Chapter 11: Financial Distress

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Corrections were made to this workbook through January of 2003. No subsequent modifications were made.

INTRODUCTION

Due to the down-turn in the economy, declining stock prices and higher unemployment, more taxpayers and businesses are experiencing financial difficulties. This can result in repossessions, debt write-down and bankruptcy. While this may help relieve part of the financial problems, these same taxpayers may find they have created an unexpected tax liability. Through the years Congress has recognized the difficulties created by financial distress and passed legislation modifying I.R.C. §108 to provide relief to assist taxpayers.

Observation. Personal bankruptcy filings were significantly higher in 2002. The majority of these bankruptcies were for non-business taxpayers who had incurred significant credit card debt in excess of their ability to pay. In most cases, excluding exempt assets, these taxpayers had a negative net worth. In the majority of these bankruptcies, no tax liabilities arose from the sale or voluntary conveyance of their assets due to the fact the FMV of those assets was less than the original purchase price. In addition, any debts discharged in bankruptcy were not taxable due to the fact that the taxpayers were in Chapter 7, 11 or 13 bankruptcy. (See Exception One later in this chapter.)

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TAX CONSEQUENCES OF PROPERTY TRANSFERS

1. TRANSFER OF ASSETS

One consequence arises from property transfers that are triggered as a part of dealing with the financial distress.

Caution. If property is sold in order to pay debts, voluntarily turned over to the creditor, or repossessed by a creditor, the transfer is a taxable event. Little relief is available for this tax liability.

The debtor may have one or more of the following tax issues to deal with:

- Capital gain or loss
- Ordinary gain or loss
- Depreciation recapture

2. DISCHARGE OF INDEBTEDNESS

Another tax consequence of financial distress arises from the discharge of indebtedness. In general, discharge of indebtedness is treated as receipt of income because the taxpayer's wealth is increased by the amount of debt that is no longer owed. However, I.R.C. §108 sets out several exceptions to the general rule. Most of the exceptions **postpone** recognition of income, and a few permanently forgive recognition of income.

Note. There are similar rules inside and outside of bankruptcy. Generally, tax rules for property transfers in financial distress are the same as for property transfers when there is no financial distress. Therefore, planning to reduce the tax triggered by property transfers is similar for taxpayers in and out of financial distress. However, timing of the taxable event will significantly affect the amount of taxes due in some cases.

TRANSACTIONS THAT CREATE TAX PROBLEMS

BUNCHING OF INCOME

Many taxpayers do their tax planning by postponing recognition of income through the use of rapid depreciation, cash accounting, installment sales, and other income deferral techniques. The common element of these planning techniques is the postponement of income reporting for income tax purposes. Unfortunately, the time for reporting postponed income is often triggered by transactions resulting from distress. Consequently, the debtor has both creditors and the IRS to pay.

For example, farmers usually sell crops the year after they are harvested, and reduce their sale income by the cost of planting next year's crop. They may have a bunching-of-income problem if financial distress prevents them from planting the next year's crop.

Example 1. Betty Stokes sold her 2001 soybean crop in January and February 2002. In April 2002, her bank refused to loan her money to plant her 2002 crop. Betty must report proceeds from her 2001 crop as income in 2002, the year of sale.

Result. As a cash basis farmer, Betty deducted the cost of raising her crop on her 2001 return. Consequently, she has no basis to reduce income from the sale. In addition, Betty will have few farm expenses to deduct in 2002 because she has quit farming.

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RAPID DEPRECIATION

Rapid depreciation delays recognition of income by reducing the basis of property used in the trade or business faster than the property decreases in value. If rapidly depreciated property is transferred as a result of financial distress, the deferred income must be recognized.

Note. This problem will be more significant with the use of the special 30% depreciation allowance.

Example 2. In 1993, Eric purchased a bulldozer for his construction business for $50,000. He claimed a total of $50,000 of depreciation on the bulldozer during the years between 1993 and 2000. In 2002, he sold the bulldozer for $20,000 to pay debts. His basis in the bulldozer at the time of sale was $0 ($50,000 purchase price – $50,000 of depreciation).

Eric has a taxable gain of $20,000 ($20,000 sale proceeds – $0 basis). Since the depreciation he claimed was more than the gain, all of the gain must be reported as ordinary income. The $20,000 gain on the sale is reported on Part III of the Form 4797.

FAMILY MEMBER INSTALLMENT SALES — I.R.C. §453B(f)

If an installment obligation is canceled (or otherwise becomes unenforceable), gain is recognized to the extent of the difference between the basis of the obligation and the fair market value (FMV) of the obligation at the time of cancellation. If the obligor and the obligee are related parties [I.R.C. §318(a)], generally spouse, children, grandchildren, and parents, the FMV of the obligation is treated as not less than its face value [*Estate of Frane v. Commissioner*, 98 T.C. 4811 (1995)].

Example 3. Through an installment sale, Sam buys development land for $250,000 from his father, Ed. Ed's tax basis in the land is $125,000. Sam makes annual principal payments of $10,000, and he pays 9% interest to Ed.

At the beginning of the fourth year of the installment sale, Sam is in severe financial trouble. He is unable to make his scheduled payments to Ed. Ed forgives the remaining principal debt of $100,000. Ed must report gain as computed below.

Sale price	$250,000
Basis	(125,000)
Gain	$125,000
Gross profit percentage	50%
Principle forgiven	$100,000
Basis (50% × 100,000)	(50,000)
Gain	$50,000

It might be argued, I.R.C. §453B(f) should not and was not intended to apply in financial distress situations. If Ed in **Example 3** acts as any creditor would given similar circumstances, the tax results should be the same as for unrelated parties. However, there is no regulation, court case, or letter ruling that currently addresses this issue. The argument is that I.R.C. §453B(f) was intended only to address a loophole permitting related taxpayers to avoid gain on disposition of an installment sales contract by **canceling** the contract rather than **transferring** the contract. Acting in a commercially reasonable manner may be an important factor in determining the applicability of I.R.C. §453B(f) when there is a related-party transaction because of financial distress.

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Observation. This trap is not a problem if land is forfeited to Ed in cancellation of the debt. If the land is forfeited, I.R.C. §1038 would determine Ed's taxable gain. The forfeiture by Sam is a taxable transaction to him. However, any resulting tax loss to Sam is not deductible because of the related-party rules of I.R.C. §267.

Sam's purchase price	$250,000
Sam's tax basis	(250,000)
FMV of property at time of forfeiture	$150,000
Sam's Tax Consequences	
Sale price	$150,000
Tax basis	(250,000)
Gain or (loss)	($100,000)

Note. The loss is not deductible to Sam because of the related-party rules of I.R.C. §267. No loss is deductible on a sale or exchange of property between members of a family (brother, sister, spouse, ancestors, and lineal descendants).

DISCHARGE OF INDEBTEDNESS INCOME CALCULATION

Debt owed	$220,000
FMV of property transferred	(150,000)
Discharge-of-indebtedness income	$70,000

Note. This discharge of indebtedness income may be taxable in some circumstances. (See the discussion beginning on pages 494 of this chapter.)

PROPERTY THAT IS TRANSFERRED TO A LENDER IS TREATED AS IF PROPERTY WERE 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 [*Bressi v. Commissioner*, 62 T.C.M. 1668, T.C. Memo, 1951-651]. The information is provided to the borrower and the IRS on Form 1099-A.

Example 4. John Mechanic has a tax basis of $10,000 in a car lift. The lift has a FMV of $25,000 but is also subject to a secured lien of $30,000 in favor of a creditor. John agrees to transfer the lift to the creditor in return for a complete discharge of the $30,000 he owes. John is treated as having sold the lift and will recognize a $15,000 gain.

Deemed sale (FMV)	$25,000
Tax basis	(10,000)
Gain	$15,000

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John's 2002 Form 1099-A follows.

For Example 4

☐ CORRECTED (if checked)

LENDER'S name, street address, city, state, ZIP code, and telephone no.			OMB No. 1545-0877	Acquisition or Abandonment of Secured Property
ABC Finance Company 117 S. Main St. Anyplace, IL 55555			2002 Form 1099-A	
LENDER'S Federal identification number 32-1234567	BORROWER'S identification number 111-11-1111	1 Date of lender's acquisition or knowledge of abandonment 6/18/02	2 Balance of principal outstanding $ 30000.00	**Copy B** **For Borrower**
BORROWER'S name John Mechanic		3	4 Fair market value of property $ 25000.00	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.) 201 State St.		5 Was borrower personally liable for repayment of the debt? ☑ Yes ☐ No		
City, state, and ZIP code Cartown, IL 55556		6 Description of property Car loft SM 12412315		
Account number (optional)				

Form 1099-A (keep for your records) Department of the Treasury - Internal Revenue Service

Example 5. Dave is a real estate developer. In 1982, he purchased 160 acres of unimproved land for $50,000. Ten years later the land had a FMV of $480,000. He borrowed $300,000, giving the bank a first mortgage on the property.

In 2002, the land has a FMV of $200,000, and Dave is in financial trouble. He and the bank agree that if he transfers the land to the bank, the bank will cancel the remaining indebtedness of $235,000.

Dave is treated for tax purposes as having sold the land to the bank for its FMV and will recognize a gain of $150,000.

Deemed sale (FMV)	$200,000
Tax basis	(50,000)
Gain	$150,000

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FORFEITURE OF LAND PURCHASED ON THE INSTALLMENT CONTRACT

Property sold on an installment contract can be forfeited to the seller in exchange for a complete release of buyer liability. In addition, some debtors transfer property to creditors in exchange for discharge of a debt. Forfeitures and exchanges have tax implications.

If a person who is obligated on a property secured recourse debt defaults on 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.

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Example 6. Dave purchases commercial property for $300,000 and pays $100,000 on the principal debt. Dave defaults when the property has a FMV of $100,000. If this is recourse debt, the seller can sue Dave for the $200,000 due on the contract.

DISCHARGE OF INDEBTEDNESS INCOME

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

Observation. Is this income taxable? If there is discharge of indebtedness income to the taxpayer, the tax practitioner must go through a rather complex computation. However, after completion of the computation, the practitioner will discover that the income is generally not subject to income tax. This computation is discussed in detail beginning on page 495 of this chapter [I.R.C. §108, generally].

