DEBT DISCHARGE INCOME IN ALL SITUATIONS

Purchase Money Debt Reductions

Purchase money debt reductions which result in debt discharge income for qualified solvent debtors will be treated as purchase price adjustments and will not result in debt discharge income.⁵⁰ The case law prior to IRC Section 108(e)(5) indicates that this provision should not apply where the debt reduction is attributable to factors such as the running of a statute of limitation.⁵¹ Obviously, this provision does not apply to mortgage foreclosures, failures to execute on judgments or third party transfers by the debtor prior to the debt reduction. It is necessary to note that even if this section applies, the disposition will still be subject to recapture of investment credit.⁵²

Ordinary Business Deduction and Interest Expenses

If payment of the debt results in a deduction on the income tax return, the fact that the debt is being discharged does not give rise to income.⁵³ This may not be as simple a conclusion as it sounds. Firstly, interest accrues on a debt whether or not it is paid, so when interest is part of the debt being discharged it may be ignored as an income item. Secondly, some taxpayers, normally non-farm, are on the accrual basis. IRC Section 163(a) allows a deduction for all interest paid or accrued during the tax period.⁵⁴ When an insolvent taxpayer or debtor does not have sufficient property to pay all debt of equal rank, all payments are first applied to principal.⁵⁵ Since accrual is not payment, it would appear initially that accrual basis taxpayers have a tax benefit in this regard.⁵⁶ However, there is a further complication.

For a cash basis taxpayer, interest must be paid to be deducted.⁵⁷ In a "full-proceeds" loan situation, where interest is paid with borrowed funds by

47. *Millar v. Comm'r*, 577 F.2d 212, 215 (3d Cir. 1978).

48. See generally 26 U.S.C. §§ 55-58 (1982).

49. See generally *id.* at §§ 61, 108.

50. *Id.* at § 108(e)(5).

51. *Fifth Avenue Fourteenth Street Corp. v. Comm'r*, 147 F.2d 453 (2d Cir. 1945); *Hirsch v. Comm'r*, 115 F.2d 656 (7th Cir. 1940); *Hextell v. Houston*, 28 F. Supp. 521 (S.D. Iowa 1939).

52. H.R. REP. NO. 833, *supra* note 16; S. REP. NO. 1035, *supra* note 18.

53. 26 U.S.C. § 108(e)(2) (1982).

54. *Id.* at § 163(a).

55. *Am. Iron and Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 266 (1914).

56. See *Zimmerman Steel v. Comm'r*, 130 F.2d 1011 (8th Cir. 1942).

57. 26 U.S.C. § 163(a) (1982).

an operating lender through a process of loaning the funds and requiring a check to the operating lender for interest payment, the deductibility is subject to question. Although prior cases allowed the deduction,⁵⁸ the authority is now clouded.⁵⁹

When Does The Taxable Event Occur In A Liquidation?

When the taxable event in a liquidation occurs will depend upon whether the transaction is voluntary or involuntary. If the state law involved allows the taxpayer to redeem the property from the foreclosure, a gain or loss will not be realized until the exemption period expires.⁶⁰ In *R. O'Dell & Sons, Co. v. Commissioner*,⁶¹ this conclusion was reached upon the commissioner's assertion that the transfer occurred at the end of the redemption period; *i.e.*, when all rights were lost.⁶² The taxpayer in *O'Dell* wanted the taxable event in the prior year when the foreclosure sale occurred.⁶³ State foreclosure laws should be examined to determine when the debt due the creditor is extinguished or when title to property passes.

HOW DOES THE INTERNAL REVENUE SERVICE FIND OUT ABOUT A FORECLOSURE?

Effective December 31, 1984, voluntary compliance is being ignored in favor of reporting requirements.⁶⁴ Under the Tax Reform Act of 1984 there are new reporting requirements which apply only to lenders who make secured loans in connection with a trade or business.⁶⁵ Under IRC Sections 6050J(a) and (e) the lender whose business loan is secured by property and who in full or partial satisfaction of a debt transfers or otherwise acquires an interest in the secured property or has reason to know that the property has been abandoned is required to file a form 1099 with the Internal Revenue Service and the debtor.⁶⁶ Under IRC Section 6050I(d) the government as a creditor must report all such transactions whether the loan is business connected or not.⁶⁷

LIQUIDATION WITHIN A BANKRUPTCY PROCEEDING

A bankruptcy case is one pursuant to Title 11 of the United States Code⁶⁸ where (1) the debtor is under the jurisdiction of the Court in the case and (2) the discharge of recourse or non-recourse indebtedness is granted by the

58. *Burck v. Comm'r*, 63 T.C. 556, 560 (1975); *Burgess v. Comm'r*, 8 T.C. 47, 50 (1947).

