

CHAPTER 11

INCOME TAX CONSEQUENCES OF FARM FINANCIAL DISTRESS

SYNOPSIS (click on section title to go directly there)

Introduction	11.1
Recognition of Gain or Loss from Transfer of Assets	11.1
Tax Planning for Gain on Transfer of Assets	11.2
Income Averaging	11.2
Timing of Income	11.2
Discharge of Debt	11.3
Exceptions to Recognition of CODI	11.4
Paying the Price	11.4
Order	11.5
Limit on Bases Reduction	11.5
Timing	11.5
Summary	11.5

Introduction

Farmers often face significant income tax consequences from financial distress transactions. The two most common income tax consequences from these transactions are

1. the recognition of gain or loss from transfer of assets, and
2. discharge of indebtedness income.

Recognition of Gain or Loss From Transfer of Assets

The rules that require the recognition of gain or loss as a result of transferring assets in financial distress are the same as those that apply to transfers outside of financial distress.

Example 11.1 Transfer of Assets

Danica Distress previously weathered financial setbacks by tapping her secured line of credit with her local bank. However, she has reached the limit of that credit and now wants to know the income tax consequences of selling her assets to pay her debts. She has \$500,000 of secured debt. Her assets are shown in Figure 11.1.

Figure 11.1: Danica's Assets

Asset	Fair Market Value	Basis
Stored grain	\$20,000	\$0
Raised herd	90,000	0
Machinery	75,000	20,000
Land	300,000	80,000
Total	\$485,000	\$100,000

Danica is married and files a joint federal income tax return with her husband, Dillon, who earns \$30,000 a year from an off-farm job. He has enough federal income tax withheld from his paycheck to pay the federal income tax on all of their income, the FICA taxes on his wages, and the self-employment tax on Danica's \$10,000 of farm income. They have two children.

If Danica sells all of her assets for their \$485,000 fair market value, she and Dillon will owe an additional \$68,747 of federal taxes on the \$385,000 (\$485,000 – \$100,000 basis) gain. However, all \$485,000 of the sales proceeds will go to her secured creditors to reduce the debt owed to them from \$500,000 to \$15,000. After paying \$485,000 of debt with the sale proceeds, Danica will still owe \$83,747 (\$68,747 + \$15,000) in taxes and lender debt.

Tax Planning for Gain on Transfer of Assets

Tax planning for the gain on the sale of assets because of financial distress is the same as planning for the sale of assets outside of financial distress. Two particularly useful strategies are income averaging and timing of income.

Income Averaging

The income-averaging rules allow farmers to use tax brackets from the 3 prior years to compute taxes on some or all of the current-year farm income. Therefore, income in the high brackets of the current year can be taxed at lower rates.

Cross-Reference

See Chapter 7 of this book for an explanation of the income-averaging rules.

Timing of Income

If farmers can control the timing of asset sales, they may delay selling some assets until the following tax year to save both income taxes and self-employment (SE) taxes.

Bunching up SE income in one year can push some of that income above the social security wage base, which is \$106,800 for 2011. Earned income above the wage base is subject to a 2.9% SE tax rate instead of the 15.3% (13.3% for 2011) tax rate that applies to earned income up to \$106,800 (for 2011). The income-averaging rules can then be used to reduce the income tax rate on the income that is pushed into a higher tax bracket by the bunching of income.

Example 11.2 Bunching Self-Employment Income

Sven Olssen potentially has \$106,800 of net earnings from self-employment in Year 1 and \$100,000 of net earnings from self-employment in Year 2. If the tax rate is 15.3% in both years, his SE tax would be \$16,340 ($\$106,800 \times 15.3\%$) in Year 1 and \$15,300 ($\$100,000 \times 15.3\%$) in Year 2, for a total of \$31,640.

If he can bunch the net earnings from self-employment into one tax year, his SE tax would be \$19,240 (\$16,340 on the first \$106,800, plus \$2,900 on the remaining \$100,000). That is a \$12,400 (\$31,640 – \$19,240) reduction in his SE tax.

Bunching up ordinary income has the added advantage of emptying the 15% regular income tax bracket for the following year so that long-term capital gains in the following year qualify for the lower tax rate for capital gains, which is 0% in 2011 and 2012.

Example 11.3 Tax Rate on Capital Gain

Carlos and Virginia Little Otter have \$100,000 of taxable income in 2011, of which \$30,000 is ordinary income and \$70,000 is long-term capital gain. The ordinary income fills up their entire 10% income tax bracket (\$17,000) and fills up \$13,000 (\$30,000 – \$17,000) of their 15% bracket. The top end of their 15% bracket is \$69,000, which means \$39,000 (\$69,000 – \$30,000) of their capital gain is taxed at 0%. The remaining \$41,000 (\$70,000 – \$39,000) is taxed at their 15% rate for capital gain.

Discharge of Debt

Creditors sometimes forgive some or all of a financially distressed taxpayer's debt because the taxpayer is unable to pay or because the cost of collecting the debt is more than the debt. For income tax purposes, if a creditor forgives debt for any reason other than for the purpose of making a gift to the debtor, the discharged debt is potentially included in taxable income as cancellation of debt income (CODI).

Example 11.4 Cancellation of Debt Income

Pete Bogg had \$100,000 of debt and \$150,000 of assets when he borrowed another \$25,000. Before he spends the \$25,000, it increases both his debt and his assets, but it does not change his \$50,000 net worth and is not taxable income. If Pete pays off the debt, his assets and debt both decrease by \$25,000, but his net worth does not change and he cannot claim an income tax deduction for the \$25,000 debt payment.