Types of Debt

There are two types of debt, **recourse** and **non-recourse** debt. They are defined as follows:

- **Recourse Debt.** Debt for which the taxpayer is personally liable. In the case of a default on payment, the holder of the debt will look to the individual or entity that incurred the debt for payment. For example, Bill borrows $30,000 to purchase a car. Upon failure to make payments, the finance company repossesses the car. At time of repossession, the loan balance is $25,000, but the car is only worth $20,000. The finance company has recourse against Bill and can make him pay the additional $5,000.
- **Non-recourse Debt.** Debt for which the borrower is not personally liable. In the prior example, the finance company would have to absorb the $5,000 loss and could not force Bill to make payment. There is very little non-recourse debt issued by lenders today.

TAX TREATMENT FOR A RECOURSE DEBT

Example 7. Based on the following facts, the purchaser will recognize a $50,000 loss on the forfeiture if the property is used in a trade or business and a $30,000 discharge of indebtedness income.

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
Loss if land is used in trade or business	
FMV of property	$50,000
Tax basis	(100,000)
Loss	($50,000)
Discharge-of-indebtedness income	
Debt remaining at time of forfeiture	$80,000
FMV of property at time of forfeiture	(50,000)
Discharge-of-indebtedness income	$30,000

TAX TREATMENT OF FORFEITING PURCHASER OR TRANSFEROR

Example 8. Assume property is used in a trade or business and debt is recourse. Based on the following facts, the purchaser will have $0 discharge of indebtedness income and a $40,000 loss.

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Assume these facts:	
Contract price for unimproved land (tax basis)	$100,000
Debt remaining at time of forfeiture	60,000
FMV of property at time of forfeiture	60,000
Loss if land is used in trade or business	
FMV of property	$60,000
Tax basis	(100,000)
Loss	($40,000)
Discharge-of-indebtedness income	
Debt remaining at time of forfeiture	$60,000
FMV of property at time of forfeiture	(60,000)
Discharge-of-indebtedness income	$0

Example 9. The following example illustrated what happens in a refinancing situation.

Assume these facts:	
Tax basis of unimproved land	$200,000
Debt remaining at time of forfeiture	600,000
FMV of property at time of forfeiture or transfer	500,000
Gain if land is used in trade or business	
FMV of property	$500,000
Tax basis	(200,000)
Gain	$300,000
Discharge-of-indebtedness income	
Debt remaining at time of forfeiture	$600,000
FMV of property at time of forfeiture	(500,000)
Discharge-of-indebtedness income	$100,000

Example 10. In 1995, Mindy purchases from Jason 10 billboards and 20 acres for $640,000. $600,000 is for I.R.C. §1245 improvements and $40,000 is for land. She makes this purchase on a contract for deed requiring a 20% down payment, with the balance amortized at 10% over 20 years.

In 2002, Mindy returns the 20 acres to Jason in exchange for Jason's cancellation of Mindy's remaining payments due under contract. On January 1, 2002, the adjusted cost basis is $166,000 ($126,000 plus land of $40,000). At the time of exchange, the FMV of the property is $320,000, and the remaining contract balance is $472,500. The tax results are:

- debt-discharge ordinary income of $152,500 (difference between FMV of property transferred, $320,000, and debt discharged, $472,500); and
- I.R.C. §1245 ordinary income of $154,000 (difference between FMV of property transferred, $320,000, and tax basis, $166,000).

Depreciation created the gain, so the entire gain is I.R.C. §1245 recapture ordinary gain.

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Facts	
Tax basis of unimproved land (at purchase)	$40,000
Tax basis on §1245 improvements (at purchase)	600,000
Tax basis of unimproved land (at cancellation)	40,000
Tax basis on §1245 improvements (at cancellation)	126,000
Debt remaining at time of forfeiture	472,500
FMV of property at time of forfeiture or transfer	320,000
Gain if land is used in trade or business	
FMV of property	$320,000
Tax basis ($40,000 + $126,000)	(166,000)
Gain (all §1245 ordinary gain)	$154,000
Discharge-of-indebtedness income	
Debt remaining at time of forfeiture	$472,500
FMV of property at time of forfeiture	(320,000)
Discharge-of-indebtedness income	$152,500

Example 11. In 2002, Frank, a contractor, transfers to a creditor a concrete finisher with a FMV of $6,000 and a tax basis of $5,500. The creditor discharges $7,500 of indebtedness for which Frank is personally liable. The amount realized on the disposition of the asset is its FMV ($6,000). The tax results are:

- a $500 gain ($6,000 – $5,500); and
- income from the discharge of indebtedness of $1,500 ($7,500 – $6,000) [Treas. Reg. §1.1001-2].

Facts	
Tax basis of finisher	$5,500
Debt remaining at time of forfeiture	7,500
FMV of machine	6,000
Gain on finisher	
FMV of property	$6,000
Tax basis	(5,500)
Gain	$500
Discharge-of-indebtedness income	
Debt remaining at time of forfeiture	$7,500
FMV of property at time of forfeiture	(6,000)
Discharge-of-indebtedness income	$1,500

Note. The above examples show the tax implications of a property forfeiture or transfer by a debtor to a creditor.

TAX TREATMENT OF DISCHARGED INDEBTEDNESS

A taxpayer generally realizes gross income from the discharge of indebtedness [I.R.C. §61(a)(12)].

Generally, the amount of debt discharged is the measure of the income that is realized by the taxpayer. If the loan is recourse, the discharged indebtedness is the difference between the FMV of the property forfeited and the amount of debt discharged. This assumes the debt exceeds the FMV of the property.

However, the discharge of certain types of indebtedness is excluded from income [I.R.C. §108(a)]. Discharge of indebtedness income is excluded from gross income if:

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Exception One. The discharge is in a bankruptcy case (including Chapter 12) [defined in I.R.C. §108(d)(2)]. This topic is discussed beginning on page 507 under Bankruptcy rules.

Exception Two. The discharge occurs when the taxpayer is insolvent.

Exception Three. The discharge is of "qualified business indebtedness" even if the taxpayer is solvent. This provision was repealed by the 1986 Tax Reform Act for discharges occurring after 1986 and is not discussed in this chapter.

Exception Four. The discharge is of qualified real property business indebtedness [defined in I.R.C. §108(c)].

Exception Five. The discharge is of qualified farm indebtedness of a qualifying farm debtor who is solvent and the debt is discharged after April 9, 1986 [subsection (g) of I.R.C. §108].

There is no discharge of indebtedness income created to the extent that payment of the indebtedness would have given the taxpayer a deduction [I.R.C. §108(e)(2)].

Examples include:

- Discharged interest not paid by a cash basis taxpayer
- Seed corn bill not paid by a cash basis farmer (See Rev. Rul. 67-200, 1967-1 C.B. 15, for the situation where an accrual basis taxpayer has deducted, but not paid, interest accrued on indebtedness. The interplay of I.R.C. §111 is also discussed.)

Note. In a Supreme Court decision the court ruled that while discharge of indebtedness income in an S corporation could meet one of the above exceptions and not be taxable, it would increase the shareholders basis in their stock. Hence they could deduct previous losses that had been suspended because of insufficient basis. Congress subsequently modified the tax codes to prevent this basis increase.

DISCHARGE OF DEBTS OF THE INSOLVENT TAXPAYER [EXCEPTION TWO]

The general rule that income is realized from the cancellation (discharge) of indebtedness applies to the insolvent taxpayer who is not in bankruptcy. **In Exception Two, the discharge of indebtedness income realized by the insolvent taxpayer is excluded from gross income [I.R.C. §108(a)(1)(B)]. However, certain "tax attributes" must be reduced** (paying the price).

Insolvency is defined in balance sheet terms as "the excess of liabilities over the FMV of assets." A qualified appraisal of assets may be necessary [I.R.C. §108(d)(3)].

The determination of whether and to what extent an individual is insolvent is made immediately before the discharge.

Accrued but unpaid interest creates insolvency but does not create discharge of indebtedness income for a cash basis taxpayer.

Note. The list of exempt assets differs between states. For example, in New York the value of a motor vehicle, up to $2,400 over any amount owed for the car is exempt. In Illinois, only the debtor's interest, not to exceed $1,200, is exempt. A personal residence may be exempt in some states but not in others.

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

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qualifies for Exceptions 4 or 5 shown above. 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.

Caution. The attribute reductions are made after determination of tax imposed for the taxable year of discharge.

Example 12. Joe (insolvent before and after the discharge) has $100,000 of debts discharged in 2002. He also has $80,000 of taxable income from 2002 property liquidations. His 2001 tax return shows a carryforward NOL of $70,000 and a carryover tax credit of $7,000. Joe will first use his NOL and tax-credit attributes to reduce income and income tax for 2002, respectively. Any unused attributes will then be reduced by the amount of debt discharged [I.R.C. §108(b)(4)(A), (B) and (C)].

Reduction of the Seven Tax Attributes

The tax attributes are reduced in the following order:

A. NOL. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year [Current year loss is used first.] [I.R.C. §108(b)(4)(B)].

B. Certain credit carryovers. Referred to as credits in the examples in this chapter, they are any carryover to or from the taxable year of the discharge of an amount allowable under:

1. I.R.C. §38 (investment tax credit)
2. I.R.C. §40 (relating to expenses of work incentive programs)
3. I.R.C. §44B (relating to credit for employment of certain new employees)
4. I.R.C. §44E (relating to alcohol used as fuel)

These credits are reduced $33\frac{1}{3}$% for each $1 of discharged indebtedness.

C. Minimum tax credit. Any minimum tax credit available under I.R.C. §53(b) as of the beginning of the tax year immediately following the taxable year of the discharge.