59. *Menz v. Comm'r*, 80 T.C. 1174, 1192 (1983); *Rev. Rul. 647*, 1970-2 C.B. 38; *Ridenour & Knobbe, Income Tax Issues*, 6 J. AGRIC. TAX & L. 473 (Spring 1984).

60. *R. O'dell & Sons Co. v. Comm'r*, 169 F.2d 247, 249 (3d Cir. 1948).

61. *Id.* at 247.

62. *Id.* at 249.

63. *Id.* at 248.

64. 26 U.S.C. § 6050J (1982).

65. The reporting requirements and penalties are discussed at *Treas. Reg. § 1.6050J-IT* (1985).

66. *See infra* note 65.

67. 26 U.S.C. § 6050I(d) (1982).

68. 11 U.S.C. § 101 *et seq.* (1982).

Court or is pursuant to a Court approved plan.⁶⁹ In general, a bankrupt debtor is required to exclude debt discharge income and apply the amount of that income against tax attributes unless the election is made to reduce the basis that the taxpayer has in depreciable property.⁷⁰ This is the trade off that a bankrupt debtor has for the exclusion of debt discharge income. The theory is to prevent the debtor from enjoying the benefits of attributes that were financed with borrowed amounts when he does not have to repay the amount borrowed.

Attribute Reduction

Application of the amount of debt discharge against tax attributes requires a determination of the tax attributes which are applicable to farmers. The excluded amount is applied to reduce tax attributes in the following order: (1) net operating loss of the taxable year of the discharge; (2) net operating loss carryovers; (3) investment credit carryovers; (4) alcohol fuel credits; (5) capital loss carryovers; (6) the basis in all assets (not just those that are depreciable.)⁷¹

In a Title 11 proceeding any balance of the debt discharge income remaining is not recognized.⁷² It makes no difference whether the debtor is rendered solvent.⁷³ Thus it would appear that there is no need to be concerned with asset value for tax purposes in a bankruptcy proceeding.

Election To Reduce Basis

The bankrupt debtor is presented with a planning opportunity. A bankrupt debtor who will be continuing to produce income after the discharge of indebtedness may wish to retain a net operating loss or another carryover. Thus, he may elect to reduce asset basis without limitation.⁷⁴ While this will mean a loss of depreciation in the future, it may preserve the benefits of income and be a reasonable trade off for the debtor. The election is a reduction dollar for dollar only if the basis reduction will also reduce the depreciation of amortization allowable in subsequent periods under IRC Section 1017(b)(3)(B).⁷⁵

If assets other than exempt assets remain following the discharge of indebtedness, the election to reduce basis, as opposed to attribute reduction, can be made under IRC Sections 108(b)(5), 108(d)(7) and 1017(c)(1).⁷⁶ The difference between this election and basis reduction under IRC Section 108(d)(2) is that the former is limited to depreciable property and real property held for

69. The election can be made on Form 982: Adjustment of Basis of Property Under Sections 1017 or 1082(a)(2).

70. 26 U.S.C. § 108 (1982).

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.* at § 108(b)(5).

75. *Id.* at § 1017(b)(3)(B).

