

INCOME TAX ASPECTS AND CONSEQUENCES OF FINANCIAL DISTRESS TRANSACTIONS

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DISCLAIMER

The law of rights between debtors and their creditors and taxation of transactions between them is highly complex and complicated. The tax laws and other legal matters by this presentation are complex. These materials are designed solely to raise issues and serve as a guideline for the reader's research. These materials were assembled solely for the purpose of education. Every taxpayer has a distinct set of facts and circumstances that makes it impossible to give solutions other than in a general guideline approach. If legal advice, tax advice, accounting assistance or other expert assistance is required, the services of a competent professional person should be sought.

THE FOCUS OF THIS TOPIC IS TO CONDUCT A GENERAL REVIEW OF THE INCOME TAX ASPECTS AND CONSEQUENCES OF ASSET LIQUIDATION, DISCHARGE OF INDEBTEDNESS, AND BANKRUPTCY. IT IS ALWAYS ENCOURAGED THAT THE DEBTOR AND CREDITOR DISCUSS DETERIORATING FINANCIAL CONDITIONS BEFORE THEY ARRIVE AT A POINT OF NO BILATERAL OPTIONS. DUE TO LIMITED TIME OF THIS CONCURRENT SESSION, IT IS NOT POSSIBLE TO COVER THESE TOPICS IN COMPLETE DETAIL.

IMPORTANT USE OF CAPITAL AS AN INPUT

Credit plays a central role in building a profitable farm/ranch business operation in the short and long run. This would also include the continuation of the farming operation to the next generation.

Capital availability can affect the productivity of farm inputs. A reduction in a line of credit could leave a beef cattle resale backgrounding operation idle, force a reduction in fertilizer rates below the optimum level, limit timely repair and maintenance costs which could cause untimely breakdowns during planting and harvest seasons. The preceding examples could have the outcome of less yield potential which would lead to less gross revenue.

In boom times, when profit margins are positive, cash flows are adequate and loan repayment poses few problems for most borrowers, the tendency is to see those conditions as a future trend. Similarly, when profit margins evaporate, cash flows dwindle and loan repayment becomes a problem for a substantial proportion of borrowers, optimism can be eclipsed with gloom. With more than a year of economic adversity, the prevailing attitude tends to be that the future could produce more of the same.

Boom times may encourage borrowers to become overextended before they realize the situation. A tightening of credit as economic conditions worsen typically comes at a time when borrowers may be highly vulnerable to a credit pull back. Reductions in capital availability can inflict substantial economic damage which may be felt for years. Forced liquidations of breeding herds, machinery or land to cover reductions in a line of credit may yield disappointing results as assets are thrown on already depressed markets.

Efforts to scale back a farming/ranching operation, if carried out with attention to long run profitability, may produce a leaner, more profitable operation. Forced adjustments made in haste may impair the economic viability of the operation, not to mention the damage to the confidence of the borrower and

to the lending relationship. During boom times, borrowing is utilized on assets that are used for collateral that have appreciated with low basis (land) and assets that have been depreciated (machinery and purchased breeding livestock that have low remaining basis). As will be discussed later, there are possible income tax consequences for the disposal of assets and debt discharge of those assets.

Another possible negative outcome of financial distress is the less likelihood of bringing home a future generation to the farming/ranching operation. This can create a negative impact on family relations when the parents must subsidize the farming operation for the farm heirs versus the non-farm heirs. In other words, the overall net worth of the parents will diminish, thus affecting the parent's standard of living in retirement and also their overall estate planning to all heirs.

Another indirect outcome of farm financial distress is based off the historical trends of children of farm families choosing non-agricultural careers after post-secondary education. For example, the land grant universities had a decline in overall enrollment in the college of agricultures during the 1980's as college students entered non-agricultural majors. Thus, this could create a shortage of skilled college of agriculture graduates for future agricultural careers.

LOAN REVIEW AND LIQUIDATION APPROACH

In the beginning stages of debt restructuring in an economic downturn for farm and ranch taxpayers, the focus is on relatively minor adjustments, in part because the downturn could be reversed if commodity prices were to increase. As the downturn deepens, as it did in the 1980's the steps taken by lenders often become more severe and could lead to major steps to reduce the scale of operations or even to force the termination of the operation.

A lesson learned in the 1980's was that debt restructuring may be in the best interests of both the borrower and the lender but the acceptance of debt restructuring is often delayed because of the belief that the downturn could end with higher commodity prices because of adverse weather conditions for crop production. In regards to livestock producers, economic recovery often relates to cycle factors affecting the supply of livestock for slaughter.

A major question when default may be on the horizon is whether preemptive steps should be taken to minimize the risk of default. While that is often a good move, and a close working relationship with the lender makes that a more likely step, whenever default actually occurs on a loan or other obligation the question is whether the matter should be resolved through foreclosure on loans, forfeiture of land contracts or bankruptcy. All tend to be disruptive for the farming or ranching operation and may become costly in the long run for both borrower and lender.

Past experience from the 1980s suggest that, if a strong working relationship exists between borrower and lender, it may be possible for parties to work out a debt restructuring plan that minimizes the economic impact on the borrower and reduces the expense generally incurred by lenders in the process.

As a possible procedure, debt restructuring could involve:

- 1) Re-amortization of the loan(s) over a longer time period
- 2) Interest rate could be reduced
- 3) Forgiveness of principal
- 4) Some combination of the above.

Important factors to consider in loan review for restructuring or liquidation

- To what extent is the loan secured with realistically valued collateral?
- Could the borrower be made financially and economically healthy with a restructuring of the loan and, if so, at what cost to the lender?
- Is the borrower-lender relationship flawed in terms of conflict of interest?
- Should a significant weight be attached to avoidance of principal reduction and or reduction of interest rate in the future aspects of maintaining borrowing ability?

Debt restructuring should always be considered when it is in the lender's best interests and may be justified when, even though not in the lender's best short-term interests, it may be in the lender's long term interest to maintain a historically profitable operation.

It is generally not rational to liquidate a loan if the loss expected to be taken is greater than what would be required to keep the borrower in business by restructuring the loan. That determination necessarily involves –

- Probable net recovery on collateral in the event of liquidation.
- The extent to which the lender is unsecured and the probability of recovery as an unsecured creditor after payment of income taxes and other costs of liquidation.
- The economic cost to the lender of interruption of interest payments in the event of liquidation.
- The probability that the borrower, after restructuring, will be able to service the resulting debt.
- The decision of restructuring, is one for the lender to decide.
- Legal and accounting fees may reach significant levels if the resolution between debtor and creditor cannot be resolved.

A comparison of outcomes (restructuring and liquidation) on a net present value basis can provide guidance as to the most rational approach for the lender.

INFORMATION NEEDED FOR PLANNING

Information needed to make decisions on the income tax consequences of bankruptcy options or the various non-bankruptcy choices (foreclosure, forfeiture, voluntary conveyance to creditors).

Inventory of all assets of the debtor. An inventory should be prepared of all assets of the debtor.

- Original cost or original basis otherwise received by gift or inheritance.
- Depreciation allowed or allowable

- Fair market value.
- Any special use valuation recapture under IRC 2032A.
- Depreciation recapture.
- Status of the asset as likely to produce ordinary income or loss, Section 1231 gain or loss or capital gain or loss.

Appraisal of all assets of the debtor. An appraisal of assets is necessary to determine the fair market value of assets at the time of discharge of indebtedness to determine solvency or insolvency and for the transfer of assets in satisfaction of a debt obligation, the nature of the gain.

List of creditors and indebtedness for which the taxpayer is obligated. The list of creditors and indebtedness should be broken down by secured and unsecured debt, recourse debt and non-recourse debt and should show a breakdown of principal and interest owed.