D. Capital loss carryovers. Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year (current year used first).

E. Basis reduction of taxpayer's property. The basis reduction must conform to the requirements of I.R.C. §1017. It is made to the taxpayer's property, and the following rules are applicable:

1. No reduction is made to the basis of property that the debtor treats as exempt property [I.R.C. §1017(c)(1)].
2. The reduction in basis is not treated as a disposition for investment credit recapture purposes [I.R.C. §1017(c)(2)].
3. The reduction in basis cannot exceed the excess of the aggregate of the bases of the property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge [but this general rule does not apply to deductions in basis under I.R.C. §108(b)(5) — Special election].
4. Reduction in basis applies to any property of taxpayer held at the beginning of the tax year following the year of discharge.
5. **Any reduction in basis is treated as a depreciation deduction.** On a later sale of the property at a gain, I.R.C. §1245 recapture (ordinary income treatment) will apply **even though the property that has a basis reduction is not I.R.C. §1245 or I.R.C. §1250 property** [I.R.C. §1017(d)(1)(A)].

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6. **Reg. §1.1017-1 prescribes the sequence of basis reduction. The following is directly from the IRS regulations:**

(a) General rule for section 108(b)(2)(E). This paragraph (a) applies to basis reductions under section 108(b)(2)(E) that are required by section 108(a)(1)(A) or (B) because the taxpayer excluded discharge of indebtedness (COD income) from gross income. A taxpayer must reduce in the following order, to the extent of the excluded COD income (but not below zero), the adjusted bases of property held on the first day of the taxable year following the taxable year that the taxpayer excluded COD income from gross income (in proportion to adjusted basis) —

(1) Real property used in a trade or business or held for investment, other than real property described in section 1221(1), that secured the discharged indebtedness immediately before the discharge;

(2) Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the discharged indebtedness immediately before the discharge;

(3) Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in section 1221(1);

(4) Inventory, accounts receivable, notes receivable, and real property described in section 1221(1); and

(5) Property not used in a trade or business nor held for investment.

(b) Operating rules — (1) Prior tax-attribute reduction. The amount of excluded COD income applied to reduce basis does not include any COD income applied to reduce tax attributes under sections 108(b)(2)(A) through (D) and, if applicable, section 108(b)(5). For example, if a taxpayer excludes $100 of COD income from gross income under section 108(a) and reduces tax attributes by $40 under sections 108(b)(2)(A) through (D), the taxpayer is required to reduce the adjusted bases of property by $60 ($100 – $40) under section 108(b)(2)(E).

(2) Multiple discharged indebtednesses. If a taxpayer has COD income attributable to more than one discharged indebtedness resulting in the reduction of tax attributes under sections 108(b)(2)(A) through (D) and, if applicable, section 108(b)(5), paragraph (b)(1) of this section must be applied by allocating the tax-attribute reductions among the indebtednesses in proportion to the amount of COD income attributable to each discharged indebtedness. For example, if a taxpayer excludes $20 of COD income attributable to secured indebtedness A and excludes $80 of COD income attributable to unsecured indebtedness B (a total exclusion of $100), and if the taxpayer reduces tax attributes by $40 under sections 108(b)(2)(A) through (D), the taxpayer must reduce the amount of COD income attributable to secured indebtedness A to $12 ($20 – ($20 ÷ $100 × $40)) and must reduce the amount of COD income attributable to unsecured indebtedness B to $48 ($80 – ($80 ÷ $100 × $40)).

(3) Limitation on basis reductions under section 108(b)(2)(E) in bankruptcy or insolvency. If COD income arises from a discharge of indebtedness in a Title 11 case or while the taxpayer is insolvent, the amount of any basis reduction under section 108(b)(2)(E) shall not exceed the excess of —

(i) The aggregate of the adjusted bases of property and the amount of money held by the taxpayer immediately after the discharge; over

(ii) The aggregate of the liabilities of the taxpayer immediately after the discharge.

(c) Modification of ordering rules for basis reductions under sections 108(b)(5) and 108(c) — (1) In general. The ordering rules prescribed in paragraph (a) of this section apply, with appropriate modifications, to basis reductions under sections 108(b)(5) and (c). Thus, a taxpayer that elects to reduce basis under

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section 108(b)(5) may, to the extent that the election applies, reduce only the adjusted basis of property described in paragraphs (a)(1), (2), and (3) of this section and, if an election is made under paragraph (f) of this section, paragraph (a)(4) of this section. Within paragraphs (a)(1),(2), (3) and (4) of this section, such a taxpayer may reduce only the adjusted bases of depreciable property. A taxpayer that elects to apply section 108(c) may reduce only the adjusted basis of property described in paragraphs (a)(1) and (3) of this section and, within paragraphs (a)(1) and (3) of this section, may reduce only the adjusted bases of depreciable real property. Furthermore, for basis reductions under section 108(c), a taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged qualified real property business indebtedness before reducing the adjusted bases of other depreciable real property. The term qualifying real property means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3). See paragraphs (f) and (g) of this section for elections relating to section 1221(1) property and partnership interests.

(2) Partial basis reductions under section 108(b)(5). If the amount of basis reductions under section 108(b)(5) is less than the amount of the COD income excluded from gross income under section 108(a), the taxpayer must reduce the balance of its tax attributes, including any remaining adjusted bases of depreciable and other property, by following the ordering rules under section 108(b)(2). For example, if a taxpayer excludes $100 of COD income from gross income under section 108(a) and elects to reduce the adjusted bases of depreciable property by $10 under section 108(b)(5), the taxpayer must reduce its remaining tax attributes by $90, starting with net operating losses under section 108(b)(2).

(3) Modification of fresh start rule for prior basis reductions under section 108(b)(5). After reducing the adjusted bases of depreciable property under section 108(b)(5), a taxpayer must compute the limitation on basis reductions under section 1017(b)(2) using the aggregate of the remaining adjusted bases of property. For example, if, immediately after the discharge of indebtedness in a Title 11 case, a taxpayer's adjusted bases of property is $100 and its undischarged indebtedness is $70, and if the taxpayer elects to reduce the adjusted bases of depreciable property by $10 under section 108(b)(5), section 1017(b)(2) limits any further basis reductions under section 108(b)(2)(E) to $20 (($100 – $10) – $70).

(d) Changes in security. If any property is added or eliminated as security for an indebtedness during the one-year period preceding the discharge of that indebtedness, such addition or elimination shall be disregarded where a principal purpose of the change is to affect the taxpayer's basis reductions under section 1017.

(e) Depreciable property. For purposes of this section, the term depreciable property means any property of a character subject to the allowance for depreciation or amortization, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor cannot reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of such property.

(f) Election to treat section 1221(1) real property as depreciable — (1) In general. For basis reductions under section 108(b)(5) and basis reductions relating to qualified farm indebtedness, a taxpayer may elect under sections 1017(b)(3)(E) and (4)(C), respectively, to treat real property described in section 1221(1) as depreciable property. This election is not available, however, for basis reductions under section 108(c).

(2) Time and manner. To make an election under section 1017(b)(3)(E) or (4)(C), a taxpayer must enter the appropriate information on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), and attach the form to a timely filed (including exten-

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sions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). An election under this paragraph (f) may be revoked only with the consent of the Commissioner.

F. **Passive activity loss and credit carryovers.** Any passive activity loss or credit carryover of the taxpayer under I.R.C. §469(b) from the taxable year of the discharge.

G. **Foreign tax credit carryovers.** Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under I.R.C. §33.

The Amount of Reduction of the Tax Attributes

General rule. Except for credit carryovers, the reductions are one dollar for each dollar excluded from income.

Credit carryover reduction. The reduction of the credits is 33 1/3¢ for each dollar excluded from income (except for the foreign tax credit).

If there is a debt discharge amount remaining after attributes are reduced and the taxpayer is insolvent before and after the discharge, the rest of the amount discharged is **not** included in income.

Election to Reduce Basis in Depreciable Property First

The insolvent taxpayer can elect to use all or a portion of the excluded indebtedness to first reduce his or her basis in depreciable property [I.R.C. §108(b)(5)]. This may enable the taxpayer to preserve net operating losses and tax credit carryovers.

Depreciable property is defined in I.R.C. §1017(e) and, by election, may include real estate held as inventory.

Depreciable property. For purposes of this section, the term "depreciable property" means any property of a character subject to the allowance for depreciation, but only if a basis reduction will reduce the amount of depreciation or amortization that would otherwise be allowable for the period immediately following such reduction.

The basis reduction is limited to depreciable assets. The basis in nondepreciable property, such as a personal residence or unimproved land, cannot be reduced.

This election is different from basis reduction under I.R.C. §108(b)(2)(D), which covers all property.

The time of the election is specified in I.R.C. §108(d)(8)(A) and regulations pertinent to that section.

When to make the reduction. The reduction in basis is made at the **beginning of the tax year following the tax year of the debt cancellation**, and it applies to property held by the taxpayer at that time. A choice to reduce basis must generally be made on the tax return for the tax year of the debt cancellation. However, if reasonable cause is established for failure to file the choice with the original tax return, the choice may be filed with an amended return or on a claim for credit or refund.

After the basis in depreciable property is reduced, the taxpayer's remaining tax attributes are reduced.

When the election is made, use **Form 982**, Reduction of Tax Attributes Due to Discharge of Indebtedness (and I.R.C. §1082 Basis Adjustment).

See **Reg. §§1.1017-1** and **-2** for guidelines in determining which properties to reduce and the reduction order. Also see **Rev. Proc. 85-44.**

Reg. §1.1017-2. Adjusted basis; discharge of indebtedness; special cases.

Reg. §1.1017-1 prescribes the general rule to be followed in adjusting basis of property where there is a proper exclusion from gross income under I.R.C. §108(a). The taxpayer may, however, have the basis of his property adjusted in a manner different from that set out in Reg. §1.1017-1 upon a proper showing to the satisfaction of the Commissioner. Such adjustment, however, must be consistent with the principles of Reg. §1.1017-1. Variations from the

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general rule may involve adjusting the basis of only part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation.

A request for variations from the general rule prescribed in Reg. §1.1017-1 shall be filed by the taxpayer with his/her return for the taxable year in which the discharge of indebtedness occurred unless a consent is permitted (under Reg. §1.108(a)-2) after the original return has been filed, in which case such request must be filed with the amended return or claim for credit or refund, as the case may be. Agreement between the taxpayer and the Commissioner as to any variations from the general rule must be effected only by a closing agreement entered into under the provisions of I.R.C. §7121. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule prescribed in Reg. §1.1017-1, then the consent filed on Form 982 shall be deemed to be a consent to the application of the general rule and the general rule will prevail in the determination of the basis of the taxpayer's property. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule and the taxpayer specifically states that he does not consent to the application of the general rule, then I.R.C. §108(a) and I.R.C. §1017 shall not apply [Reg. §1.1017-2].