76. *Id.* at §§ 108(b)(5), (d)(7), 1017(c)(1).

sale as inventory pursuant to IRC Section 1017(b)(3)(E)(i).⁷⁷

The taxpayer can reduce the basis in the property to zero even though there is indebtedness against the property and pursuant to IRC Section 1017(c)(2) the basis reduction will not trigger investment credit recapture.⁷⁸ That conclusion follows from IRC Section 108(b)(5)(B), which limits the election to the aggregate adjusted basis of the depreciable property held on the first day of the tax year following the discharge.⁷⁹ Furthermore, the taxpayer/debtor can elect to switch horses in midstream by first reducing basis to a certain amount and then applying debt discharge income to tax attributes under IRC Section 108(b)(5)(A).⁸⁰

In any event, the election must be made according to regulations or on the debtor's tax return in the year of discharge.⁸¹ The election cannot be revoked without Internal Revenue Service consent under IRC Section 108(d)(8)(B).⁸² The pitfall in making the election is obvious. A gain on the later sale or disposition of reduced basis assets is subject to recapture as ordinary income under IRC Sections 1245, 1250 and 1017(d).⁸³

A further planning opportunity is available where the debtor was partially liquidated during the course of the year. If, as a result, the taxpayer elected to reduce the basis in his remaining depreciable property in order to preserve a net operating loss, the same debtor may by re-equipping or restocking depreciable livestock prior to the end of that tax year increase property available for new depreciation and new investment credit.

SHORT YEAR ELECTION

The bankrupt debtor that is not a partnership or a corporation can also make an election for a short tax year under IRC Sections 1398(d)(1) and (2)(A).⁸⁴ The making of this election results in two tax years that are each less than twelve months long. Under IRC Section 1398 the election must be made within a period ending on the fifteenth day of the fourth month following the commencement of the bankruptcy proceedings.⁸⁵ This election is not conditioned on Internal Revenue Service approval under IRC Section 1398(d)(2)(A).⁸⁶ Once the election is made, it is irrevocable.⁸⁷ The election is not available to a debtor who has no assets other than exempt property.⁸⁸ A separate tax return is required for each portion of the tax year and any income

77. *Id.* at § 1017(b)(3)(E)(i).

78. *Id.* at § 1017(c)(2).

79. *Id.* at § 108(b)(5)(B).

80. *Id.* at § 108(b)(5)(A).

81. *Id.* at § 108(d)(8)(A).

82. *Id.* at § 108(d)(8)(B).

83. *Id.* at §§ 1245, 1250, 1017(d).

84. *Id.* at §§ 1398(d)(1), (2)(A).

85. *Id.* at § 1398(d)(2)(D).

86. *Id.* at § 1398(d)(2)(A).

87. *Id.* at § 1398(d)(2)(D).

88. *Id.* at § 1398(d)(2)(C).

involved must be annualized.⁸⁹

This allows the debtor an additional planning opportunity with regard to the use of bankruptcy. The tax liability of the debtor for the first short year is an allowable claim in the bankruptcy estate since it arose before filing.⁹⁰ If the debtor has taxable income during the first short period, he may wish to make the election for a short year if the estate has or is expected to almost certainly have assets. The contrary is true if there would be a loss during the first short period. The election should not be made if the goal is to allow the estate to receive the tax attribute and set it off against income of the estate. In the event that a partial voluntary liquidation has occurred prior to the farmer realizing the tax problem, it is submitted that a Chapter 11 proceeding⁹¹ could be filed and an election made for a short tax year to convert any income tax liability into an estate claim. The caveat is that in the event there are no assets in the bankruptcy there will be a continuing nondischargeable tax liability against the debtor for the first two short tax years. Consequently, the efforts to avoid taxation by the use of the bankruptcy will be of no value.

The bankruptcy estate will succeed to any tax attributes of the debtor unused at the time of filing under IRC Section 1398(g).⁹² The unused tax attributes from the bankruptcy estate will pass back to the taxpayer upon termination of the bankruptcy estate under IRC Section 1398(i).⁹³ The election for the short tax year is voided upon dismissal of the bankruptcy or a conversion of the case to a Chapter 13 proceeding⁹⁴ pursuant to IRC Section 1398(b)(1).⁹⁵

The use of Chapter 7⁹⁶ or Chapter 11 proceedings⁹⁷ provides the debtor with many tax planning opportunities. All of these must be explored prior to allowing the debtor to engage in a deed in lieu of foreclosure, a voluntary auction or a bankruptcy proceeding.

DISCHARGE OF INDEBTEDNESS INCOME FOR AN INSOLVENT DEBTOR

Insolvency is defined under the Bankruptcy Tax Act of 1980 as the excess of liabilities over the fair market value of the assets immediately before the discharge.⁹⁸ There appears to be no limit as to the types of assets which are to be considered in this computation. Thus, it would appear that both tangible and intangible assets can be included. Arguably, asset value could be offset by depreciation in reserve on the debtor's books. All of this arises since the term "liabilities" is not defined in the Bankruptcy Tax Act.

