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**Treatment of Farmers' Discharge
of Indebtedness Income Under
the Tax Reform Act of 1986**

by

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Treatment of Farmers' Discharge of Indebtedness Income Under the Tax Reform Act of 1986

At a time when farmers are caught in the midst of the worst economic crisis since the Great Depression,¹ it seems inappropriate to talk of the importance of income tax planning. Tax planning, however, is critical to financially distressed farmers because of the potentially large tax liability they face from discharge of indebtedness income. This income arises whenever a creditor extinguishes a farmer's debt in exchange for the farmer's turnover of assets valued below the face amount of the debt.² The difference between the face amount of the debt and the value of the assets constitutes discharge of indebtedness income³ that must be included in the farmer's gross income.⁴ If the discharge of indebtedness income is great, a

1. Des Moines Reg., Jan. 19, 1986, at X1, col. 1.

2. See Treas. Reg. § 1.61-12(a) (as amended in 1980). "A taxpayer may realize income by the payment or purchase of his obligations at less than their face value." *Id.*

3. See *id.* § 1.1001-2(c) (Example 8) (1980).

4. I.R.C. § 61(12) (1982). One justification for treating discharged debt as taxable income posits that discharge of indebtedness income increases the taxpayer's net worth. In *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), the Supreme Court articulated this justification. *Kirby Lumber Co.* involved a taxpayer-corporation that had issued bonds which soon declined in value. See *id.* at 2. When market interest rates increased later in the year, the taxpayer repurchased some of the bonds for \$137,521.30 less than their par value. *Id.* The Court held that the \$137,521.30 was taxable income because the taxpayer "made available \$137,521.30 [of] assets previously offset by the obligation of bonds now extinct." *Id.* at 3. Because "there was no shrinkage of assets," the Court concluded that the taxpayer realized an accession to income properly subject to taxation. *Id.*

After *Kirby Lumber Co.*, one could not be sure whether the Court would treat a financially distressed taxpayer the same as the financially sound taxpayer in *Kirby*. In *Commissioner v. Jacobsen*, 336 U.S. 28 (1949), the Court held that the two taxpayers could be treated the same. See *id.* at 39. *Jacobsen* involved a taxpayer who had issued bonds and then later suffered a financial setback. See *id.* at 32-34. Investors in the bonds feared that the taxpayer ultimately would not be able to pay the par amount of the bonds, and they sold the bonds back to the taxpayer at a discounted rate. *Id.* at 33. The Court held that the difference between the face amount of the bonds and the discounted repurchase price constituted taxable income. See *id.* at 38-40. The Court argued that the taxpayer's gain was comparable to a gain the taxpayer could have realized from purchasing a third party's bonds at a discount and reselling them at par value. See *id.* at 39.

A related, but more refined, justification for taxing discharge of indebtedness income posits that this income is a proper means of recouping benefits that a taxpayer reaps from using borrowed funds. See M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* § 3.02, at 52-54 (4th ed. 1985). Borrowed funds are not included in the borrower's gross income because the borrower's newly acquired debt offsets the cash received by the borrower. *Id.* at 52. Thus, the borrower's net worth has not increased. *Id.* When the borrower spends the loan receipts for business expenses, however, the borrower receives immediate tax benefits. *Id.* at 53. Business expenses generate deductions; outlays for machinery increase depreciation deductions, and so on. *Id.* The borrower's expenditure of untaxed loan receipts, therefore, reduces the borrower's tax liability. If the borrower ultimately repays the loan in full, the repayment does not yield a current deduction and the prior deductions do not seem objectionable because the Treasury is made whole when the borrower repays the loan with after-tax income. *Id.* If the borrower does not fully repay the loan, however, the taxpayer realizes discharge of indebtedness

financially distressed farmer may incur a significant tax liability when payment of the liability is least possible.

Before the enactment of the Tax Reform Act of 1986,⁵ section 108 of the Internal Revenue Code (I.R.C.)⁶ permitted solvent taxpayers to defer payment of taxes on discharge of indebtedness income.⁷ Sections 405⁸ and 822⁹ of the Tax Reform Act of 1986 change section 108's treatment of solvent taxpayers. Section 108, as amended, no longer permits all solvent taxpayers to defer payment of taxes on discharge of indebtedness income.¹⁰ Only solvent farmers realizing income from discharge of "qualified farm indebtedness"¹¹ can continue to do so.¹² Solvent farmers who qualify can also defer payment of taxation to an even greater extent than they could under old section 108.¹³ Thus, while the Tax Reform Act provides additional relief to solvent farmers, it deprives similarly situated nonfarmers of the opportunity to defer payment of taxes on discharge of indebtedness income. This seemingly inequitable distinction, and the justifications for the distinction, are issues that must be addressed.