- No income is realized and tax attributes to the extent that payment of a liability would have given rise to an income tax deduction (accrued interest and account payables).
- Losses between related parties are disallowed.

List of the taxpayer's attributes. It is necessary to ascertain the amount of the taxpayer's net operating loss carryover, net capital loss carryovers and tax credit carryovers. The taxpayer's tax attributes are important in determining whether property should be transferred outside of bankruptcy in satisfaction of indebtedness or the taxpayer should file for bankruptcy. Tax attributes must be reduced to the extent of discharged indebtedness (unless the taxpayer is eligible to and does elect to reduce the basis of certain depreciable property in lieu of tax attributes) with different rules for taxpayers who are solvent, insolvent or in bankruptcy.

Calculation of income tax liability under various alternatives. A complete calculation of state and federal income tax liability under the various asset liquidation and bankruptcy choices is highly advisable before decisions are made on alternative liquidation/bankruptcy routes. The calculation should include the various recapture possibilities. Moreover, the calculation should show who bears the burden of tax liability under the various options. The matter of who bears the tax burden can be highly important, for example, in the case of unsecured creditors in bankruptcy, the tax burden may represent one of the more powerful aspects to encourage creditors' acceptance of a plan. The matter of who bears the tax burden is also highly important to the debtor from the standpoint of tax liability remaining with the debtor after property transfers have been concluded. The income tax consequences in bankruptcy should be reviewed carefully with attention given to the income tax treatment under a Chapter 12 filing (for farm and ranch bankruptcies) which is substantially less favorable to the debtor than the other bankruptcy chapters.

PAYMENT OF DEBT WITH PROPERTY

With farm commodity prices receding from the higher levels of 2012 and 2013, concerns are being focused about loan forgiveness. Another question of loan forgiveness is the difference in treatment between recourse and non-recourse loans.

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

Recourse debt

- If property is sold for cash and the cash is applied on the debt, the taxpayer has—
 - Asset gain or loss from the transfer of the property, measured by the difference between the adjusted income tax basis of the transferred property and the amount received for the property and would be taxed in accordance with the gain on sale rules, and
 - Gain or loss from payment of the debt, which is measured by the difference between the unpaid balance of the debt and the amount paid toward the debt, would be taxed under the discharge of indebtedness rules.
- Thus, the above two bullet points is known as the two-step approach.
- If debt relief obtained by the transfer of property is to be taxed in the same manner as debt relief secured by payment of cash, the same two-step procedure would apply. The taxpayer would have—
 - Asset gain or loss from the transfer of the property, measured by the difference between the adjusted income tax basis of the property and the fair market value of the property, and
 - Gain or loss from payment of the debt measured by the difference between the unpaid balance of the debt and the fair market value of the property.
- If the fair market value of the transferred property is less than the unpaid balance of debt, the unsatisfied portion of the debt would produce cancellation of indebtedness income to the debtor.
- If the fair market value of the property exceeds the unpaid balance of the debt, the excess is taxable to the creditor, if the creditor keeps all proceeds from eventual asset disposition.
- The difference between the basis and the fair market value (or foreclosure sale price) is gain or loss from disposition of the property.

Non-recourse debt

- The two step analysis discussed above seems equally valid in the case of non-recourse debt so long as the fair market value of the property exceeds or is equal to the unpaid balance of debt.
- If the value of the property is less than the unpaid balance of the debt, the amount realized on the asset portion of the transaction must be calculated by reference to the unpaid balance of the debt rather than by reference to the fair market value of the property.

(Difference between property basis and debt is gain; no discharge of indebtedness income).
This would be the one-step approach instead of the two-step approach.

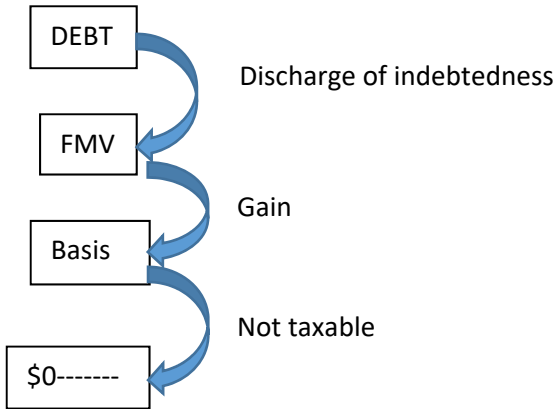
- It is irrelevant that the fair market value of the secured property may be far less than the face amount of the forgiven debts.

Examples of non-recourse debt is commodity loans from the Commodity Credit Corporation to the extent that the debtor may pay off the loan with a sufficient amount of an eligible commodity having a price support value equal to the outstanding value of the loan.

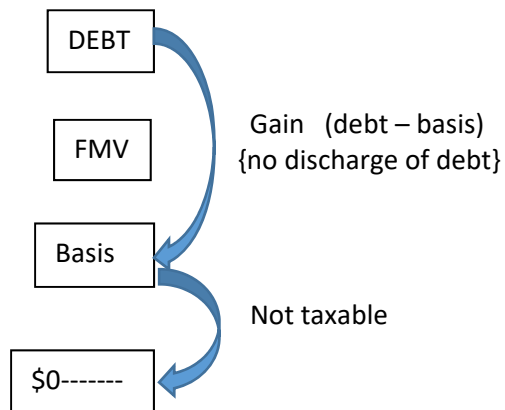
A contract of sale for farmland with the remedy limited to forfeiture of the land in question with no rights to pursue other assets, would be a non-recourse debt.

A debtor in bankruptcy may encounter non-recourse treatment where property subject to recourse debt has been abandoned to the bankruptcy estate.

RECOURSE DEBT



NON-RECOURSE DEBT



Fair market value is not looked at on non-recourse debt. Only basis and debt is relevant.

DISCHARGE OF INDEBTEDNESS

The downturn in farm commodity prices have focused attention once again on forgiveness of debt or ***discharge of indebtedness income***. For many tax preparers and attorneys (and debtors and lenders) it is the first time since the 1980's to see significant problems in repaying debt on farm loans. The rules have remained largely unchanged over the past thirty years.

In general, if indebtedness is cancelled or forgiven, the amount cancelled or forgiven must be included in gross income.

- Forgiveness of principal does have income tax consequences in general. Some exceptions to the general rule exists.

It is important to note that the rules on forgiveness of debt (or discharge of indebtedness) for farm or ranch taxpayers are significantly different from the rules applicable to other types of businesses.

However, relief provisions are available, even for solvent taxpayers, under some circumstances. This will be discussed later in more detail.

Rationale of Tax Rules in Debt Discharge Context:

When a person borrows money, he/she obviously enjoys an economic benefit at the time funds are received from the lender. Since such receipt, however, is offset by the obligation to repay the debt, such receipt is not considered a taxable event.

If, at a later time, all or part of the obligation to repay is discharged, the debtor FULLY enjoys the economic benefit related to their earlier receipt of loan proceeds.

This economic benefit is “realized income”. This realized income may or may not be treated as taxable income (i.e.,_may or may not be both realized and recognized income).

Income is realized from the discharge of indebtedness. Whether realized income is recognized depends on whether it is excluded. If income is excluded, it is not recognized.

As a general rule, taxable income results when a debtor’s obligation is discharged (i.e. canceled) for less than amount due.

Some exceptions to general rule (IRC section 108):

IRC section 108 provides “gross income does not include any amount which would be includible in gross income by reason of the discharge of indebtedness of the taxpayer if --

- Debtors in bankruptcy
- Discharge of indebtedness for an insolvent debtor outside bankruptcy
- Discharge of indebtedness for a solvent qualified farm debtor

In other words, income from the discharge of indebtedness, to the extent that such discharge occurs in a Federal Bankruptcy case, or *while the debtor is insolvent (up to the point of solvency)*, is income realized, but not recognized.