89. *Id.* at §§ 1398(d)(2)(E), (F).

90. *Id.* at § 1398(e)(1).

91. 11 U.S.C. §§ 1101 *et seq.* (1982).

92. 26 U.S.C. § 1398(g) (1982).

93. *Id.* at § 1398(i).

94. 11 U.S.C. §§ 1301 *et seq.* (1982).

95. 26 U.S.C. § 1398(b)(1) (1982).

96. 11 U.S.C. §§ 701 *et seq.* (1982).

97. *Id.* at §§ 1101 *et seq.*

98. 26 U.S.C. § 108(d)(3) (1982); *see also* 11 U.S.C. § 101(26) (1982).

The general rule is that a discharge of indebtedness occurring when a debtor is insolvent and not in bankruptcy will be excluded from income up to the amount by which the debtor is insolvent.⁹⁹ This breaks down into some easy rules of thumb. If the debtor is insolvent both before and after the liquidation, the same rules that apply to a debtor in a Title 11 proceeding will apply to the insolvent debtor not in Title 11 proceedings.¹⁰⁰ Thus there will be a reduction in tax attributes in the same manner as in bankruptcy.¹⁰¹ Again, the election to reduce basis rather than tax attributes may be used.¹⁰² If the debtor is solvent after the discharge of indebtedness income, then he is treated in the same manner on that income rendering him solvent as is a solvent debtor.¹⁰³ Thus, to determine the tax treatment of discharge of indebtedness income to such a taxpayer, both the rules of Title 11 proceedings and the rules for solvent debtors should be looked to. No complete explanation of them will be undertaken in this section.

It is important to note that in the event of a workout or a settlement it is the date of the settlement of claims and not the date of the agreement for workout or settlement that is to be used as a determination point for the computation of insolvency.¹⁰⁴ Thus, a planning opportunity is presented. If it is at all possible to manipulate the liabilities or the assets prior to a workout, tax benefits may result. If the goal is to use tax attributes such as net operating loss carryovers, then the debtor will want to be insolvent. It is submitted that a Chapter 7 or a Chapter 11 bankruptcy proceeding should be part of every workout unless there is insolvency both before and after discharge and the questions of capital gain or alternative minimum tax are resolved.

DISCHARGE OF INDEBTEDNESS INCOME FOR THE SOLVENT DEBTOR

The only available method by which a solvent debtor can exclude debt discharge income is by use of the exception for a "qualified business indebtedness."¹⁰⁵ Under IRC Section 108(d)(4), "qualified business indebtedness" is any debt incurred or assumed by a corporation or an individual in connection with property used in a trade or business which the taxpayer elects to have treated under the statute.¹⁰⁶ It is assumed that in almost all situations farm property will qualify for property used in a trade or business. This approach is more limited than it was under the law prior to the Bankruptcy Tax Act.

Since there is not a definition of "solvency" in either the IRC or the Bankruptcy Code, it would seem obvious that a taxpayer is solvent when the fair market value of assets exceeds liabilities. The taxpayer must elect to apply the excluded debt discharge income to reduce basis under IRC Sections

99. 26 U.S.C. § 108(a)(3).

100. *Id.* at § 108(b).

101. *Id.*

102. *Id.* at § 108(b)(5).

103. *Id.* at § 108(a)(3).

104. *Id.* at § 108(d)(3).

105. *Id.* at § 108(c).

106. *Id.* at § 108(d)(4).