This Comment assesses the impact that the Tax Reform Act of 1986 will have on solvent farmers who realize discharge of indebtedness income. The Comment first explains how to calculate discharge of indebtedness income¹⁴ and how taxation on that income could be deferred under section 108 by solvent taxpayers before the Tax Reform Act of 1986.¹⁵ The Comment then explains how section 108, as amended, affects solvent farmers.¹⁶ Finally, the Comment weighs the pros and cons of new section 108 and concludes that, although the reforms may create an inequitable distinction between similarly situated farmers and nonfarmers, the distinction is justifiable.¹⁷

When a taxpayer's asset is turned over to a creditor in cancellation of indebtedness, treasury regulations require that the transaction be fractionalized into gain realized and debt discharged.¹⁸ The asset's fair market value minus its basis (cost) equals the gain realized,¹⁹ and the face amount of the debt minus the asset's fair market value reflects discharge of

income. *Id.* This income should be taxed, it is argued, either because the taxpayer initially paid no taxes on the loan receipts or because the taxpayer received numerous tax benefits from the expenditure of the untaxed loan receipts. *Id.*

5. Tax Reform Act of 1986, Pub. L. No. 99-514, 9A U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 1 (1986).

6. I.R.C. § 108 (1982) (amended 1986).

7. See *infra* text accompanying notes 24-29.

8. Tax Reform Act of 1986, Pub. L. No. 99-514, § 405, 9A U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 140 (1986) (amending I.R.C. § 108 (1982)).

9. *Id.* § 822, 9A U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 289 (1986) (repealing I.R.C. § 108(a)(1)(C)).

10. *Id.*

11. *Id.* § 405(a), 9A U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 140 (1986).

12. See *id.*

13. See *infra* text accompanying notes 36-44.

14. See *infra* text accompanying notes 18-23.

15. See *infra* text accompanying notes 24-29.

16. See *infra* text accompanying notes 30-44.

17. See *infra* text accompanying notes 45-61.

18. Treas. Reg. § 1.1001-2(c) (Example 8) (1980).

19. See *id.*

indebtedness income.²⁰ Thus, if a taxpayer satisfies a \$7500 debt by transferring to a creditor an asset with a fair market value of \$6000 and a basis of zero, the taxpayer realizes a gain of \$6000 ($\$6000 - \$0 = \6000). The discharge of indebtedness income to the taxpayer is \$1500 ($\$7500 - 6000 = \1500).²¹ The taxpayer's current gross income includes the discharge of indebtedness,²² unless the taxpayer can use section 108's deferral provisions.²³

Before the recent amendments to section 108, all solvent taxpayers could defer taxation on discharge of indebtedness income upon showing that the debt discharged was "a qualified business indebtedness" (*i.e.*, incurred or assumed by a taxpayer in connection with property used in the debtor's trade or business).²⁴ Solvent taxpayers meeting the burden had two options: they could pay taxes on the income in the current year or elect to defer payment of taxes on the income.²⁵

Several considerations influenced the taxpayer's decision whether to elect deferral under old section 108. If the taxpayer had made no election, then all discharge of indebtedness income would be taxed immediately²⁶ and the increase in income could push the taxpayer into a higher tax bracket.²⁷ If the taxpayer had made the election, the taxpayer would pay less tax in the current year.²⁸ In turn, however, the taxpayer would be required to reduce bases in depreciable assets to the extent of the discharge of indebtedness income.²⁹ Future depreciation deductions, as a result, would be lower, and would increase the taxpayer's burden in future years.

The Tax Reform Act of 1986 radically changes section 108's treatment of solvent taxpayers. They can no longer elect to defer payment of taxes on discharge of indebtedness income³⁰ unless the income results from the discharge of a qualified farm indebtedness.³¹ Qualified farm indebtedness exists if three conditions are met: (1) the "indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming";³² (2) the debt was discharged by a "qualified person" (*e.g.*, business lender);³³ and (3) fifty percent or more of the average annual gross receipts of the taxpayer for the three taxable years preceding the year in which the discharge of indebtedness occurs must be attributable to the

20. *See id.*

21. *See id.*

22. I.R.C. § 61(a)(12) (1982).

23. *See id.* § 108(a)(1).

24. *See id.* § 108(a)(1)(C), *repealed by* Tax Reform Act of 1986 § 822(a).

25. *See infra* text accompanying notes 26-29.

26. *See* I.R.C. § 61(a)(12) (1982) (discharge of indebtedness income constitutes gross income).