Insolvency is defined in balance sheet terms as “the excess of liabilities over the fair market value of assets”. An appraisal of assets is recommended for documentation.

- 1) The determination of whether and to what extent an individual is insolvent is made immediately before the discharge.
- 2) Accrued but unpaid interest creates insolvency but does not create discharge-of-indebtedness income for a cash basis taxpayer.
- 3) Exempt assets - those assets that creditors cannot satisfy their claims against are included in the insolvency calculation. Before 1999, exempt property was not included in the solvency calculations. In that year, the IRS changed its position to include exempt property.

The amount of discharge-of-indebtedness income “excluded” is limited to the amount of the debtor’s insolvency. If the amount of debt discharged exceeds the amount of insolvency, the taxpayer is made solvent and the discharge-of-indebtedness income may have to be recognized under the solvent taxpayer rules unless the taxpayer qualifies for the solvent farm debtor.

However, the amount of discharge that would otherwise be taxable under the discharge-of-indebtedness rule must be first used to reduce certain tax attributes of the debtor taxpayer. The attribute reductions are made after the determination of the tax imposed for the taxable year of the discharge.

Since income realized, but not recognized, is not taxable income, no current tax liability results.

In some instances, solvent farmers incurring debt discharge will also be entitled to section 108 non-recognition treatment. Under legislation enacted toward the end of the farm debt crisis of the 1980's, effective for discharges after April 9, 1986, discharges of indebtedness arising from an agreement between a person engaged in the trade or business of farming and a "qualified person" as lender to discharge "qualified farm indebtedness" is treated for federal income tax purposes under a special provision (if qualified conditions are met).

However, such non-recognition of income is not without a curse: certain tax attributes of the debtor must be reduced simultaneously with the debt reduction.

For tax years beginning after 1993, those tax attributes which may be so reduced, in order, are:

- Net operating losses
- Business tax credits
- Minimum tax credits
- Capital losses
- Asset basis
- Passive activity loss and credit carryovers
- Foreign tax credits

After the tax attributes have been reduced, any remaining discharge of indebtedness is used to reduce the income tax basis of qualified property of the debtor.

The income tax basis reduction is:

- 1) Depreciable property
- 2) Land used or held for use in the trade or business of farming
- 3) Other qualified property

In lieu of reducing the above-listed tax attributes, the debtor may elect to apply the reduction first against the basis of depreciable property owned by the debtor.

The result of current non-recognition of income and reduction of corresponding tax attributes is that taxable income is deferred, not ultimately avoided.

Reason: Net operating losses, credits, depreciation deductions, and the like will not be available in the future to reduce taxes.

To the extent an insolvent debtor is made solvent by debt discharge, taxable gain may result.

The character of debt discharge income is generally ordinary income and could be subject to self-employment tax in the case of inventory assets. By contrast, the character of income resulting from the transfer of property in satisfaction of debt may vary depending on whether the debt is recourse or non-recourse.

Effective tax planning relating to the discharge of a debtor's debt can often critically enhance the chances of a debtor's post-(debt) discharge financial survival.

Special debt discharge tax rules exist for different types of entities (i.e. individuals, partnerships, corporations, etc.).

The "qualified person" requirement focuses on the lender involved. The qualified person is defined as someone who is actively and regularly engaged in the business of lending money and who is not

- 1) Related to the taxpayer
- 2) A person from whom the taxpayer acquired the property
- 3) A person who receives a fee with respect to the taxpayer's investment in the property.

To be eligible as "qualified farm indebtedness", the indebtedness must be incurred directly in connection with the operation by the taxpayer of the trade or business of farming and 50 percent or more of the average gross receipts of the taxpayer for the three preceding taxable years must be attributable to the trade or business of farming. Cash rent is not considered farm gross receipts for the 50 percent average gross receipts test.

There is no discharge of indebtedness income created to the extent that payment of the indebtedness would have given the taxpayer a deduction (IRS code section 108(e)(2)). Examples are:

- 1) Cancellation of accrued interest under a cash basis taxpayer.
- 2) Seed, chemical, fertilizer, feed, repair and etc. bills that are owed by a cash basis farmer.

TRANSACTIONS THAT CREATE INCOME TAX PROBLEMS

1. Bunching of Income.

Many taxpayers do their tax planning by postponing the recognition of income through the use of rapid depreciation, cash accounting, installment sales, and other income deferral techniques. The common element of those planning techniques is the postponement of the time when income has to be reported for income tax purposes. Unfortunately, the time for reporting that postponed income is often triggered by transactions that result from financial distress. Consequently, the debtor has not only creditors to pay, but also the Internal Revenue Service (IRS).

EXAMPLE 1

Betty Beans sold her 2015 soybean crop in March 2016. In April 2016, her bank did not renew her operating crop loan for the 2016 planted crops. Betty must report the proceeds from

her 2015 crop as income in 2016, the year of sale. Thus, Betty could not find secure financing for the 2016 crops.

Result. Since as a cash basis farmer she deducted the cost of raising that crop on her 2015 income tax return, she has no basis to reduce the income from the sale. She will also have few farm expenses to deduct in 2016 because she has quit farming. Betty will be subject to federal, state and self-employment taxes in most states (at the present time, this income will not be subject to state income taxes in Kansas).

EXAMPLE 2

Same facts as in example 1, except Betty did not quit farming. However, she obtained financing from one of the input vendors at a higher interest rate, than the local bank. The input vendor has repayment due on November 15, 2016, with no extension of the loan payment.

Result. Betty will have two crop sales in 2016, but only one series of deductible crop inputs for the year. She cannot obtain local bank financing to obtain prepaid expenses in late 2016, thus she will have to wait until 2017 to obtain input vendor credit and thus, cannot deduct inputs until after fall harvest 2017.

2. Rapid Depreciation

Rapid depreciation also delays the recognition of income by reducing the basis of property used in the trade or business faster than the property decreases in value. If property that has been on accelerated depreciation is transferred as a result of financial distress, the income that was deferred must now be recognized (depreciation recapture).

EXAMPLE 3

Fred Farmer purchased a grain drill in 2014 for \$50,000. He claimed a total of \$50,000 of accelerated depreciation in 2014. In 2016 he sold the grain drill to pay off some debts He received \$30,000 for the grain drill. His tax depreciation basis in the grain drill at the time of the sale was \$0 (\$50,000 purchase price - \$50,000 of depreciation).

Result. Fred Farmer has a taxable gain of \$30,000 (\$30,000 sales proceeds - \$0 basis). Since the depreciation he claimed was more than the gain, all of the gain must be reported as ordinary income. The \$30,000 gain on the sale is reported on FORM 4797 and thus will be subject to whatever marginal income tax rate that Fred Farmer will fall into. This will include federal and state income tax liability but not self-employment taxes (at the present time all of the preceding taxes would be required in Kansas).

3. Property That is turned over to the Lender Is Treated as if the Property was Sold

A transfer of property to a lender to discharge a debt is a taxable transfer, even though the debtor receives no cash. In such a case, the debtor may have an income tax liability with no cash to pay the tax. The information is provided to the borrower and the IRS on FORM 1099-A.

EXAMPLE 4

Jim has an income tax basis in a planter of \$10,000. The planter has a fair market value of \$25,000 but is also subject to a secured lien in favor of a creditor of \$30,000. Jim agrees to transfer the planter to the creditor in return for a complete discharge of the \$30,000 he owes. In this example it is assumed this is recourse debt and the taxpayer is solvent.

Result. Jim is treated as having sold the planter to the creditor for \$25,000 and has \$15,000 of gain to recognize for income tax purposes (\$25,000 sales price, i.e., fair market value, minus the \$10,000 income tax basis). The other issue is the discharge of indebtedness that must be recognized of \$5,000 (\$30,000 debt - \$25,000 fair market value).