Reg. §1.1017-1(g) prescribes the sequence of basis reduction for partnerships. The following is directly from the IRS regulations:

(1) Partnership COD income. For purposes of paragraph (a) of this section, a taxpayer must treat a distributive share of a partnership's COD income as attributable to a discharged indebtedness secured by the taxpayer's interest in that partnership.

(2) Partnership interest treated as depreciable property — (i) In general. For purposes of making basis reductions, if a taxpayer makes an election under section 108(b)(5) (or 108(c)), the taxpayer must treat a partnership interest as depreciable property (or depreciable real property) to the extent of the partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property), provided that the partnership consents to a corresponding reduction in the partnership's basis (inside basis) in depreciable property (or depreciable real property) with respect to such partner.

(ii) Request by partner and consent of partnership — (A) In general. Except as otherwise provided in this paragraph (g)(2)(ii), a taxpayer may choose whether or not to request that a partnership reduce the inside basis of its depreciable property (or depreciable real property) with respect to the taxpayer, and the partnership may grant or withhold such consent, in its sole discretion. A request by the taxpayer must be made before the due date (including extensions) for filing the taxpayer's Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

(B) Request for consent required. A taxpayer must request a partnership's consent to reduce inside basis if, at the time of the discharge, the taxpayer owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership, or if reductions to the basis of the taxpayer's depreciable property (or depreciable real property) are being made with respect to the taxpayer's distributive share of COD income of the partnership.

(C) Granting of request required. A partnership must consent to reduce its partners' shares of inside basis with respect to a discharged indebtedness if consent is requested with respect to that indebtedness by partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership or five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. For example, if there is a cancellation of partnership indebtedness that is secured by real property used in a partnership's trade or business, and if partners owning (in the aggregate) 90% of the capital and profits interests of the partnership elect to exclude the

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COD income under section 108(c), the partnership must make the appropriate reductions in those partners' shares of inside basis.

(iii) Partnership consent statement — (A) Partnership requirement. A consenting partnership must include with the Form 1065, U.S. Partnership Return of Income, for the taxable year following the year that ends with or within the taxable year the taxpayer excludes COD income from gross income under section 108(a), and must provide to the taxpayer on or before the due date of the taxpayer's return (including extensions) for the taxable year in which the taxpayer excludes COD income from gross income, a statement that —

(1) Contains the name, address, and taxpayer identification number of the partnership; and

(2) States the amount of the reduction of the partner's proportionate interest in the adjusted bases of the partnership's depreciable property or depreciable real property, whichever is applicable.

(B) Taxpayer's requirement. Statements described in paragraph (g)(2)(iii)(A) of this section must be attached to a taxpayer's timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

(iv) Partner's share of partnership basis — (A) In general. For purposes of this paragraph (g), a partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property) is equal to the sum of —

(1) The partner's I.R.C. §743(b) basis adjustments to items of partnership depreciable property (or depreciable real property); and

(2) The common basis depreciation deductions (but not including remedial allocations of depreciation deductions under §1.704-3(d)) that, under the terms of the partnership agreement effective for the taxable year in which the discharge of indebtedness occurs, are reasonably expected to be allocated to the partner over the property's remaining useful life. The assumptions made by a partnership in determining the reasonably expected allocation of depreciation deductions must be consistent for each partner. For example, a partnership may not treat the same depreciation deductions as being reasonably expected by more than one partner.

(B) Effective date. This paragraph (g)(2)(iv) applies to elections made under I.R.C. §§108(b)(5) and 108(c) on or after December 15, 1999.

(v) Treatment of basis reduction — (A) Basis adjustment. The amount of the reduction to the basis of depreciable partnership property constitutes an adjustment to the basis of partnership property with respect to the partner only. No adjustment is made to the common basis of partnership property. Thus, for purposes of income, deduction, gain, loss, and distribution, the partner will have a special basis for those partnership properties the bases of which are adjusted under section 1017 and this section.

(B) Recovery of adjustments to basis of partnership property. Adjustments to the basis of partnership property under this section are recovered in the manner described in §1.743-1.

(C) Effect of basis reduction. Adjustments to the basis of partnership property under this section are treated in the same manner and have the same effect as an adjustment to the basis of partnership property under section 743(b). The following example illustrates this paragraph (g)(2)(v):

Example. (i) A, B, and C are equal partners in partnership PRS, which owns (among other things) Asset 1, an item of depreciable property with a basis of $30,000. A's basis in its

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partnership interest is $20,000. Under the terms of the partnership agreement, A's share of the depreciation deductions from Asset 1 over its remaining useful life will be $10,000. Under section 1017, A requests, and PRS agrees, to decrease the basis of Asset 1 with respect to A by $10,000.

Example. (ii) In the year following the reduction of basis under section 1017, PRS amends its partnership agreement to provide that items of depreciation and loss from Asset 1 will be allocated equally between B and C. In that year, A's distributive share of the partnership's common basis depreciation deductions from Asset 1 is now $0. Under §1.743-1(j)(4)(ii)(B), the amount of the section 1017 basis adjustment that A recovers during the year is $1,000. A will report $1,000 of ordinary income because A's distributive share of the partnership's common basis depreciation deductions from Asset 1 ($0) is insufficient to offset the amount of the section 1017 basis adjustment recovered by A during the year ($1,000).

Example. (iii) In the following year, PRS sells Asset 1 for $15,000 and recognizes a $12,000 loss. This loss is allocated equally between B and C, and A's share of the loss is $0. Upon the sale of Asset 1, A recovers its entire remaining section 1017 basis adjustment ($9,000). A will report $9,000 of ordinary income.

(D) Effective date. This paragraph (g)(2)(v) applies to elections made under sections 108(b)(5) and 108(c) on or after December 15, 1999.

(3) Partnership basis reduction. The rules of this section (including this paragraph (g)) apply in determining the properties to which the partnership's basis reductions must be made.

(h) Special allocation rule for cases to which section 1398 applies. If a bankruptcy estate and a taxpayer to whom section 1398 applies (concerning only individuals under Chapter 7 or 11 of Title 11 of the United States Code) hold property subject to basis reduction under section 108(b)(2)(E) or (5) on the first day of the taxable year following the taxable year of discharge, the bankruptcy estate must reduce all of the adjusted bases of its property before the taxpayer is required to reduce any adjusted bases of property.

(i) Effective date. This section applies to discharges of indebtedness occurring on or after October 22, 1998 [Reg. §1.1017-1.].

QUALIFIED REAL PROPERTY BUSINESS [EXCEPTION FOUR] [I.R.C. §108(C)]

If the debtor is solvent when the debt is discharged, **is not** in bankruptcy, and **does not** qualify for the solvent farmer provision, he/she may qualify for an exception for debt on real property that is used in a trade or business. IRS Pub. 334, *Tax Guide for Small Business*, describes this provision as follows:

Qualified real property business debt. A taxpayer can elect to exclude (up to certain limits) the discharge of qualified real property business debt. (C corporations cannot make this election.) If the taxpayer makes the election, he/she **must** reduce the basis of depreciable real property by the amount excluded. This reduction is made at the beginning of the tax year following the tax year in which the discharge occurs. However, if the property is disposed of before that time, the basis must be reduced immediately before the disposition.

Discharge of qualified real property business debt. Qualified real property business indebtedness is indebtedness (other than qualified farm debt):

A. That was incurred or assumed in connection with real property used in a trade or business;

B. That was secured by such real property;

C. That was incurred or assumed:

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1. Before January 1, 1993, or
2. If incurred or assumed on or after that date, is to acquire, construct, or substantially improve such real property; and

D. To which the taxpayer elects to apply these rules.

Qualified real property business indebtedness includes refinancing of indebtedness described in (C) above, but only to the extent it does not exceed the indebtedness being refinanced.

The amount excluded cannot exceed either:

A. The excess (if any) of:

1. The outstanding principal of qualified real property business indebtedness (immediately before the discharge), minus
2. The FMV (immediately before the discharge) of the business real property that is security for the debt, reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by this property immediately before the discharge; or

B. The total adjusted bases of depreciable real property held by the taxpayer immediately before the discharge. These adjusted bases are determined after any basis reduction due to a discharge in bankruptcy, insolvency, or of qualified farm indebtedness. Depreciable real property acquired in contemplation of the discharge is not taken into account.

Election. To make this election, a Form 982 is completed and attached to the income tax return for year in which the discharge occurs. If the election is not filed with the original return, the election may be made with an amended return or claimed by showing reasonable cause for failure to file it with the original return.

Example 13. Bob Johnson owns real property used in his business with a tax basis of $200,000, a FMV of $250,000, and qualified debt of $300,000. $50,000 of the debt is discharged by the lender on July 1, 2001. Bob is solvent before and after the discharge. The discharge is excludable under the new provision. Bob reduces the tax basis of the property by $50,000 as of January 1, 2002. The reduction in basis is reported on Form 982.

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For Example 13

Form **982** (Rev. September 2000) Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ Attach this form to your income tax return.

OMB No. 1545-0046 Attachment Sequence No. 94

Name shown on return: **Bob Johnson** Identifying number: **111-22-3333**

Part I General Information (see instructions)

1 Amount excluded is due to (check applicable box(es)):
- a Discharge of indebtedness in a title 11 case ☐
- b Discharge of indebtedness to the extent insolvent (not in a title 11 case) ☐
- c Discharge of qualified farm indebtedness ☐
- d Discharge of qualified real property business indebtedness ☒

2 Total amount of discharged indebtedness excluded from gross income . . . 2

3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? ☒ Yes ☐ No

Part II Reduction of Tax Attributes (You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements.)