27. *See id.* § 1 (tax tables).

28. The taxpayer's gross income in the current year would be reduced by the amount the taxpayer elected to reduce bases in depreciable assets. *See id.* § 108(a)(1)(C), *repealed by* Tax Reform Act of 1986 § 822(a).

29. *See id.* § 108(c), *repealed by* Tax Reform Act of 1986 § 822(b)(2).

30. Tax Reform Act of 1986 § 822(a) (striking out § 108(a)(1)(C)).

31. *Id.* § 405.

32. *Id.* § 405(a).

33. *See id.* ("qualified person" in § 405(a) is defined by reference to I.R.C. § 46(c)(8)(D)(iv) (1982)).

trade or business of farming.³⁴ Obviously, solvent nonfarmers cannot fulfill these criteria and, therefore, can no longer defer payment of taxes on discharge of indebtedness income.³⁵ Solvent farmers meeting the above criteria can defer payment of such taxes.

Section 405 of the Tax Reform Act also increases the extent to which certain solvent farmers can defer payment of taxes. Under old section 108, solvent farmers could defer payment of taxes on discharge of indebtedness only to the extent that bases existed in depreciable property.³⁶ Section 108, as amended, provides a more liberal deferral scheme by treating qualifying solvent farmers almost the same as insolvent taxpayers for purposes of section 108.³⁷ Like insolvent taxpayers, qualifying solvent farmers can elect either to apply discharge of indebtedness income against certain tax attributes³⁸ or to apply it to reduce bases in any amount of depreciable property before reducing tax attributes.³⁹ Solvent farmers electing the former option must offset discharge of indebtedness income in the following order: first, by reducing certain tax attributes (including net operating loss, investment tax credits, and capital loss carryovers);⁴⁰ second, if discharge of indebtedness income remains, by reducing bases in property other than land used or held for use in farming;⁴¹ last, if discharge of indebtedness income still remains, by reducing bases in land used or held for use in farming.⁴²

If solvent farmers instead elect to reduce bases in depreciable property, the bases do not have to be reduced to zero before reducing the tax attributes listed above.⁴³ Solvent farmers can switch horses in midstream by electing to reduce some of the bases in depreciable property before offsetting the discharge of indebtedness income against tax attributes.⁴⁴

Section 108's preferential treatment of solvent farmers over solvent nonfarmers raises two significant policy concerns. First, tax policy does not favor dissimilar taxation of similarly situated taxpayers.⁴⁵ Under section

34. *Id.*

35. It should be noted that the criteria for qualified farm indebtedness focus only on the source of income and whether the debt was incurred directly as a result of the farming operation. See Tax Reform Act of 1986 § 405(a). The statute does not require the taxpayer actually to work on the farm. Consequently, taxpayers that invest in farming operations arguably would be eligible for § 405's benefits.

36. I.R.C. § 108(c)(2) (1982), *repealed by* Tax Reform Act of 1986 § 822(b)(2).

37. See Tax Reform Act of 1986 § 405(a) ("the discharge by a qualified person of qualified farm indebtedness of a taxpayer who is not insolvent at the time of the discharge shall be treated in the same manner as if the discharge had occurred when the taxpayer was insolvent."). Section 405(b) does change the order in the types of property in which bases will be reduced. For a discussion of this, see *infra* text accompanying notes 40-44.

38. I.R.C. § 108(b)(2) (1982).

39. See *id.* § 108(b)(5).

40. See *id.* § 108(b)(2).

41. See Tax Reform Act of 1986 § 405(b).

42. *Id.*

43. I.R.C. § 108(b)(5)(A), (C) (1982).

44. See *id.*; C. McQUEEN & J. CRESTOL, *FEDERAL TAX ASPECTS OF BANKRUPTCY* 2-17 (1985) (discussing tax treatment of insolvent debtors before enactment of Tax Reform Act).

45. See DEPARTMENT OF THE TREASURY, *1 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH*, TREASURY DEPARTMENT REPORT TO THE PRESIDENT 14 (1984) [hereinafter *TREASURY REPORT*]. The Treasury Report states that:

108, however, qualifying solvent farmers pay less tax in the current year than solvent nonfarmers,⁴⁶ although some members of both taxpayer groups might desperately need to defer discharge of indebtedness income. Second, tax policy disfavors taxation that distorts the allocation of resources in a free market economy.⁴⁷ Section 108 encourages private investment in farming and discourages private investment in nonfarming activities, although the free play of market forces arguably indicates that, but for section 108, fewer scarce resources would be invested in a depressed farm economy.