EXAMPLE 5

Frank purchased a 240-acre unimproved farm in 1990 for \$120,000. In 2010, when the farm had a fair market value of \$480,000, he borrowed \$300,000, giving the bank a first mortgage on the property in that amount. In 2016, when the farm has a fair market value of \$200,000, he and the bank agree that if Frank transfers the farm to the bank, the bank will cancel the remaining indebtedness of \$235,000. This loan is recourse debt and the taxpayer is solvent.

Result. Frank is treated for tax purposes as having sold the farm to the bank for its fair market value of \$200,000 and must report the difference between his tax basis of \$120,000 and the \$200,000 (selling price) or \$80,000, as taxable gain in 2016. The other issue is the discharge of indebtedness that must be recognized of \$35,000 (\$235,000 debt - \$200,000 fair market value).

4. Tax Consequences to a Buyer on the Forfeiture of Land Purchased on the Installment Contract Basis or on the Transfer of Assets by a Debtor to a Creditor in Exchange for the Discharge of a Debt.

Farmland and other real estate was sold on the installment contract basis. Property is being forfeited to the seller in exchange for a complete release of buyer liability. Some debtors are transferring property to creditors in exchange for the discharge of a debt. These forfeitures and exchanges have tax implications.

If a person who is obligated on a recourse debt by secured property defaults on the payments and forfeits the property to the creditor, the creditor can obtain a judgment against the debtor for any amount of the debt not satisfied by the forfeited property.

EXAMPLE 6

Barry purchases property for \$300,000 and pays \$100,000 on the principal debt. Barry defaults when the property has a fair market value of \$100,000. If this is recourse debt, the seller can sue Barry for the \$200,000 due on the contract.

If the debt is recourse debt, there is discharge-of-indebtedness income in situations where the fair market value of the property transferred to the creditor is less than the debt released or discharged.

If there is discharge-of-indebtedness income to the taxpayer, the tax preparer must go through a complex procedure. However, after completion of the procedure, the income is generally not subject to income tax. This exception would be under IRS code section 108, generally.

Assume these facts:

Contract price for unimproved land (tax basis)	\$100,000
Debt remaining at time of forfeiture	80,000
FMV of property at time of forfeiture	50,000

Result: The purchaser recognizes a \$50,000 IRS code section 1231 loss if this land is used in a trade or business. This is the difference between the buyer's basis of \$100,000 and the amount realized (FMV of the property) of \$50,000. The purchaser also has \$30,000 of discharge-of-indebtedness income that may or may not have to be recognized depending on the status at the time of discharge. This is the difference between the fair market value of the property transferred or forfeited and the debt discharged. (Again IRS code section 108(a)).

EXAMPLE 6a: Tax treatment of forfeiting purchaser or transferor (assume property is used in trade or business of farming and debt is recourse)

Contract price for unimproved land (tax basis)	\$100,000
Debt remaining at time of forfeiture or transfer	60,000
FMV at time of forfeiture or transfer	60,000

Result: Debt discharge of \$0 (debt discharged is not more than FMV of property transferred) and a \$40,000 loss (difference between tax basis of \$100,000 and value of property forfeited, \$60,000).

EXAMPLE 6b: (Refinancing)

Tax basis of unimproved land	\$200,000
Debt remaining at time of forfeiture or transfer	600,000
FMV at time of forfeiture or transfer	500,000

Result: Debt discharge income of \$100,000 (\$600,000 - \$500,000) [IRS code section 108 for deferral] and \$300,000 gain (\$500,000 - \$200,000).

EXAMPLE 7

Frank, insolvent before and after the discharge, has \$100,000 of debts discharged in 2016. He also has \$80,000 of taxable income from 2016 property liquidations. His 2015 income tax return shows a carryforward NOL of \$70,000. Frank will first use his NOL to reduce income and income tax for 2016. Any unused attributes will then be reduced by the amount of debt discharged. (Also see IRS code section 108).

EXAMPLE 8: INSOLVENT TAXPAYER NOT IN BANKRUPTCY

Facts: Henry Insolvent

<u>Asset</u>	<u>Tax Basis</u>	<u>FMV</u>	<u>Liability</u>	<u>Creditor</u>
Cash	\$3,000	\$3,000	-0-	
Unimproved farmland	200,000	200,000	\$300,000	A
Depreciable business assets	100,000	100,000	123,000	B
Grain inventory	<u>0</u>	<u>25,000</u>	<u>25,000</u>	C
TOTAL	\$303,000	\$328,000	\$448,000	

As part of the reorganization outside of bankruptcy, Creditor A reduces the mortgage debt by \$100,000 and Creditor B reduces the secured debt by \$23,000.

- Immediately before discharge: \$120,000 insolvent (\$328,000 - \$448,000)
- Immediately after discharge: \$3000 solvent (\$328,000 - \$325,000)
- 2015 income tax information: \$15,000 NOL carryforward
- Discharge in 2016
- 2016 income tax information: No attributes used-no tax liability

Income Tax Result – Option one (No election to reduce basis first)

- 1) There is \$120,000 of discharge of indebtedness for the insolvent taxpayer. (The taxpayer is solvent in regard to the other \$3000 discharged).
- 2) Tax attributes have to be reduced to the extent of the \$120,000 discharge.
 - a) The NOL carryforward of \$15,000 reduces discharged debt dollar for dollar. Thus, \$105,000 of discharge is remaining at this point (\$120,000 - \$15,000 = \$105,000).
 - b) Basis reduction is \$0 because the aggregate of the basis of the property held by the taxpayer immediately after the discharge (\$303,000) did not exceed the aggregate of the liabilities of the taxpayer immediately after the discharge (\$325,000).
 - c) The amount of discharge remaining (\$105,000) is not included in income because the debtor was insolvent to that extent.
- 3) \$3000 of discharged indebtedness is reportable as income unless the solvent farmer rule applies.

Option Two (Elect to reduce depreciable basis first)

- 1) Tax attributes have to be reduced to the extent of the \$120,000 discharge.
 - a) Depreciable basis of depreciable business assets is reduced from \$100,000 to \$0. Thus \$20,000 of discharge is remaining at this point (\$120,000 - \$100,000 = \$20,000).
 - b) Tax attribute of \$15,000 of NOL is eliminated.
 - c) \$3000 of the \$123,000 discharge is taxed as ordinary income unless the solvent farmer rule applies.

Tax result if solvent farmer rule applies – Option one - same result except that the \$3000 discharge for a solvent farmer would be used to reduce the tax basis of the farm machinery. This is allowed because all other attributes have already been reduced to \$0.

Option Two (Elect to reduce depreciable basis first)

- o Same result as above.

EXAMPLE 9: TAXPAYER MADE SOLVENT BY THE DISCHARGE

Albert is a farmer with the following balance sheet as of June 1, 2016.

<u>Assets</u>	<u>Tax Basis</u>	<u>FMV</u>
Cash	\$ 1,000	\$ 1,000
Grain	0	20,000
Machinery	80,000	90,000
Breeding stock	0	40,000
Other	5,000	5,000
<u>Land</u>	<u>230,000</u>	<u>230,000</u>
TOTAL	\$316,000	\$386,000

Liabilities and Equity

Accounts payable	4,000
Operating loan	80,000
Machinery	50,000
Real estate	300,000
<u>TOTAL liabilities</u>	<u>\$434,000</u>
EQUITY (Insolvent)	(\$48,000)

NOL carryforward to 2016 ** \$30,000

Capital loss carryforward to 2016 ** \$1000

Albert is a qualified farmer and in an attempt to solve his cash flow problems, convinces his creditors to do the following:

- 1) The bank will reduce the debt on his real estate loan by \$70,000, and
- 2) Farmers Bank & Trust will reduce his current operating loan by \$30,000.