Enter amount excluded from gross income:

		Line	Amount
4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	4	50,000
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	
9	Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge	9	
10	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	10	
11	For a discharge of qualified farm indebtedness, applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5	11a	
b	Land used or held for use in a trade or business of farming	11b	
c	Other property used or held for use in a trade or business, or for the production of income	11c	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13	

Part III Consent of Corporation to Adjustment of Basis of its Property Under Section 1082(a)(2)

Under section 1081(b), the corporation named above has excluded $ ____________ from its gross income for the tax year beginning ____________ , and ending ____________ .
Under that section the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ____________ .
(State of incorporation)

Note: *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of form. Generally, the amount by which you benefit from the discharge of indebtedness is included in your gross income. However, under certain circumstances described in section 108, you may exclude the amount of discharged indebtedness from your gross income. Unless you check the box on line 1d or make the election on line 5, the amount excluded from gross income reduces certain tax attributes either dollar for dollar or 33⅓ cents per dollar (see below).

Use **Part I** of Form 982 to indicate why any amount received from the discharge of indebtedness should be excluded from gross income.

Use **Part II** to report your reduction of tax attributes. The reduction must be made in the following order:

- Any net operating loss (NOL) for the tax year of the discharge (and any NOL carryover to that year) (dollar for dollar);
- Any general business credit carryover to or from the tax year of the discharge (33⅓ cents per dollar);
- Any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge (33⅓ cents per dollar);
- Any net capital loss for the tax year of the discharge (and any capital loss carryover to that tax year) (dollar for dollar);
- Basis of property (dollar for dollar);
- Any passive activity loss (dollar for dollar) and credit (33⅓ cents per dollar) carryovers from the tax year of the discharge; and
- Any foreign tax credit carryover to or from the tax year of the discharge (33⅓ cents per dollar).

Use **Part III** to exclude from gross income under section 1081(b) any amounts of income attributable to the transfer of property described in that section.

Definitions. A "title 11 case" is a case under title 11 of the United States Code (relating to bankruptcy), but only if you are under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is under a plan approved by the court.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 17066E Form **982** (Rev. 9-2000)

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SOLVENT FARMERS [EXCEPTION FIVE]

Some solvent farm debtors who have a debt discharged will be treated similarly to (but not the same as) insolvent debtors. This rule applies only to a debt discharged after April 9, 1986. (For purposes of I.R.C. §§108 and 1017, discharge by a qualified person of qualified farm indebtedness of a taxpayer who is not insolvent at the time of the discharge is treated in the same manner as if the discharge occurred while the taxpayer was insolvent.)

I.R.C. §108(G) SPECIAL RULES FOR DISCHARGE OF QUALIFIED FARM INDEBTEDNESS

(1) Discharge Must be by Qualified Person: —

(A) In General. — Subparagraph (C) of subsection (a)(I) shall apply only if the discharge is by a qualified person.

(B) Qualified Person. — For purposes of subparagraph (A), the term "qualified person" has the meaning given to such term by section 46(c)(8)(D)(iv); except that such term shall include any Federal, State, or local government or agency or instrumentality thereof.

Note. A **qualified person** is a person actively and regularly engaged in the business of lending money and who is not:

- a person related to the taxpayer,
- a person from whom the taxpayer acquired the property
- a person who receives a fee with respect to the taxpayer's investment in the property

(2) Qualified Farm Indebtedness. — For purposes of this section, indebtedness of a taxpayer shall be treated as qualified farm indebtedness if:

(a) such indebtedness has incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and

(b) 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

(3) Amount Excluded Cannot Exceed Sum of Tax Attributes and Business and Investment Assets:

(a) In General. — The amount excluded under subparagraph (C) of subsection (a)(I) shall not exceed the sum of:

(i) the adjusted tax attributes of the taxpayer, and

(ii) the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(b) Adjusted Tax Attributes. — For purposes of subparagraph (A), the term "adjusted tax attributes" means the sum of the tax attributes described in subparagraphs (A), (B), (C), (D),(F) and (G) of subsection (b)(2) determined by taking into account $3 for each $1 of the attributes described in subparagraphs (B), (C), and (G) of subsection (b)(2) and the attribute described in subparagraph (F) of subsection (b)(2) to the extent attributable to any passive activity credit carryover.

(C) Qualified Property. — For purposes of this paragraph, the term "qualified property" means any property which is used or is held for use in a trade or business or for the production of income.

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(D) Coordination with Insolvency Exclusion. — For purposes of this paragraph, the adjusted basis of any qualified property and the amount of the adjusted tax attributes shall be determined after any reduction under subsection (b) by reason of amounts excluded from gross income under subsection (a)(1)(B).

Note. To the extent the attributes do not absorb the discharge amount, the excess is taxable income.

TREATMENT OF DISCHARGE OF INDEBTEDNESS INCOME OF CERTAIN SOLVENT FARMERS — OTHER ITEMS — EXPLANATION

For purposes of determining whether a taxpayer's indebtedness is qualified farm indebtedness, the gross receipts test is applied by dividing the taxpayer's aggregate gross receipts **from farming** for the three-taxable-year-period preceding the taxable year of the discharge by the taxpayer's aggregate gross receipts from **all sources** for that period. In addition, the term "qualified person" is modified to include a federal, state, or local government or agency or instrumentality thereof.

After tax attributes have been reduced in the order prescribed for **insolvent taxpayers**, amounts excluded from income under the qualified farm indebtedness provision may be applied to reduce basis in assets used or held for use in a trade or business or for the production of income (i.e., in "qualified property").

Basis reduction occurs **first** with respect to depreciable property, **then** with respect to land used in the business of farming, and **then** with respect to other qualified property.

The amount excluded under this provision may not exceed the taxpayer's total available discharge of indebtedness income. After the taxpayer has reduced tax attributes and basis in qualified property, income will be recognized. (Applies to discharges after April 6, 1986).

PURCHASE-PRICE ADJUSTMENTS [I.R.C. §108(E)(5)]

In order to alleviate one cause of taxpayer disputes with the IRS, Congress added I.R.C. §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. This section provides that where the **seller of specific 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. This 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.)

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. Furthermore, 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, such as the running of a statute of limitations. [If a statute of limitations results in discharge, income will be recognized under I.R.C. §61(a)(12).] 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 nonrecognition treatment.

Example 14. Ted purchases unimproved property for $120,000. He pays $10,000 down and gives a $110,000 purchase-money mortgage for the balance. After Ted pays $75,000 on the mortgage, the seller agreed to reduce the balance of the debt by $15,000. Since Ted is solvent, there is $15,000 in discharge-of-debt income absent I.R.C. §108(e)(5). Under I.R.C. §108(e)(5), Ted reduces his basis in the property to $105,000. If the value of the property increases, Ted would be required to recognize a larger gain when it is sold.

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In **Example 14**, if depreciable property qualifying for the investment tax credit (ITC) was involved, further adjustments would have to be made.

- Basis reduction by the purchaser would have to be apportioned among depreciable and nondepreciable assets.
- Basis reduction in ITC assets would create potential investment tax credit recapture liability. (Reduction would be retroactive to date of purchase; holding period would not be relevant.)
- If basis reduction reduces an asset's basis below $0, the purchaser would likely recognize ordinary income to that extent.
- If payments remain due to the seller, the seller, because of the reduction in purchase price, must recalculate his/her gross profit percentage for the payments yet to be made.

DEBTS DISCHARGED IN BANKRUPTCY [EXCEPTION ONE]

The amount of the debt discharged is not included in income because of Exception One. Solvency of the taxpayer is not important for tax purposes, provided the taxpayer is in a Title 11 proceeding (including Chapter 12). However, the **amount of discharge** that would otherwise be taxable under the discharge of indebtedness rule **must be used to reduce tax attributes**.

If the debtor is an individual filing for bankruptcy under Title 11 of the U.S. Code, **the required reduction of tax attributes must be made to the attributes acquired from the debtor taxpayer by the bankruptcy estate, a separate taxable entity resulting from the filing of the case**. This is the outcome for Chapter 7 and Chapter 11 Bankruptcies. Also, the choice of whether to first reduce the basis of depreciable property before reducing other tax attributes must be made by the trustee of the bankruptcy estate.

The order of reduction and the basis adjustment election are the same as discussed beginning on page 496 "Insolvent Debtors Outside of Bankruptcy."

Chapter 12 and Chapter 13 **do not** create a separate taxable entity. The debtor, not the estate, reduces tax attributes.

Question: When is the debt discharged under Chapter 12 for tax purposes?

Answer: Probably at the end of the 3-year or 5-year plan period. This can work to the taxpayer's benefit.

Example 15. Insolvent taxpayer not in bankruptcy.

Facts: Sam Insolvent (renegotiated debt in 2002)

Asset	Tax Basis	FMV	Liability	Creditor
Cash	$3,000	$3,000	$0	
Unimproved land	200,000	200,000	300,000	A
Depreciable business assets	100,000	100,000	123,000	B
Other assets	0	25,000	25,000	C
Total	$303,000	$328,000	$448,000	
Other*	$65,000	$65,000	$0	

For purposes of the insolvency test, assets beyond the reach of creditors are not included [Ltr. Rul. 8920019]. These assets are listed as "other."

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As part of a 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: $3,000 solvent ($328,000 – $325,000)
- 2000 tax information: $15,000 NOL carryforward, $5,000 credits carry forward
- 2001 tax information: No attributes used. No tax liability

Tax Result — Option One (No Election to Reduce Basis First)

A. There is discharge of indebtedness of $120,000 for the insolvent taxpayer. The taxpayer is solvent in regard to the other $3,000 discharged.

B. Tax attributes have to be reduced to the extent of the $120,000 discharge.

1. 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).
2. The credits carryforward of $5,000 reduces $3 of discharged debt for each $1 of tax credit. Thus, $90,000 of discharge is remaining at this point ($105,000 – $15,000 = $90,000).
3. 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). Note that this limiting rule does not apply where the election is made to reduce the basis of depreciable property first under I.R.C. §108(b)(5) [I.R.C. §§1017(b)(2)(A) and (B)].
4. The amount of discharge remaining ($90,000) is not included in income because the debtor was insolvent to that extent.

C. $3,000 of discharged indebtedness is reportable as income unless the solvent farmer or the qualified real property business indebtedness rules apply (discussed below).

Tax Result — Option Two (Elect to Reduce Depreciable Basis First)

A. Tax attributes have to be reduced to the extent of the $120,000 discharge.

1. 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). (See Reg §1.1017-1 for sequence.)
2. Tax attributes of $15,000 of NOL and 1/3($1,667) of credits (3-for-1 rule) are eliminated. The remaining $3,333 of credits would be available to offset tax liability in 2003.
3. $3,000 of the $123,000 discharge is taxed as ordinary income unless the solvent farmer or qualified real property business indebtedness rules apply.