108(a)(1)(c), 108(d)(4) and 108(c)(1)(A).¹⁰⁷ The election is made on the tax return for the year of the debt discharge income¹⁰⁸ and cannot be revoked without the consent of the Internal Revenue Service.¹⁰⁹ The election must be made on the tax return for the year in which the debt discharge income is received.¹¹⁰ It is important to note that the fact the debt is secured by property used in the taxpayer's trade or business does not necessarily mean that the debt was incurred in that trade or business.¹¹¹

The solvent taxpayer with debt discharge income from a "qualified business indebtedness" who makes the election must first reduce the aggregate basis of his depreciable assets.¹¹² This reduction occurs at the beginning of the taxable year following the discharge.¹¹³ The sequence of the basis reduction follows IRC Section 1017 in the following manner: (1) property acquired with the proceeds of the debt; (2) property securing the debt; (3) non-inventory property; (4) inventory and receivables.¹¹⁴ Income will be recognized to the extent that debt discharge income exceeds the basis of "depreciable" property.¹¹⁵ Under IRC Section 1017(d)(1) a gain on the subsequent disposition of property of which the basis has been reduced is subject to recapture as ordinary income;¹¹⁶ however, the reduction in basis will not trigger investment tax credit recapture under IRC Section 1017(c)(2).¹¹⁷

The amended effective date for basis reduction in the Bankruptcy Tax Act presents a planning opportunity. The effective date for the basis reduction will now be the first day of the tax year following the discharge.¹¹⁸ Thus, if the taxpayer wants to preserve the advantage of income exclusion, it is possible for him to purchase depreciable property before the beginning of the next tax year.

TAX RETURNS, TAX LIENS AND ADMINISTRATION WITHIN THE BANKRUPTCY CASE

Determination of Tax Liability

IRC Section 1398(a) applies to all cases filed by individuals under Chapter 7 or Chapter 11 of Title 11, U.S.C. after March 24, 1981.¹¹⁹ The Bankruptcy Court has jurisdiction over all of the assets of the case,¹²⁰ and under 11 U.S.C. Section 362(a)(8) the commencement of the proceeding triggers the

107. *Id.* at §§ 108(a)(1)(c), 108(d)(4), 108(c)(1)(A).

108. *Id.* at § 108(d)(8)(A).

109. *Id.* at § 108(d)(8)(B).

110. *Id.* at § 108(d)(8)(A).

111. The lender may take a security interest in all assets though the purpose of the loan may have been personal.

112. 26 U.S.C. § 108(c)(1) (1982).

113. *Id.* at § 108(c)(2).

114. *Id.* at § 1017(b)(1).

115. *Id.* at § 1017(b)(3)(B).

116. *Id.* at § 1017(d)(1)(A).

117. *Id.* at § 1017(c)(2).

118. *Id.* at § 1017(a).

119. *Id.* at § 1398(a).

120. 28 U.S.C. §§ 157, 1334 (1982); 11 U.S.C. §§ 105, 541 (1982).

automatic stay which applies to the institution or continuation of any tax court proceedings involving the debtor, including a challenge to an asserted tax deficiency against the debtor.¹²¹ Under 11 U.S.C. Section 362(d) the Bankruptcy Judge is authorized to lift the stay and permit the debtor to institute or continue tax court cases.¹²² It is important to note, however, that the assets of the estate set out in 11 U.S.C. Section 541 are not subject to Internal Revenue Service levy for pre-petition tax liabilities.¹²³ The remedy of the Internal Revenue Service is to file a proof of claim.¹²⁴

This presents a planning opportunity. If you are filing for a debtor who is a corporate officer and there are tax liabilities, you may wish to notify the tax authorities or file a lien against the assets of the corporation before you file the bankruptcy proceeding. Consequently, the lien will be perfected against the assets of the corporation and the payment of the taxes will be a priority within the bankruptcy proceedings. The ranking of priority among claims in the Bankruptcy Code is set out in 11 U.S.C. Section 507. Priorities are set in the following order: first, administrative expenses including taxes, fines and penalties incurred by the estate; sixth, income taxes for tax years ending on or before the date of filing and any recapture of investment credit claimed by debtor prior to filing.¹²⁵

Under 11 U.S.C. Section 505(a) the jurisdiction of the Bankruptcy Court to determine the liability for a tax deficiency is continued regardless of whether the deficiency has been assessed, unless there was a prior adjudication.¹²⁶ In most jurisdictions the rule of practice is for the Clerk of Court to give notice to the Internal Revenue Service and other creditors. It is required to be given within ten days and must contain certain information. Such notice also meets the requirements of IRC Section 6903.¹²⁷ If this notice is not given, the Statute of Limitations on assessments under IRC Section 6872 is suspended for up to two years.¹²⁸ A willful failure to give information to the Internal Revenue Service under IRC Section 7203 is a misdemeanor with up to a \$25,000 fine or one year imprisonment.¹²⁹

The Bankruptcy Court may determine refund claims.¹³⁰ This jurisdiction arises if the trustee files an administrative claim for a refund with the Internal Revenue Service and 120 days lapse or if a claim for a refund is denied.¹³¹

Under IRC Section 6871(b) the Internal Revenue Service is authorized to make an immediate assessment of the tax imposed on an individual debtor's

121. 11 U.S.C. § 362(a)(8) (1982).