Albert, as a result of these actions, has gone from a position of \$48,000 insolvent to \$52,000 solvent.

To the extent he was insolvent immediately before the discharge, he is an insolvent debtor outside of bankruptcy and those rules applied.

	Before	After	Discharge absorbed
Attribute reduction: NOL	30,000	-0-	(30,000)
Capital loss	1,000	-0-	(1,000)
*Basis	<u>316,000</u>	<u>\$316,000</u>	<u>-0-</u>
			\$34,000

The \$14,000 not absorbed (\$48,000 - \$34,000) is not included in income.

*Aggregate basis immediately after discharge	\$316,000
Aggregate liabilities immediately after discharge	\$334,000
Excess of basis over liabilities	0
Reduction of basis	0

Solvency portion:

Attributes:	
NOL	0
Capital loss	0
Basis	0
Basis of all depreciable property	\$80,000
Solvency portion of discharge	\$52,000
<u>Basis reduction</u>	<u>\$52,000</u>
Taxable income	0

5. Tax Consequences on the Repossession of Real Property

On repossession, the amount of gain recognized is the lesser of

- (1) The amount of cash and the fair market value of other property received prior to the reacquisition (but only to the extent such money and other property exceeds the amount of gain reported prior to the reacquisition)

OR

- (2) The amount of gain realized on the sale (adjusted sales price less adjusted income tax basis) in excess of the gain previously recognized before the reacquisition and the money or other property transferred by the seller in connection with the reacquisition.

EXAMPLE 10

Farmland acquired in 1970 was sold by Fred under installment contract on January 2, 2015, to Jim for \$150,000 calling for \$15,000 down and payments of \$15,000 per year for nine years. The land had an adjusted income tax basis at the time of sale of \$30,000. The seller received the down payment and the first regular payment for the following year, with all payments income tax reported, where upon Jim proceeded to forfeit his interest in the property back to Fred.

Step 1: Calculate the amount of cash and the fair market value of the property received prior to reacquisition

Year of sale	\$15,000
Following year	15,000

Step 2: Subtract the gain returned as income for the period prior to acquisition

Determine gross profit
= \$150,000 - \$30,000
= \$120,000

Determine total contract price
= \$150,000

Fraction reported as gain
= Gross profit/Total contract price
= \$120,000/\$150,000
= 80%

Gain reported
= \$30,000 x 80%
= \$24,000

Gain before application of second application	
Money and other property received	\$30,000
Less: gain reported	<u>24,000</u>
	6,000

Step 3: Determine the second limitation on amount of gain

Sales price of property		\$150,000
Less: adjusted basis at time of sale	\$30,000	
plus gain returned as income before acquisition	<u>24,000</u>	
	\$54,000	<u>\$54,000</u>
Limitation on amount of gain		\$96,000

Step 4: Determine the lesser figure from Step 2 or Step 3 as the amount of gain resulting from reacquisition \$6,000

The character of the gain from reacquisition is determined by the character of the gain from the original sale.

The adjusted income tax basis for the property is the sum of three amounts:

- (1) The adjusted income tax basis to the seller of the indebtedness, determined as of the date of repossession
- (2) The taxable gain resulting from reacquisition
- (3) The money and other property (at fair market value) paid by the seller as reacquisition costs

EXAMPLE 11

Assume farmland was sold for \$250,000 on January 1, 2013. The seller received a \$50,000 down payment plus a \$200,000 mortgage payable at \$40,000 annually, commencing January 1, 2014. The adjusted basis in the property was \$200,000. The seller used the installment sale method for reporting the gain. The gross profit percentage is 20 percent (\$50,000 gain over \$250,000 selling price). In 2013, the seller included \$10,000 (20 percent of \$50,000 down payment) in income. In 2013, the seller included \$8000 (20 percent of \$40,000 payment received) in income. The purchaser defaulted on January 1, 2015, where upon the seller repossessed the farmland. The costs of repossession were \$5,000. Fair market value at the time of repossession was \$300,000. The income tax basis for the farm land in the hands of the seller would be calculated as follows:

Original contract price		\$250,000
Less payments received		<u>(90,000)</u>
Balance		160,000
Less unrealized gain (\$160,000 x 20%)		<u>(32,000)</u>
Seller's adjusted basis in contract given up		\$128,000
Plus - -		
Taxable gain on repossession	\$27,000	
Repossession costs	<u>5,000</u>	
	32,000	<u>32,000</u>
New income tax basis of property		\$160,000

The holding period of the reacquired property, for purposes of subsequent disposition, includes the period during which the seller held the property prior to the original sale plus the period after reacquisition. However, the holding period does not include the time between the original sale and the date of reacquisition.

6. Purchase Price Adjustment

In order to solve one cause of taxpayer disputes with the IRS, Congress added IRS code section 108(e)(5) to the Code to distinguish between true discharge-of-debt situations and those situations merely involving an adjustment to the purchase price of an asset. The seller of property reduces a debt that arose out of the purchaser of that property, the reduction to the purchaser of the purchase money debt is treated, for both buyer and seller, as an adjustment to purchase price, and the purchaser does not recognize any debt discharge income.

The purchase price reduction rule is not elective. A solvent debtor coming within the provision may not choose to recognize debt-discharge income as a result of the price reduction.

EXAMPLE 12

John purchases farm land for \$120,000 a few years ago where he pays \$10,000 down and gives a \$110,000 purchase-money mortgage for the balance. If, after \$75,000 has been paid on the mortgage, the seller agrees to reduce the balance of the debt by \$15,000, and if the purchaser is solvent at that time, there would be \$15,000 in discharge-of-debt income absent IRS code section 108(e)(5).

Under IRS code section 108(e)(5), instead of recognizing income, the purchaser would reduce his basis in the property to \$105,000. Assuming that the price of the property will increase in the future years, John would be required to recognize a larger gain upon a subsequent resale.

The rule will apply only if the reduction to the purchaser ***does not occur*** in a bankruptcy case or ***when the purchaser is insolvent***, and only if the amount of the reduction would otherwise be treated as income from the discharge of indebtedness, but for this rule.

Also, if the debt is transferred to another party by the seller (regardless of whether related to the buyer), the rule will not apply. Nor will the rule apply where the debt is reduced because of factors not involving direct agreement or action by the seller. The rule is not contingent upon renegotiation of the initial purchase price by mutual agreement, however, unilateral reduction by the seller is sufficient to result in non-recognition treatment. The reduction must be based solely on direct, arm's length negotiations between the original buyer and the original seller.

BANKRUPTCY: THE LAST RESORT

A decision to file for bankruptcy should be made only after determining bankruptcy is the best way for a taxpayer to deal with their financial problems. The following information only reviews a few tax aspects of bankruptcy. It is the purpose of this report to focus into the income tax effects of bankruptcy. Any taxpayer that is considering bankruptcy, should seek an attorney that specializes in bankruptcy law and also utilize a tax consultant that understands the income tax code for tax planning strategies.

When farmers find themselves being pressured by outside creditors and finds themselves in financial stress with little or no cash flow to meet the demands of creditors, there are several options. Some of which are:

- 1) Stall for time to pay off the creditors
- 2) Cooperate with the lender(s) in the sale of some asset(s)
- 3) Refinance, if possible
- 4) Seek protection in Bankruptcy Court

Of all the above items, the least understood is item #4.

What is Bankruptcy?

Bankruptcy is a legal proceeding in which a person who cannot pay his or her bills can get a fresh financial start. The right to file for bankruptcy is provided by federal law and all bankruptcy cases are handled in federal court. Filing bankruptcy immediately stops all of your creditors from seeking to collect debts from you, at least until your debts are sorted out according to the law.