Tax Result if Solvent Farmer Rule Applies — Option One

Same result as above except the $3,000 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.

Tax Result if Solvent Farmer Rule Applies —Option Two (Elect to Reduce Depreciable Basis First)

1. Same result as above except $1,000 of the $3,333 credits remaining would be absorbed (3-for-1 rule) by the amount of the solvency discharge, $3,000.

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2. Thus, $2,333 of credits would be available to reduce tax liability in 2003.
3. There would be no taxable income to report.

Tax Result if Qualified Real Property Business Indebtedness Rule Applies

If the taxpayer does not qualify for the solvent farmer provisions, but does meet the threshold requirements for the qualified real property business indebtedness rule, the following results occur.

- **Option One.** Same result as above except the $3,000 discharge that exceeds the taxpayer's insolvency is excluded and it reduces basis in depreciable real property by $3,000.
- **Option Two (Elect to Reduce Depreciable Basis First).** Same result as above except $3,000 discharge that exceeds the taxpayer's insolvency is not excluded since there is no depreciable basis in real property to reduce.

Example 16. John Apple has the following balance sheet as of March 31, 2002.

Assets	Tax Basis	FMV
Current		
Cash	$1,000	$1,000
Accounts receivable	0	20,000
Intermediate		
Machinery/equipment	80,000	130,000
*Exempt property	50,000	0
Other	5,000	5,000
Fixed		
Real estate	180,000	230,000
Total Assets	$266,000	$386,000

Liabilities and Equity	Tax Basis	FMV
Current		
Accounts payable		$4,000
Notes payable		80,000
Accrued interest:		
Current notes	$3,000	
Intermediate notes	2,000	
Long-term debt	15,000	20,000
Intermediate		
Machinery/equipment		$110,000
Long-term		
Real estate (incurred 1-5-90)		300,000
Total Liabilities		$514,000
Equity (insolvent)		($128,000)

On April 1, 2002, the bank reduced the principal debt on John's real estate mortgage by $70,000 (from $300,000 to $230,000).

Assets	Tax Basis	FMV
Current		
Cash	$1,000	$1,000
Accounts receivable	0	20,000
Intermediate		
Machinery/equipment	80,000	130,000
*Exempt property	50,000	0
Other	5,000	5,000
Fixed		
Real estate	180,000	230,000
Total Assets	$266,000	$386,000

Liabilities and Equity	Tax Basis	FMV
Current		
Accounts payable		$4,000
Notes payable		80,000
Accrued interest:		
Current notes	$3,000	
Intermediate notes	2,000	
Long-term debt	15,000	20,000
Intermediate		
Machinery/equipment		$110,000
Long-term		
Real estate (Incurred 1-5-90)		230,000
Total Liabilities		$444,000
Equity (Insolvent)		($58,000)

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John's insolvency was reduced from $128,000 to $58,000. He was clearly insolvent before and after the discharge.

Step one information. John carried forward into 2002 from 2001 the following:

- $12,000 of NOL
- $10,000 of credits
- $3,000 of capital loss

Step two information. After preparing John's 2002 return, the tax practitioner finds the NOL is reduced to $10,000, the credits carryforward to 2003 is $10,000, and the $3,000 of capital loss is fully absorbed in 2002 (no carryforward to 2003).

Step three information. Divide aggregate of basis of property held immediately after discharge, $266,000, by aggregate of liabilities immediately after discharge, $444,000; aggregate excess = none.

Step four. His discharge of indebtedness income is $70,000.

Step five. Reduction of tax attributes is below:

	Before reduction	After reduction
NOL	$10,000	$0
Credits	10,000	0
Capital loss	0	0
Excess of basis	0	0
Foreign tax credit	0	0
Discharge-of-indebtedness income	70,000	
NOL	(10,000)	
Credits (3 for 1)	(30,000)	
Discharge-of-indebtedness income after attribute reduction	$30,000	

Observation. The taxpayer is insolvent before and after the discharge of indebtedness, so the $30,000 income is not subject to tax.

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If John elected to reduce the basis of depreciable assets first, in order to preserve his other tax attributes for an expected high-income year in 2003, he would classify his property and reduce his basis as follows:

(1) Property used in a trade or business (other than inventory, notes, or accounts receivable) purchased with the debt.	Land was purchased with debt but its basis cannot be reduced under §108(b)(5).
(2) Property used in a trade or business (other than inventory, notes, or accounts receivable) used to secure the debt.	The land basis cannot be reduced.
(3) Remaining property used in the trade or business (other than inventory, notes, or accounts receivable) on a pro rata basis.	Machinery and equipment; see below.
(4) Inventory, notes, and accounts receivable of the trade or business on a pro rata basis.	
(5) Property held for the production of income on a pro rata basis.	
(6) Other property on a pro rata basis.	

Asset	FMV	Basis	Pro rata %				Reduction*	New basis**
Machine 1	$40,000	$30,000	37.5	×	$70,000	=	$26,250	$3,750
Truck	20,000	15,000	18.8	×	70,000	=	13,160	1,840
Machine 2	30,000	35,000	43.7	×	70,000	=	30,590	4,410
	$90,000	$80,000	100.0				$70,000	$10,000

*Treated as a depreciation deduction under I.R.C. §1245.

**Complete Form 982 and attach to 2002 tax return.

DEPRECIATION FOR 2002 ON ASSETS

Reg. §1.168-2 — Basis Redetermination reads as follows:

> *(3) Redeterminations. (i) For the taxable year (and subsequent taxable years) in which the unadjusted basis of recovery property is redetermined (e.g., due to contingent purchase price or discharge of indebtedness), the recovery allowance shall be the amount determined by multiplying the redetermined adjusted basis by the redetermined applicable percentage. For purposes of this subparagraph, the redetermination adjusted basis is the unadjusted basis reduced by the recovery allowance previously allowed or allowable to the taxpayer with respect to the property and adjusted to reflect the redetermination. The redetermined applicable percentage is the percentage determined by dividing the applicable percentage otherwise provided in paragraph (b), (c), (g), or (m) of §1.168-2 for the recovery year by an amount equal to the unrecovered percentage (i.e., 100 percent minus the applicable percentage for recovery years prior to the year in which the basis is redetermined). Thus, the increase or decrease in basis shall be accounted for over the remaining recovery years beginning with the recovery year in which the basis is redetermined.*

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Example 17 (Regulation Example). On July 15, 1984, Mary places in service 5-year recovery property with an unadjusted basis of $100,000. In order to purchase the property, she borrowed $80,000 from Arthur. On December 1, 1984, Arthur forgives $10,000 of the indebtedness. Mary makes the election provided in I.R.C. §108(d)(4). The recovery allowance for the property in 1984 is $15,000. Under I.R.C. §1017(a), as of January 1, 1985, the adjusted basis of the property is $75,000. In 1985, the recovery allowance is $19,411.77 [22 ÷ (1.00 – .15) × ($100,000 – ($10,000 + $15,000))]. In 1986, 1987, and 1988 the recovery allowance is $18,529.41 in each year [21 ÷ (1.00 – .15) × ($100,000 – ($10,000 + $15,000))][Reg. §1.168-2].

1st year depreciation	
Original Basis	$100,000
1st year depreciation %	15%
1st year depreciation 1984	$15,000
Basis after COD	
Original cost	$100,000
1st year depreciation	(15,000)
Adjusted basis	$85,000
Debt foregiven	(10,000)
New basis	$75,000
2nd year depreciation %	
Normal 2nd year %	22%
Remaining depreciation % (1 – .15)	85%
2nd year modified % (22%/85%)	25.88235%
2nd year depreciation 1985	
New basis	$75,000
2nd year depreciation %	25.8824%
2nd year depreciation 1985	$19,411.76
3rd - 5th year depreciation %	
Normal 3rd - 5th year %	21%
Remaining depreciation % (1 – .15)	85%
2nd year modified % (22%/85%)	24.70588%
3rd - 5th year depreciation	
Basis after COD	$75,000.00
3rd - 5th year %	24.705882%
3rd - 5th year depreciation	$18,529.41

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TAXPAYER MADE SOLVENT BY THE DISCHARGE

Example 18. Glenn is a farmer with the following balance sheet as of April 1, 2001:

Assets	Tax Basis	FMV
Current		
Cash	$1,000	$1,000
Stored grain	0	20,000
Intermediate		
Machinery/equipment	80,000	90,000
Breeding stock	0	40,000
*Exempt property	50,000	
Other	5,000	5,000
Fixed		
Real estate	230,000	230,000
Total	$316,000	$386,000

*Not included

Liabilities and Equity	Tax Basis	FMV
Current		
Accounts payable		$4,000
Notes payable		80,000
Intermediate		
Machinery/equipment		50,000
Long-term		
Real estate		300,000
Total liabilities		$434,000
Equity		(48,000)
Total Liabilities and Equity		$386,000

- NOL carryforward to 2002 — $30,000
- Credit carryforward to 2002 — $1,000
- Capital-loss carryforward to 2002 — $1,000

As a qualified farmer, Glenn attempts to solve his cash-flow problems by convincing his creditors to do the following:

1. the bank will reduce the debt on his real estate mortgage by $70,000; and
2. Farm Credit Services will reduce his current note payable by $30,000.

Glenn's balance sheet after the cancellation of debt is as follows:

Assets	Tax Basis	FMV
Current		
Cash	$1,000	$1,000
Stored grain	0	20,000
Intermediate		
Machinery/equipment	80,000	90,000
Breeding stock	0	40,000
*Exempt property	50,000	
Other	5,000	5,000
Fixed		
Real estate	230,000	230,000
Total	$316,000	$386,000

*Not included

Liabilities and Equity	Tax Basis	FMV
Current		
Accounts payable		$4,000
Notes payable		50,000
Intermediate		
Machinery/equipment		50,000
Long-term		
Real estate		230,000
Total liabilities		$334,000
Equity		52,000
Total Liabilities and Equity		$386,000

As a result of these actions, Glenn has shifted 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 are applied.