The legislative history of the Tax Reform Act does not directly address these policy concerns. The legislative history indicates that Congress eliminated the deferral scheme for solvent taxpayers with qualified business indebtedness for two reasons. First, Congress determined that the deferral scheme was too generous;⁴⁸ regardless of the taxpayer's ability to pay, solvent taxpayers with income arising from discharge of a qualified business indebtedness could defer payment of tax on the income.⁴⁹ Second, Congress reasoned that a solvent taxpayer's ability to use the deferral scheme depended on whether the taxpayer was lucky enough to have existing bases in depreciable assets against which to offset discharge of indebtedness income.⁵⁰ Solvent taxpayers with significant bases could benefit from section 108's deferral scheme; solvent taxpayers without bases could not.⁵¹

In deciding to enhance benefits for solvent farmers, Congress recognized that farmers were in the midst of a financial crisis⁵² and that Congress had either passed or was considering numerous measures designed to alleviate the crisis.⁵³ One measure that was under consideration sought to induce farm lenders to discharge a portion of a farmer's indebtedness in exchange for the federal government's guarantee on a limited amount of the farmer's remaining indebtedness.⁵⁴ Congress determined, however, that this measure would be ineffective if solvent farmers resisted the

A tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair. For example, if two similar families have the same income, they should ordinarily pay roughly the same amount of income tax, regardless of the sources or uses of that income. A fair tax system does not allow some taxpayers to avoid taxes by legal means or to evade them by illegal means.

Id.

46. *See supra* text accompanying notes 24-35.

47. *See* TREASURY REPORT, *supra* note 45, at 13. The Treasury Report stated that: One of the primary advantages of a free market economy is its tendency to allocate economic resources to their most productive uses Any tax inevitably discourages the type of activity that is taxed. An ideal tax system would, however, interfere with private decisions as little as possible. That is, it would not unnecessarily distort choices about how income is earned and how it is spent.

Id.

48. *See* Senate Finance Committee, Tax Reform Bill of 1986 General Explanation, H.R. DOC. NO. 3838, 99th CONG., 2d SESS. 161 (1986) (C.C.H. Special 11, extra Edition of Report No. 25).

49. *Id.*

50. *See id.*

51. *See id.*

52. *See id.* at 272.

53. *See id.*

54. *See id.*

discharge of indebtedness because of the tax liability they might face in the current tax year.⁵⁵ Thus, Congress enhanced the ability of solvent farmers to defer payment of tax on discharge of indebtedness income so that farmers would not "forfeit their farmland rather than participate in these new federal farm programs designed to enable them to continue in farming."⁵⁶

Despite these seemingly sound justifications for amending section 108, the justifications do not necessarily refute the contention that the amendments are in conflict with fundamental tax policies. The fact remains that solvent nonfarmers might need section 108's benefits as much as solvent farmers do. The solution to this problem does not mean that solvent farmers should lose the liberal benefits provided by section 108's deferral scheme. Rather, the solution is for Congress to identify solvent nonfarmers who are as distressed as solvent farmers. Once identified, Congress could allow these nonfarmers to use section 108's deferral provisions. This is not to argue that Congress could easily or feasibly identify these groups, but only that Congress's inability to do so should not serve as a basis for denying section 108's benefits to solvent farmers, a group that Congress has identified as worthy of special treatment.⁵⁷

Congress's justifications for amending section 108 also run counter to the notion that tax policy should not distort the free play of market forces.⁵⁸ Proponents of economic neutrality in the tax law could readily point out that, but for the amendments, fewer individuals would allocate scarce resources to a faltering farm economy.⁵⁹ This contention is beyond dispute. Equally uncontroversial is the contention that the Internal Revenue Code inherently runs counter to notions of economic neutrality and that, therefore, one should dismiss economic neutrality⁶⁰ as a viable goal of tax law. This debate over abstract goals simply does not reflect the reality of the impetus for extending preferential treatment to solvent farmers. Rather, recognition must be given to the congressional choice to interfere with the free market in order to assist financially troubled farmers. In the amendments to section 108, Congress determined that a liberalized deferral scheme for marginally solvent farmers was necessary to assure that other legislative measures designed to alleviate the farm crisis were not compromised.⁶¹ Economic neutrality may be debated within this context, but the argument contributes nothing if it ignores the antecedent decision by Congress to encourage investment in the farm economy.

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55. *See id.*

56. *Id.*

57. *See id.*

58. *See supra* note 47.

59. *See* TREASURY REPORT, *supra* note 45, at 13.

60. *Id.* ("Any tax inevitably discourages the type of activity that is taxed.")

61. *See supra* text accompanying notes 52-56.