Farmers should understand bankruptcy procedures, their rights as a debtor and the right of their creditors during bankruptcy. In addition, a farmer should be aware of and understand both the effect of bankruptcy and the different alternatives to bankruptcy. In the end, bankruptcy should always be considered a last resort.

Choosing to seek the protection of the Bankruptcy Code is a serious decision. While the Bankruptcy Code may help alleviate your debt, the choice does not come without consequences.

First of all, bankruptcy petitions are public information and may be published in local newspapers. Many people feel uncomfortable with their private difficulties being exposed to the general public. Filing bankruptcy will also be reported to most major credit bureaus.

Second, you and your financial affairs will be subject to scrutiny by your creditors and the Bankruptcy Court. Many financial decisions will require the approval of the court.

Finally, the farmer may have to bear the loss of many assets. In this case, it will be increasingly difficult to continue farming or return to farming in the future.

What Can Bankruptcy Do for Me?

Bankruptcy may make it possible for you to:

- Eliminate the legal obligation to pay most or all of your obligations. This is called a “discharge” of debts. It is designed to give you a fresh financial start.

- Stop foreclosure on your residence and allow you an opportunity to catch up on missed payments. (Bankruptcy does not, however, automatically eliminate mortgages and other liens on your property without payment).
- Prevent repossession of an automobile or other property, or force the creditor to return property even after it has been repossessed.
- Stop wage garnishment, debt collection harassment and similar creditor actions to collect a debt.

What Bankruptcy Can Not Do for Me?

Bankruptcy cannot, however cure every financial problem. Nor is it the right step for every individual. In bankruptcy, it is usually NOT possible to:

- Eliminate certain rights of “secured” creditors. A creditor is “secured” if it has taken a mortgage or other lien on property as collateral for a loan. Common examples are car loans and home mortgages. You CAN force secured creditors to take payments over time in the bankruptcy process and bankruptcy CAN eliminate your obligation to pay any additional money on the debt if you decide to give back the property unless you continue to pay the debt.
- Discharge types of debts singled out by the bankruptcy law for special treatment, such as child support, alimony, most student loans, court restitution orders, criminal fines and most taxes.
- Protect cosigners on your debts. When a relative or friend has co-signed a loan, and the consumer discharges the loan in bankruptcy, the cosigner may still have to repay all or part of the loan.
- Discharge debts that arise after bankruptcy has been filed.

BANKRUPTCY OPTIONS

If some type of workout cannot be negotiated, bankruptcy may be the only alternative. Although bankruptcy usually is viewed as “throwing in the towel,” the Bankruptcy Code actually offers some choices. Under the Bankruptcy Reform Act of 2005, there are several types of bankruptcy protection available, which involve rearranging the debtor’s financial affairs to allow them to continue operating their business or the liquidation of the debtor’s asset.

There are four types of bankruptcy cases provided under the law:

- CHAPTER 7 is known as “straight” bankruptcy or “liquidation.” It requires an individual to give up property which is not “exempt” under the law, so the property can be sold to pay creditors. Generally, those who file chapter 7 keep all of their property except which is very valuable or which is subject to a lien which they cannot avoid or afford to pay. It is the most logical choice for a farmer who cannot continue to farm and must terminate their farming operation. However, it may not be the best option for a farmer who wishes to remain farming and avoid liquidation. To qualify for relief under Chapter 7, the debtor must be an individual, partnership, corporation or other business entity. An individual debtor’s eligibility for Chapter 7 protection is subject to the “means test”. The means test prohibits certain high income or high assets debtors

from filing for Chapter 7 protection. The means test applies when the debtor's current monthly income is more than the state median income. If the debtor's current monthly income is more than the state median income then, to be eligible for chapter 7, the debtor's disposable income is examined.

- CHAPTER 12 was added to the Bankruptcy Code in 1986 during a deep financial crisis in the farm economy. and subsequently amended in 2005. It is designed specifically for the "reorganization" of family farmers and fishermen. Chapter 12 is only available to persons who meet the definition of "family farmer" set forth in the statute. A family farmer may either be an individual or a corporation or a partnership or a limited liability entity. Chapter 12 is closely modeled after Chapter 13; however, Chapter 12 has higher debt limits intended to enable traditional family farms to be eligible for a reorganizational bankruptcy. However, Chapter 12 does have debt limits and thus a Chapter 12 may not be an option and Chapter 11 may be the only option for reorganization.
- CHAPTER 11, known as "reorganization" is used by businesses and a few individuals whose debts are very large. If a farm debtor cannot qualify for Chapter 12, Chapter 11 provides similar reorganization possibilities. In general, any partnership, corporation or limited liability entity may be a debtor in a Chapter 11 case.
- CHAPTER 13 is a type of "reorganization" used by individuals to pay all or a portion of their debts over a period of years using their current income.

CHAPTER 12

There are several tests which must be met in order to qualify as a family farmer. An individual or a married couple that engage in a farming operation must now meet the following specific eligibility requirements:

- The farmer's total amount of debt cannot be greater than \$4,031,575 as of the day the case is filed.
- At least fifty percent (50%) of the aggregate debt must come from the farming operation.
- The farmer must meet a "gross income from farming" test. More than fifty percent (50%) of the gross income for the taxable year before the bankruptcy is filed must come from the farm operation. The Bankruptcy Reform Act provided an alternative. Farmers can also meet the gross income test if more than fifty percent (50%) of their gross income in each of the second and third taxable years before the bankruptcy filing came from the farming operation.

A corporation, partnership or limited liability entity that engages in a farming operation can also be eligible for Chapter 12 relief if it meets the following specific eligibility requirements:

- More than fifty percent (50%) of the outstanding stock or equity in the partnership, corporation or limited liability entity must be held by one family or by one family and the relatives of the members of that family.
- This family or their relatives must conduct the farming operation.
- More than eighty percent (80%) of the value of the assets of the corporation, partnership or limited liability must be related to the farming operation.

- The debts of the corporation, partnership or limited liability entity must not be greater than \$4,031,575, with this amount increased each 3 years with the Consumer Price Index. This reflects a change, as noted with regard to the individual limitation.
- Not less than fifty percent (50%) of the corporation, partnership or limited liability entity liquidated debt must arise out of farming operation that is owned or operated by the corporation, partnership or limited liability entity.
- If a corporation issues stock, its stock must not be publicly traded.

Since its enactment, there has been a substantial amount of litigation concerning whether a person is eligible for Chapter 12. Generally, the debtor must be actively involved in farming operations in order to be eligible. If the taxpayer rents out their farmland for cash rent, they will not likely be found to be engaged in farming.

Note that most aspects of the definition of “family farmer” will depend on defining some aspect of farming: farm income, farm debt, engaged in farming and etc. There has been a considerable amount of case law on these issues, sometimes with inconsistent results between jurisdictions.

TAX CONSIDERATIONS OF BANKRUPTCY

In the event that the debtor seeks protection of the Bankruptcy Code, additional results and planning opportunities follow. **If a debtor files bankruptcy under either Chapter 7 or 11, a new taxable entity is created.** The bankruptcy estate is a taxable entity that is separate and distinct from the debtor. All property owned by the debtor at the time the bankruptcy is started passes by the operation of the Bankruptcy Code to the bankruptcy estate. The transfer of assets by the debtor to the bankruptcy estate is not treated as a taxable disposition. Thus, the transfer does not require income tax to be paid on the gain in the assets involved. Nor does the transfer trigger income tax liability from the recapture of depreciation. The bankruptcy estate is treated as the debtor would have been treated had not filed for bankruptcy.