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		Before	After	Discharge Absorbed
Attribute reduction:	NOL	$30,000	$0	($30,000)
	Credits	1,000	0	(3,000)
	Capital loss	1,000	0	(1,000)
	*Basis	316,000	316,000	0
				($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
Credits	0
Capital loss	0
Basis	0
Foreign tax credit	0

Basis of all depreciable property	$80,000
Solvency portion of discharge	52,000
*Basis reduction	(52,000)
Taxable income	$0

*Basis redetermination was discussed in Example 14.

TAXPAYER MADE SOLVENT BY THE DISCHARGE WITH QUALIFIED BUSINESS INDEBTEDNESS [I.R.C. §108(C)]

Example 19. Glenda is a business owner with the following balance sheet as of April 1, 2002.

Assets

	Tax Basis	FMV
Current		
Cash	$5,000	$5,000
Intermediate		
Machinery/equipment	40,000	190,000
*Exempt property	50,000	
Other	5,000	5,000
Fixed		
Real estate incurred 1-5-91	50,000	50,000
Depreciable real estate incurred	200,000	230,000
Total	$300,000	$480,000

Liabilities and Equity

	Tax Basis	FMV
Current		
Accounts payable		$4,000
Notes payable		80,000
Intermediate		
Machinery/equipment		50,000
Long-term		
Real estate		400,000
Total liabilities		$534,000
Equity		(54,000)
Total Liabilities and Equity		$480,000

*Not included

- NOL Carryforward to 2002 — $30,000
- Credit Carryforward to 2002 — $1,000
- Capital-loss carryforward to 2002 — $1,000

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In an attempt to solve her cash-flow problems, Glenda convinces the bank to reduce the debt on her real estate mortgage by $100,000.

Glenda's balance sheet after the cancellation of debt is as follows:

Assets	Tax Basis	FMV
Current		
Cash	$5,000	$5,000
Intermediate		
Machinery/equipment	40,000	190,000
*Exempt property	50,000	
Other	5,000	5,000
Fixed		
Real estate incurred 1-5-91	50,000	50,000
Depreciable real estate incurred	200,000	230,000
Total	$300,000	$480,000

Liabilities and Equity	Tax Basis	FMV
Current		
Accounts payable		$4,000
Notes payable		80,000
Intermediate		
Machinery/equipment		50,000
Long-term		
Real estate		300,000
Total liabilities		$434,000
Equity		46,000
Total Liabilities and Equity		$480,000

*Not included

As a result of these actions, Glenda has gone from a position of $54,000 insolvent to $46,000 solvent.

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

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		Before	After	Discharge Absorbed
Attribute reduction:	NOL	$30,000	0	($30,000)
	Credits	1,000	0	(3,000)
	Capital loss	1,000	0	(1,000)
	*Basis	316,000	316,000	0
				($34,000)

The $20,000 not absorbed ($54,000 – $34,000) is not included in income.

*Aggregate basis immediately after discharge	$300,000
Aggregate liabilities immediately after discharge	434,000
Excess of basis over liabilities	0
Reduction of basis	0

Solvency portion:

Attributes:		
NOL	$0	
Credits	0	
Capital loss	0	
Basis	0	
Foreign tax credit	0	
Basis of all depreciable property		200,000
Solvency portion of discharge		46,000
*Basis reduction		$46,000

Proof. The amount **excluded** cannot exceed either:

A. The excess (if any) of:

1. the outstanding principal of qualified real property business indebtedness (immediately before the discharge), minus
2. the FMV (immediately before the discharge) of the business real property that is security for the debt, reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by this property immediately before the discharge; **or**

B. The total adjusted bases of depreciable real property held immediately before the discharge. These adjusted bases are determined after any basis reduction due to a discharge in bankruptcy, insolvency, or of qualified farm indebtedness. Depreciable real property acquired in contemplation of the discharge is not taken into account.

Real estate principle	$400,000
FMV real estate	(280,000)
	$120,000
	OR
Adjusted basis depreciable real property	$200,000

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BANKRUPTCY PROCEDURE AND THE BANKRUPTCY ESTATE [IRS PUB. 908]

CREATING THE BANKRUPTCY ESTATE

If an individual debtor files for bankruptcy under Chapter 7 or 11 of the Bankruptcy Code, a separate "estate" is created consisting of property that belonged to the debtor before the filing date. This bankruptcy estate is a new taxable entity, completely separate from the individual debtor.

The estate is managed by a 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 estate also gives the individual debtor a "fresh start" — wages earned and property bought by the individual after the bankruptcy case has begun belong to him/her and does 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.

INCOME, DEDUCTION, AND CREDITS OF 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. It does **not** include amounts the debtor receives or accrues as income before the beginning of the bankruptcy case. Similarly, the estate, and not the individual debtor, must include any gross income the estate receives or accrues after the beginning of the bankruptcy case.

The bankruptcy estate may deduct or take a credit for any expenses it pays or incurs, in the same way the debtor would have deducted or credited them had he/she continued in the same trade, business, or activity and actually paid or accrued the expenses. Allowable expenses include administrative 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, individual deductions, and the zero bracket amount for a married individual filing separately in arriving at his/her taxable income. The tax on the taxable income is figured by using the rates for a married individual filing separately.

RETURN REQUIREMENTS AND PAYMENT OF TAX

If a return is required, the trustee (or debtor-in-possession) completes only the identification area at the top of the Form 1041, enters any tax due, and signs and dates it. Form 1041 is a transmittal for Form 1040, U.S. Individual Income Tax Return. Form 1040 is completed and tax is calculated using the tax rate schedule for a married person filing separately. In the top margin of Form 1040, **"Attachment to Form 1041. DO NOT DETACH"** is written. Form 1040 is attached to the Form 1041.

The trustee in bankruptcy is responsible for obtaining an employer identification number for the estate to use in filing any tax returns.

Caution. The trustee (or debtor-in-possession) must withhold income and Social Security taxes and file employment tax returns with respect to any wages paid by the trustee (or debtor), including wage claims paid as administrative expenses. Until these employment taxes are deposited, they should be segregated in a separate bank account to ensure that funds are available to satisfy the liability. If the employment taxes are not paid as required, the trustee may be held personally liable for payment of the taxes.

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The trustee has the duty to prepare and file Forms W-2, Wage and Tax Statements, in connection with wage claims paid by the trustee, regardless of whether the claims accrued before or during bankruptcy.

Partnerships and Corporations. A separate taxable estate is not created when a partnership or corporation files a bankruptcy petition. However, the court appointed trustee is responsible for filing the regular income tax returns on Form 1065 or Form 1120.

TRANSFERS BETWEEN DEBTOR AND BANKRUPTCY ESTATE

A transfer (other than by sale or exchange) of an asset from the individual debtor to the bankruptcy estate is not treated as a "disposition" for income tax purposes. The transfer does not result in gain or loss, recapture of deductions or credits, or acceleration of income or deductions.

The estate is treated like the debtor would be with respect to the transferred asset. When the bankruptcy estate is dissolved, any resulting transfer (other than by sale or exchange) of the estate's assets to the debtor is not treated as a disposition. Therefore, like 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

A. It is important to note that the total of attributes received by the estate is determined in part by the decision of the debtor to file a short-year personal return.

B. The bankruptcy estate must treat its tax attributes in the same way they would be treated by an individual debtor. These items must be determined as of the *first day of the debtor's tax year in which his/her bankruptcy case begins.* The bankruptcy estate gets the following items from the individual debtor.

1. Net operating loss carryovers
2. Carryovers of excess charitable contributions
3. Recovery exclusion (relating to bad debts, prior taxes, and delinquency amounts)
4. Credit carryovers
5. Capital loss carryovers
6. Basis, holding period, and character of assets
7. Method of accounting (the same one used by the debtor)
8. Passive activity loss and credit carryovers
9. Unused at-risk deductions
10. Other tax attributes to the extent provided in regulations

ADMINISTRATIVE EXPENSES

The bankruptcy estate is allowed a deduction for administrative expense and any fees or charges assessed against it under Chapter 123 of Title 28 of the United States Code. These expenses are deductible whether or not they are considered trade or business expenses or investment expenses. However, they are subject to disallowance under other provisions, such as those disallowing certain capital expenditures, taxes, or expenses relating to tax-exempt interest. Expenses belonging to, or directly related to, the estate can only be deducted by the estate and never by the debtor.

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If the administrative expenses of the bankruptcy estate are more than its gross income for the tax year, the excess amount may be carried back three years or forward seven years. The amounts can only be carried back or forward to a tax year of the estate and never to a tax year of the individual debtor.

TERMINATION OF THE ESTATE

If the bankruptcy estate has any tax attributes at the time it is dissolved, the individual debtor must assume the attributes and treat them in the same way the estate had treated them. The debtor must assume these attributes even if they first arose during the administration of the estate.

Carrybacks from the estate. If the bankruptcy estate itself incurs a net operating loss, apart from any losses passing to the estate from the individual debtor, it can carry the loss back not only to its own earlier tax years, but also to those of the individual debtor before the year in which the bankruptcy case began. The estate may also carry back excess credits, such as the investment credit, to pre-bankruptcy years of the individual debtor.

Carrybacks from the debtor's activities. An individual debtor cannot carry back any net operating loss or tax credit from a tax year ending after the bankruptcy case has begun to any tax year ending before the case began.

DETERMINATION OF THE TAX YEAR OF THE BANKRUPT

Note. 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 [I.R.C. §1398(d)(1)].

The normal tax year may be divided into two parts:

- the first year ends the day before the bankruptcy petition is filed; and
- 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 petition is filed [IRS Pub. 908].

- 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 [I.R.C. §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 become those of the estate unless the debtor elects to divide his/her 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 from the bankruptcy estate as a priority claim. (If the taxes can't 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 his/her bankruptcy estate.

Note. There is practical application to farmers, who traditionally receive substantial income in the early months of their tax year.

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TAX PLANNING: THE BANKRUPTCY ALTERNATIVE AND ELECTION OF TWO SHORT YEARS

Example 20. Luke is a calendar-year taxpayer. He is in financial difficulty and decides to sell assets in January 2002 to pay his debts. On March 1, 2002 he decides to declare bankruptcy. If he does not elect two short tax years, the gain he realized on the sale of assets will be included on the return he files for the full year. His 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. If the estate cannot pay this tax, the debtor is personally liable.