122. *Id.* at § 362(d).

123. *United States v. Whiting Pools*, 103 S. Ct. 2309, 2315 (1983); *I.R.S. v. Norton*, 717 F.2d 767, 771 (3d Cir. 1983); *see Acquilino v. United States*, 363 U.S. 509 (1960).

124. 11 U.S.C. § 507(a)(6) (1982).

125. *Id.* at § 507(a).

126. *Id.* at § 505(a).

127. 26 U.S.C. § 6903(a) (1982).

128. *Id.* at § 6872.

129. *Id.* at § 7205.

130. 11 U.S.C. § 505(a) (1982).

131. *Id.* at § 505(a)(2)(B)(i).

bankruptcy estate.¹³² The Internal Revenue Service is also authorized to assess the tax imposed on the debtor if the liability for the tax has become *res judicata* pursuant to a Bankruptcy Court determination.¹³³ Thus in such instances normal deficiency procedures are not followed.

Under IRC Section 6012(a)(9) a bankruptcy estate with gross income of \$2,700 or more must file a return.¹³⁴ Gross income is defined in IRC Section 61(a). The estate succeeds to the debtor's tax attributes.¹³⁵ A \$1,000 exemption is available to the estate under IRC Section 151.¹³⁶ The legislative history supports the conclusion that the estate is not eligible for income averaging.¹³⁷ The estate must use the debtor's method of accounting pursuant to IRC Section 1398(g)(7).¹³⁸ The tax year may vary under IRC Section 441(a).¹³⁹

Return Filing Requirements

The bankruptcy estate has certain expenses which are deductible. IRC Section 1398(h) allows the bankruptcy estate of an individual certain deductions unless the other provisions of the Internal Revenue Code disallow the same or require them to be capitalized.¹⁴⁰ Those deductible amounts include any administrative expense under 11 U.S.C. Section 503 or any fee charged or assessed against the estate under 28 U.S.C. Section 123.¹⁴¹ These expenses are allowed as deductions only to the estate.¹⁴² Carry-back and carry-forward are allowed and any net operating loss deductions are to be applied first under IRC Sections 172 and IRC 1398(h)(2)(C) and (D).¹⁴³

It is possible to speed up the determination process. Under 11 U.S.C. Section 505(b) the trustee or debtor in possession may request a determination of the estate's unpaid tax liability.¹⁴⁴ A written application together with a return must be filed with the District Director according to specified procedures.¹⁴⁵ This procedure fixes time frames for discharge of the tax liability.¹⁴⁶ Under IRC Section 108(d)(7) the estate has the right to make the election to reduce basis or tax attributes; thus the debtor loses that control in a Chapter 7.¹⁴⁷

132. 26 U.S.C. § 6871(b) (1982).

133. *Id.* at § 6871(c).

134. *Id.* at § 6012(a)(9).

135. *Id.* at § 1398(g).

136. *Id.* at § 151(b).

137. S. REP. NO. 1035, 96th Cong., 2d Sess. 29 (1980).

138. 26 U.S.C. § 1398(g)(7) (1982).

139. *Id.* at § 441(a).

140. *Id.* at § 1398(h).

141. *Id.*

142. *Id.*

143. *Id.* at §§ 172, 1398(h)(2)(C), (D).

144. 11 U.S.C. § 505(b) (1982).

145. Rev. Proc. 17, 1981-1 C.B. 688.

146. *Id.*

147. 26 U.S.C. § 108(d)(7) (1982).