After the bankruptcy case has been initiated, income generated from assets included in a bankruptcy estate is included in the bankruptcy estate’s income. Thus, if the bankruptcy estate disposes of assets or suffers a foreclosure and triggers income tax liability in the process, the income tax liability is a priority claim in the estate as an administration expense. As a result, the tax due is paid ahead of general unsecured creditors. Any income tax liability remaining does not pass back to the debtor, however. The bankruptcy trustee in a Chapter 7 case could determine that it is in the best interest of the estate to “abandon” certain assets to the debtor and out of the bankruptcy estate if there is an income tax liability that leaves no equity in the assets(s) to the trustee after the secured creditor(s) are satisfied. If assets are sold in the bankruptcy estate, then the income taxes are the obligation of the bankruptcy estate and not the debtor.

Besides automatically transferring all the debtor’s property to the estate, the initiation of a bankruptcy case gives an individual debtor one significant choice. The taxpayer may elect a short tax year, ending the day before the bankruptcy filing. The taxpayer thus creates two short tax years for themselves. The

income tax liability in the short year becomes a priority claim against assets in the bankruptcy estate. That is because the bankruptcy estate is responsible for all the debtor's liabilities at the time of bankruptcy, including income taxes that accrue before the date of bankruptcy. As a result, electing to end a tax year before the day of bankruptcy causes the taxes on the income earned to that date to become a debt of the bankruptcy estate. If there are insufficient assets to pay the income tax, the remaining liability is non-dischargeable. Any remaining income tax liability for the first year returns to the debtor and can be collected from the taxpayer later.

In the event the debtor does not elect a short year, the tax on the income earned during the during the tax year in which the debtor bankruptcy occurs will accrue after the date of bankruptcy and will therefore not become a debt of the estate. As a result, none of the debtor's income tax liability can be collected for the year of bankruptcy filing for the bankruptcy estate.

The debtor's selection of a single tax year or two short years also affects the amount of tax attributes that pass from the debtor to the bankruptcy estate. The bankruptcy estate receives the tax attributes of the debtor as of the beginning of the tax year in which the bankruptcy was initiated. Therefore, if the debtor chooses a single tax year, the attributes that he or she has at the beginning of that year will pass to the bankruptcy estate and cannot be used by the debtor on the tax return for that year. If the debtor chooses two short tax years, the attributes do not pass to the bankruptcy estate until the beginning of the second short year. Therefore, the debtor can apply the tax attributes on his or her return for the short year first.

In most cases, if the debtor has income before the date the bankruptcy was initiated, it is usually to their advantage to choose short tax years. By doing so, the debtor not only makes the taxes on that income a debt of the estate, but also reduces the amount of taxes owed on that income.

Unlike Chapter 7 and 11, the legislation creating Chapter 12 and 13 did not create a separate tax entity for a Chapter 12 and 13 debtor. Instead, the debtor must propose a plan to pay their creditors over 3- 5 years. Since a separate entity is not created, the debtor does not have the option of filing a short tax year federal return.

In 2005 Congress amended Chapter 12. It was believed that the amendments would provide debtors capital gain tax relief. Prior to 2005, if a debtor in bankruptcy sold real estate and raised breeding livestock while in bankruptcy, the resulting capital gains from the sale of the property would be a priority claim by the government. The debtor would pay this claim in full during the life of the plan. For a farming operation that had very low basis on its real estate, this often prevented the debtor from obtaining a discharge (or closing their Chapter 12 plan).

When Congress amended Chapter 12 in 2005, it was believed by many that Congress amended the Bankruptcy Code to allow any "capital gain" taxes of the debtor to be a general unsecured claim of the government, a claim that does not have to be paid in full to obtain a bankruptcy discharge. The government disagreed with this interpretation and in 2012 the United States Supreme Court ruled that any capital gain taxes realized from the sale of farm assets sold during the bankruptcy must be paid during the 3-5 year term of the Chapter 12 plan. The United States Supreme Court did not address

capital gain taxes realized from the sale of farm assets **BEFORE** the bankruptcy is filed. A number of lower courts have held that these taxes can be treated as a general unsecured claim. **THUS, CAPITAL GAIN TAXES REALIZED FROM THE SALE OF FARM ASSETS BEFORE THE BANKRUPTCY IS FILED REMAINS AN UNSETTLED AREA OF LAW. THUS, THE TAX OBLIGATIONS ARE NON-DISCHARGEABLE AND MUST BE PAID BY THE DEBTOR.**

In summary, Chapter 12 will not be successful for many family farmers, due to the fact that their debt levels are above the limitations and income taxes are not dischargeable. Thus, if the farming operation needs to down size or liquidate assets to cash flow, the debtor will be liable for income and capital gain taxes that will most likely make it impossible to cash flow.

Also, the debtor might be subject to alternative minimum tax. The alternative minimum tax was included in the tax code to prevent a taxpayer with a high income from avoiding substantial tax liability by using tax exclusions, deductions and credits to reduce their taxable income. The taxpayer must then make adjustments and add back certain tax preferences to arrive at the taxpayer's alternative minimum taxable income. Some common examples of tax preferences and adjustments that affect farmers include the excess of accelerated depreciation over straight-line depreciation on real property and an increase to gain on the sale of property sold or foreclosed upon.

Chapter 12 might not be as effective today in preserving family farms as in the 1980's for two reasons:

- Today's farming operations tend to be dramatically larger than in the 1980's, consequently, it seems likely that many farmers who might need Chapter 12 relief in the future will not qualify for such relief because of the debt limit eligible requirement.
- Chapter 12 arrived in 1986 at an opportune time for providing successful relief to farmers because of recent farm asset value reductions, high debt levels based on high asset values and interest rate declines. Accordingly, late 1980's farmers in Chapter 12 could confirm plans that discharge large amounts of debt and repaid the diminished value of retained assets at reduced interest rates. Today farm land values are still high and interest rates have been low for quite some time, therefore, a confirmable Chapter 12 plan in today's reality would probably not discharge much, if any, debt or achieve any significant interest rate reduction.

Therefore, Chapter 7 might be the only option which means the farming operation will no longer continue or exist to present and future generations. Thus, needless to say, bankruptcy is very complex and every farming operation has a set of circumstances that do not fit each family.

BANKRUPTCY PROCEDURE AND THE BANKRUPTCY ESTATE

Creating the Bankruptcy Estate

- If an individual debtor files for bankruptcy under Chapter 7 or 11 of the Bankruptcy Code (**not Chapter 12 or 13**), a separate "estate" is created consisting of property that belonged to the debtor before the filing date.
- The bankruptcy estate is a new taxable entity, *completely separate from the individual debtor.*

- The estate is managed by the trustee for the benefit of any creditors and it may produce its own income as well as its own expenses.
- The creation of a separate bankruptcy also gives the individual debtor a “fresh start” – for example; wages earned and property purchased by the individual after the bankruptcy case has started, belong to the taxpayer and do not become a part of the bankruptcy estate.
- If a bankruptcy case involving an individual debtor was begun, but is later dismissed by the bankruptcy court, the estate is not treated as a separate entity. The individual debtor is treated as if the bankruptcy petition had never been filed in the first place.

Income and Deductions of the Bankruptcy Estate

- The gross income of the bankruptcy estate of an individual debtor includes any of the debtor’s gross income to which the estate is entitled under the bankruptcy law.
- The bankruptcy estate may deduct or take credit for any expenses it pays or incurs, in the same way the debtor would have deducted or credited them had he or she continued in the same trade, business or activity and actually paid or accrued the expenses. Allowable expenses, such as attorney fees and court costs.
- The taxable income of the bankruptcy estate is figured in the same way as for an individual. The estate is allowed one personal exemption and individual deductions. The tax on the taxable income is figured by using the rates for a married individual filing separate. The tax return to be filed is FORM 1041, filing under “Bankruptcy Estate”.