However, if Pete's lender forgives \$25,000 of his debt, his debt goes down by \$25,000 but his assets do not decrease. Therefore, his net worth increases by \$25,000, which is CODI that may have to be included in taxable income.

Repossession of assets can also result in a taxable gain on disposition.

Example 11.5 Repossession of Assets

Paige Turner borrowed \$100,000 from her bank to buy a \$120,000 tractor in 2007. In 2011, she was unable to make the payments on the loan and the bank repossessed the tractor. At the time of repossession, the remaining debt was \$75,000 and the tractor's fair market value (FMV) was \$50,000. The bank decided to not pursue a claim for payment of the rest of the debt because Paige was insolvent.

For income tax purposes, Paige is treated as selling the tractor to the bank for its \$50,000 FMV and then using the \$50,000 to pay that much of her \$75,000 debt. The remaining \$25,000 of debt is potentially CODI.

Paige had claimed \$68,544 of depreciation on the tractor before 2011, and she can claim \$7,350 of depreciation for 2011 (half-year convention and the fifth year of 7-year property). Her adjusted basis in the tractor then is \$44,106 (\$120,000 – \$68,544 – \$7,350), and she has a \$5,894 (\$50,000 – \$44,106) gain on the deemed sale. The depreciation recapture rules treat all of that gain as ordinary income.

Exceptions to Recognition of CODI

If any of the following exceptions applies, the debtor does not have to include CODI in income.

1. A deduction for the amount paid would be allowable if the taxpayer paid the debt that was discharged. Examples include feed or other farm inputs purchased on credit from the seller and interest on a loan.
2. The debt was discharged in bankruptcy.
3. The debt discharged was *qualified principal residence debt* that was discharged before January 1, 2013.
4. The debtor was insolvent at the time the debt was discharged.
5. The seller of property under an installment contract discharged the debt, and the original purchaser under the contract owed the debt that was discharged.
6. The debt discharged is *qualified farm indebtedness*.
7. The debtor is not a C corporation, and the debt discharged is *qualified real property business indebtedness*.

If discharged debt qualifies for more than one of these exceptions, the first applicable exception in the list is applied to the discharged debt.

Example 11.6 Qualified Farm Debt

Because the \$25,000 of debt that was discharged in Example 11.5 was discharged while Paige was insolvent, Paige does not have to include the \$25,000 CODI in her gross income, although she must record it on her federal income tax return.

Paying the Price

In most cases, the taxpayer must pay a price for not recognizing CODI. The price is a reduction of the taxpayer's following tax attributes:

1. Net operating loss (NOL): Any NOL for the tax year of the discharge, and any NOL carryover to such year.
2. General business credit: Any carryover to or from the tax year of debt discharge of an amount includable in determining the amount allowable as a general business credit.
3. Minimum tax credit: The amount of the minimum tax credit available at the beginning of the tax year immediately following the tax year of the discharge.
4. Capital loss carryovers: Any net capital loss for the tax year of the discharge, and any capital loss carryover to such year.
5. Basis reduction: The basis of the taxpayer's property.
6. Passive activity loss and credit carryovers: Any passive activity loss or credit carryover of the taxpayer from the taxyear of the discharge.
7. Foreign tax credit carryovers: Any carryover to or from the tax year of the discharge for determining the amount allowable as a foreign tax credit.

Credits are reduced \$1 for every \$3 of CODI that is excluded from income. The other tax attributes are reduced \$1 for every \$1 of CODI that is excluded from income. The CODI exclusion and tax attribute reductions are reported on IRS Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness.

Order

The general rule is that the tax attributes are reduced in the order listed. However, a taxpayer can elect to reduce the basis in depreciable property first.

Example 11.7 Attribute Reduction

Paige from Example 11.5 must reduce her tax attributes to pay the price for not including the \$25,000 discharged debt in her gross income. If she has no NOL, general business credit, minimum tax credit, or capital loss carryovers, she must reduce the basis in her farm assets by \$25,000.

Limit on Basis Reduction

If the debt discharge is excluded from income under the bankruptcy or insolvency exceptions, a limit applies to the reduction of basis in assets. The aggregate basis in the taxpayer's assets is reduced only down to the remaining debt after the discharge, so that the taxpayer's assets may equal his or her remaining liabilities.

Timing

The attribute reduction occurs after taxes are computed for the year of the debt discharge. Therefore, the attributes are used on the tax return before they are subject to reduction under the CODI rules.

Example 11.8 Timing of Attribute Reduction

Paige from Example 11.7 must reduce the basis in her assets after she has claimed depreciation for 2011 and calculated gain on sale of assets in 2011. Assume that she had only one asset after the tractor was repossessed—land with a \$60,000 basis and a \$100,000 FMV.

If Paige sells the land in 2011 (the same year the tractor was repossessed), she must recognize \$40,000 (\$100,000 – \$60,000) of gain on the land. She then has no basis in assets to reduce and therefore does not have to pay a price for not recognizing the \$25,000 of CODI.

If she waits until 2012 to sell the land, she must reduce its basis by \$25,000 at the end of 2011 (to pay the price of excluding the CODI from her taxable income). She will then have a \$65,000 (\$100,000 – \$35,000 reduced basis) gain to report on her 2012 income tax return.

Summary

Farmers in financial distress face income tax consequences from transferring their assets as well as from cancellation of debt. Those taxes can be minimized by planning the timing of the transfers and the cancellation of debt, as well as by electing income tax options that reduce taxes. To make the best use of the tax-planning opportunities, it is important for farmers to consult their tax advisers before they enter into transactions to restructure their debt..