Payment of Unpaid Tax Liabilities

If the debtor already has unpaid tax liabilities at the time the bankruptcy proceedings are commenced, there are certain actions that the debtor should take in order to reduce or extend those liabilities if he is operating pursuant to a Chapter 11. The taxpayer/debtor does have the right to designate how payments to the IRS are to be applied.¹⁴⁸ In *In re Hannan Trucking* the Internal Revenue Service was allowed to allocate payment as it desired and accordingly assessed the principal shareholder and officer the 100 percent penalty assessment of IRC Section 6672.¹⁴⁹ The debtor and his attorney failed to timely instruct the Internal Revenue Service during the bankruptcy that the funds paid were first to be applied to the trust fund liability for FICA and to withholding.¹⁵⁰ The general rule is that the taxpayer's power of designating what claims are to be first paid "evaporates upon the expiration of the time period for filing a timely tax return."¹⁵¹

Other case law has affected the Internal Revenue Service assessments. The court has enjoined the Internal Revenue Service from assessing the 100% penalty unless the Internal Revenue Service has made a showing that the government is in jeopardy.¹⁵² The Court in *H & R Ice Co., Inc.* found that when a plan was confirmed providing for payment the Internal Revenue Service was not insecure.¹⁵³

In applying the provisions of 11 U.S.C. Section 506 the value of a properly filed Internal Revenue Service tax lien is only secured to the extent of the value of the property against which the lien is filed.¹⁵⁴ This value is a question of fact and its determination is double edged (as in other matters).

There is case law that might enable the debtor to exercise certain planning with regard to Internal Revenue Service claims.¹⁵⁵ In *In re Frost* the court held in a Chapter 13 situation that the Internal Revenue Service may not charge interest after the filing of the Chapter 13 proceeding.¹⁵⁶ The same case further indicated that payments made pursuant to the plan are voluntary and the debtor can direct their allocation.¹⁵⁷

Termination of the Estate

The estate can be terminated by plan confirmation, full administration and discharge of trustee or dismissal of the case.¹⁵⁸ Under IRC Section 1398(i) the debtor succeeds to unused net operating losses, capital loss carry-

148. *In re Hannan Trucking*, 17 Bankr. 475 (N.D. Tex. 1981).

149. *Id.* at 479.

150. *Id.* at 478-79.

151. *Id.* at 478, citing *Hirsch v. United States*, 396 F. Supp. 170, 173 (S.D. Ohio 1975).

152. *In re H & R Ice Co., Inc.*, 24 Bankr. 28, 31-32 (W.D. Mo. 1982).

153. *Id.* at 32.

154. 11 U.S.C. § 506(a) (1982).

155. *In re Frost*, 19 Bankr. 804 (D. Kan. 1982).

156. *Id.* at 809-10.

157. *Id.* at 809.

158. 11 U.S.C. §§ 350(a); 1141 (1982).

overs and basis. IRC Section 1398(f)(2) prevents the termination of the estate from being a disposition which is a taxable event.¹⁵⁹

The debtor has obvious tax consequences. First, the tax year of the debtor and the estate are not the same under IRC Section 1398(d)(1).¹⁶⁰ Of course, the debtor has the election for the short year if made prior to filing, but the election is not available if the debtor has only exempt assets.¹⁶¹ Secondly, under IRC Section 1398(j)(2)(B) the debtor may not carry back any net operating loss, etcetera from a post bankruptcy tax year to a pre-bankruptcy tax year.¹⁶² Finally, according to IRC Section 1398(b)(1) the tax returns filed must all be amended if the case is dismissed, because the provisions of IRC Section 108 with regard to bankruptcy do not apply.¹⁶³

CONCLUSION

In conclusion it would seem advisable to thoroughly review the tax attributes, tax returns, value of assets and debt situation of the farmer who is contemplating a voluntary liquidation or who is being subjected to a foreclosure. A determination must be made as to whether or not a Chapter 7 or a Chapter 11 bankruptcy would best suit the farmer in order to preserve a fresh start for him after a total or partial liquidation. The planning opportunities within the bankruptcy proceedings are varied and more beneficial to the debtor than those available outside of bankruptcy and it is contemplated that in most situations a bankruptcy of some type will be necessary.

159. 26 U.S.C. § 1398(f)(2) (1982).

160. *Id.* at § 1398(d)(1).

161. *Id.* at § 1017(c).

162. *Id.* at § 1398(j)(2)(B).

163. *Id.* at § 1398(b)(1).