Transfers between Debtor and Bankruptcy Estate

- A transfer of an asset from the individual debtor to the bankruptcy estate is not treated as a “disposition” for income tax purposes. This means that the transfer does not result in gain or loss, recapture of deductions or credits, or acceleration of income or deductions.
- The estate is treated just as the debtor would be with respect to the transferred asset.
- When bankruptcy estate is terminated, that is, dissolved any resulting transfer of the estate’s assets to the debtor is not treated as a disposition. Therefore, as with the transfer of an asset to the estate, this transfer does not result in gain or loss, recapture of deductions or credits, or acceleration of income or deductions. The debtor is treated in the same way the estate would be regarding the transferred assets.
- **Attribute Carryovers**

The bankruptcy estate must treat its tax attributes in the same way that they would be treated by the individual debtor. These items must be determined as of the first day of the Debtor’s tax year in which his or her bankruptcy case begins.

It is important to note that the total attributes received by the estate is determined in part by the decision of the debtor to file a short-year personal return. (This will be discussed later).

DETERMINATION OF THE YEAR OF THE BANKRUPT

As a general rule, the tax year of the bankrupt does not change when the bankruptcy petition is filed. There is an EXCEPTION to the general rule if there is a Chapter 7 or Chapter 11 case.

- The normal tax year may be divided into two parts.
- The first year ends the day before the bankruptcy petition is filed.
- The second short year begins the day the bankruptcy is filed and ends on the bankrupt's normal year end date.
- The decision to divide the bankrupt's tax year is made by filing an election by the fifteenth day of the fourth month after the end of the month the bankruptcy is filed.
- The election is irrevocable.
- The election is not available to a debtor who has no assets other than property that may be treated as exempt property.
- The income for the short years must be annualized (IRS Code 443).
- The selection of tax years for the bankrupt determines the amount of bankrupt's tax attributes that are transferred to the bankruptcy estate or are used against the income the bankrupt earned before filing the bankruptcy petition. The tax attributes of the debtor automatically becomes those of the estate unless the debtor elects to divide their tax year into two parts. If the election is made, then only the attributes remaining after the first short-year individual's return is filed are transferred to the bankruptcy estate.
- The tax owed by the bankrupt for tax years prior to filing (including the short year if the election is made) is generally payable out of the bankruptcy estate as a priority claim. (If the taxes cannot be paid they are still a liability of the debtor.)
- The tax owed by the bankrupt for the years ending after the filing is paid by the bankrupt and not by the bankruptcy estate.
- The two short-year tax returns might be a good practical application to farmers who traditionally receive substantial income in early months of their tax year.
- Self-employment tax is not annualized for each short year. Thus, a taxpayer could have a large self-employment tax liability.

TAX PLANNING USING THE BANKRUPTCY ALTERNATIVE AND THE ELECTION OF TWO SHORT TAXABLE YEARS.

EXAMPLE 13

Assume Frank who is a calendar-year taxpayer, is in financial difficulty and sells some assets in January to pay debts. On the first of March he decides to declare bankruptcy. If he does not elect two short tax years, the gain he realized on the sale of the assets will be included on the return he files for the full year. Those taxes will not be a debt of the bankruptcy estate. If he elects two short tax years, the income taxes on the gain from the sale of the assets will accrue before bankruptcy was declared. Therefore, the taxes on the gain will become a debt of the bankruptcy estate. Note, that if the estate cannot pay this tax, the debtor is still personally liable.

EXAMPLE 14

Assume Frank has tax attributes (depreciation, net operating loss, capital loss carryforwards, etc.) remaining after the last income tax return filed before the year of bankruptcy. The selection of a single tax year or two short tax years will also affect the amount of tax attributes that pass from the debtor to the bankrupt estate. The rule is that the bankrupt estate receives the tax attributes of the debtor as of the beginning of the tax year in which bankruptcy occurred. Therefore, if Frank chooses a single tax year, the attributes that he has at the beginning of the year will pass to the bankrupt estate and cannot be used by him on his tax return for that year. If Frank chooses two short tax years, the attributes do not pass to the bankrupt estate until the beginning of the second short year.

EXAMPLE 15

If Frank has taxable income before the date of the bankruptcy, it is most likely to Frank's advantage to choose two short years. By doing so, Frank makes the taxes on that income a debt of the estate but will reduce the amount of taxes owed on that income. The reduction of the taxes is an advantage to Frank if the estate does not have enough assets to pay the tax because the taxes will not be discharge in bankruptcy and will become a debt of Frank when the bankruptcy estate is closed. The cost to Frank of applying the tax attributes to his tax return by electing two short years is a potential reduction in the amount of tax attributes that pass from the bankrupt estate back to Frank when the estate is closed. If the bankrupt estate would absorb all the tax attributes anyway, the use of the attributes in Frank's first year will have no effect on the attributes that are passed back to Frank.

CHOOSING BANKRUPTCY TO AVOID TAXABLE GAIN TO DEBTOR (NOT APPLICABLE TO CHAPTER 12 OR 13 CASES)

Transferring Tax Liability to Bankruptcy Estate

EXAMPLE 16

If there is income generated from the sale of property by the bankruptcy estate, it is paid as an administrative expense. If there are insufficient funds to pay the tax, the unpaid amount is not a liability of Frank. If Frank has grain and livestock inventory that is sold by the estate, Frank would be relieved of the personal tax burden on these taxable dispositions and also for the sale of real estate that generates a taxable gain. Transferring tax liability to the bankruptcy estate by having the estate rather than Frank sell the property may be a major reason for suggesting Chapter 7 liquidating bankruptcy instead of a workout outside of bankruptcy.

Warning. A possible major income tax trap for Frank in the above example is the right of the bankruptcy trustee to "abandon" any property that is a disadvantage to the estate or that is of very little value. This will likely include property, the value of which is less than the secured debt against the property. The

position at the IRS and the courts has been that when property is abandoned to the debtor, the later disposition of this property by the debtor creates tax liability for the debtor, not the bankruptcy estate.

EXAMPLE 17

Careful analysis is required. The attorney and tax preparer will have to carefully analyze the individual properties of the debtor and the secured debt on each to be able to provide a fairly accurate tax liability estimate. **Most farmers have very little unsecured debt.**

Fred files a Chapter 7 bankruptcy petition with the following assets:

Asset	Tax Basis	FMV	Secured Liability	Gain if Sold or Forfeited
Grain	0	120,000	130,000	120,000
Machinery	25,000	75,000	150,000	50,000
Farm #1	100,000	140,000	120,000	40,000
Farm #2	200,000	300,000	400,000	100,000

OUTCOME. Under the rules discussed above, it is likely the trustee would abandon the Grain, Machinery and Farm #2 to the debtor: The taxable gain of \$270,000 may be taxed to the debtor. Farm #1 would be sold by the trustee because it would generate \$20,000 to pay unsecured creditors. That gain would be taxable to the bankruptcy estate.

EXAMPLE 18

One of the major items for the tax consultant to decide upon is whether it would be advantageous to have Fred to elect two short tax years. If Chapter 7 is filed, then Fred has two options with respect to choosing a tax year:

- 1) Continue with the same tax year “as if” there were no bankruptcy
- 2) Set up two short tax years:
 - a) The first short year would be from the beginning of the year to the day before the bankruptcy is filed
 - b) The second short year would begin on the day of the bankruptcy is filed to the end of the normal tax year of Fred.

To illustrate: Fred is a calendar year taxpayer that declares bankruptcy on May 20.

OPTION I: [January 1 -----December 31]

OPTION II: [January 1 -----May 19][May 20 -----December 31]

The option selected can have an effect on:

- Whether Fred or the bankruptcy estate pays the tax
- When and how much of Fred’s tax attributes are absorbed
- Self-employment taxes that are imposed on Fred