Absorption of attributes. The debtor's selection of a single tax year or two short tax years will affect the amount of tax attributes that pass from the debtor to the bankruptcy estate. The rule is the bankruptcy estate receives the tax attributes of the debtor as of the beginning of the tax year in which bankruptcy occurred [I.R.C. §1398(g)]. Therefore, if the debtor chooses a single tax year, the attributes that he/she has at the beginning of the year will pass to the bankruptcy estate and cannot be used by the debtor on his/her 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/her return for the first short year.

If the debtor has taxable income before the date of bankruptcy, it is usually to the debtor's advantage to choose two short years. By doing so, the debtor not only makes taxes on the income a debt of the estate, but will reduce the amount of taxes owed on the income. The reduction of taxes is an advantage to the debtor, if the estate does not have enough assets to pay the tax. The taxes will not be discharged in bankruptcy and will become a debt of the debtor when the bankruptcy estate is closed [11 U.S.C. §523(a)(1)(A)]. The cost to the debtor of applying the tax attributes to his/her own return by electing two short years is a potential reduction in the amount of tax attributes that pass from the bankruptcy estate back to the debtor when the estate is closed. If the bankruptcy estate would absorb all the tax attributes anyway, the use of the attributes in the debtor's first short year will have no effect on the attributes that are passed back to the debtor.

DISCHARGE OF UNPAID TAXES OF DEBTOR [IRS PUB. 908]

As a general rule, there is no discharge for an individual debtor at the termination of a bankruptcy case for prepetition taxes or for taxes for which no return, a late return (filed after a date two years before the filing of the bankruptcy petition), or a fraudulent return was filed. Claims against an individual for other taxes predating the bankruptcy petition by more than three years may be discharged.

Prepetition taxes. The following federal taxes are prepetition unsecured priority taxes of the government:

- Income taxes for tax years ending on or before the date of filing the bankruptcy petition, for which a return is last due (including extension) after a date three years before the filing of the petition.
- Income taxes assessed within 240 days before the date of filing the petition. This 240-day period is increased by any time, plus 30 days, during which an offer in compromise with respect to these taxes was pending, that was made within 240 days after the assessment.
- Income taxes, other than those for which no return, a later return (filed within two years of the filing of the bankruptcy petition), or a fraudulent return was filed, that were not assessed before but are assessable after the filing of the petition.
- Withholding taxes on which the debtor is liable in any capacity.

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- Employment taxes on the first $2,000 of wages, salaries, or commissions (including vacation, severance, and sick-leave pay) earned by each individual employee from the debtor within the 90-day period before the earlier of the date of cessation of the debtor's business or the date of filing bankruptcy petition (whether or not actually paid before the date), and employment taxes for which a return is last due (including extensions) after a date three years before the filing of the petition.
- Excise taxes on transactions occurring before the date of filing the bankruptcy petition, for which a return, if required, is last due (including extensions) after a date three years before the filing of the petition. If a return is not required, these excise taxes include only those on transactions occurring during the three years immediately before the date of filing the petition.
- Taxes arising in the ordinary course of the debtor's business or financial affairs in an involuntary bankruptcy case, after the filing of the bankruptcy petition but before the earlier of the appointment of a trustee or the order for relief.

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

TRANSFERRING TAX LIABILITY TO THE BANKRUPTCY ESTATE

Note. If there is income tax generated from the sale of property by the bankruptcy estate, it is paid as an administrative expense [I.R.C. §6012(a)(9)]. If there are insufficient funds to pay this tax, the unpaid amount is not a tax liability of the debtor. A cash basis farmer whose grain and livestock inventory is sold by the estate would be relieved of the personal tax burden on these taxable dispositions (likewise for the sale of real estate that generates a taxable gain). Transferring tax liability to the bankruptcy estate by having the estate rather than the debtor sell the property may be a major reason for suggesting Chapter 7 liquidating bankruptcy instead of a resolution outside of bankruptcy.

Caution. A major tax trap is the right of the trustee to abandon any property that is burdensome to the estate or that is of inconsequential value [11 U.S.C. §541(a)]. This will likely include property, the value of which is less than the secured debt against the property. The position of the IRS and the courts has been 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.

In the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor is not treated as a disposition for purposes of any provision assigning tax consequences to a disposition, and the debtor is treated as the estate would be treated with respect to that asset [I.R.C. §1398(f)(2)].

Careful analysis is required. The tax professional will have to analyze the individual properties of the debtor and the secured debt on each to be able to provide an accurate tax liability estimate.

Note. Most farmers have very little unsecured debt.

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Example 21. Farmer Luke files a Chapter 7 bankruptcy petition with the following assets:

Asset	Tax basis	FMV	Secured Liability	Gain if Sold or Forfeited
A Grain	$0	$120,000	$130,000	$120,000
B Machinery	25,000	75,000	150,000	50,000
C Farm X	100,000	140,000	120,000	40,000
D Farm Y	200,000	300,000	400,000	100,000

Observation. Under the rules just discussed, it is likely the trustee would abandon Assets A, B, and D to the debtor: The taxable gain of $270,000 will be taxed to the debtor unless the *Lane* case theory can be successfully argued. Asset C 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.

Is the abandonment of property by a bankruptcy trustee a taxable event that creates tax liability for the bankruptcy estate? — An updated discussion.

A bankruptcy trustee, during the administration of the estate, can abandon any property that is "burdensome to the estate or that is of inconsequential value and benefit to the estate" [11 U.S.C. §544(a)].

I.R.C. §1398(f)(2) provides the rules for tax consequences of transfers from the estate to the debtor.

Transfer from estate to debtor not treated as disposition. In the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the debtor shall be treated as the estate would be treated with respect to such asset.

Until recently the IRS and the courts were in agreement that abandonment of property pursuant to 11 U.S.C. §544(a) was not a taxable event **to the estate**.

The determination is important because trapping the tax liability in the estate allows the debtor to claim an income tax basis equal to the FMV of the property at the time it is abandoned. Consequently, upon a later foreclosure or other transfer, the debtor has little or no gain to report. If the gain is not trapped in the estate, the debtor receives a carryover basis and must report gain calculated with that basis upon a later foreclosure or other transfer. Taxes on that gain do not become a liability of the estate because the tax was not due before the filing of the petition [11 U.S.C. §507(a)(7)(A)(i)]. Those taxes are also not discharged by the bankruptcy proceeding because they were not due three years before the filing of the petition [11 U.S.C. §523(a)(1)(A)].

A.J. Lane & Co., Inc. [92-1 USTC ¶50,059 (p. 83,238) (U.S. Bankr. Ct., Dist. Mass.) 133 B.R. 264, (10/21/91)], **determined abandonment to be a taxable event and distinguished the earlier cases.**

In *A.J. Lane & Co., Inc.* a Chapter 11 bankruptcy trustee requested authority to abandon property back to the debtors. At the time of the request, a creditor had been given relief from the automatic stay and had scheduled foreclosure sales.

The only reason given by the bankruptcy trustee for wanting to abandon was a desire to avoid the substantial income tax liability that would result from the foreclosure sale. The court noted that the secured encumbrances on all the properties exceeded their FMVs (p. 83,239). This factor generally is sufficient justification for the trustee to abandon properties during bankruptcy proceedings. Property may be abandoned if it is of inconsequential value or is burdensome to the estate [11 U.S.C. §554].

The court also acknowledged that in Ltr. Rul. 9017075 (Jan. 31, 1990), the IRS took the position that abandonment by the bankruptcy estate during the case had no tax consequences to the estate.

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The court determined that the trustee could abandon the property to any party with a possessory interest, which includes a party having a secured interest (p. 83,240).

The court concluded that the phrase "of inconsequential value and benefit to the estate" did not automatically include property that is encumbered beyond its FMV (p. 83,240). However, this conclusion seems to be applicable only in Chapter 11 cases because of the availability of the cram-down provisions of 11 U.S.C. §1129(b)(2)(A). That conclusion makes the projected tax burden relevant because of the need to determine its application to the trustee's right to abandon property that is "burdensome to the estate." In this case the burden was the projected amount of tax liability.

The debtor argued that it made no difference because abandonment other than at the "termination of the estate" was a taxable event, citing *Commissioner v. Court Holding Co.*, 324 U.S. 331, 65 S. Ct. 707, 89 L. Ed. 981 (1945) and *Yarbro v. Commissioner*, 737 F.2d 479 (5th Cir. 1984) cert. denied, 469 U.S. 1189, 105 S. Ct. 959.

The court distinguished the *Samore v. Olson (In re Olson)* and *In re McGowan* cases, which concluded there were no tax consequences to the estate on abandonment of property.

In re Olson [100 B.R. 458 (Bankr. N.D. Iowa, 1989), aff'd, 121 B.R. 346 (N.D. Iowa 1990), aff'd 930 F.2d 6 (8th Cir. 1994)], the trustee requested a determination that the bankruptcy estate was not liable for income taxes as a result of the abandonment of property during the administration of the estate.

Prior to filing a Chapter 7 petition, a creditor had begun foreclosure proceedings against the abandoned tracts of land. After the trustee abandoned the property, the creditor sold the property at a foreclosure sale.

1. Without the knowledge of the trustee, the debtor filed a fiduciary tax return showing tax due as a result of the abandonment.
2. The court found that the abandonment was proper under 11 U.S.C. §554(a) and that the term "termination of the estate" in I.R.C. §1398(f)(2) was broad enough to include the termination of the estate's **interest** in property under 11 U.S.C. §554(a), and therefore the abandonment was not a taxable event to the estate.
3. A "fresh start" argument was made by the debtors, but the court countered by stating that, statutorily, a Chapter 7 debtor is not discharged from all tax debts and if the discharge rules needed to be changed, it was the responsibility of Congress.

The court in *In re McGowan* [95 B.R. 104 (Bankr. N.D. Iowa, 1988)] actually dealt with the issue first. The debtor had filed a Chapter 7 petition. During the bankruptcy administration, farm equipment and machinery were abandoned by the trustee. The fiduciary return filed by the estate reported the abandonment as a taxable event. The IRS took the position that the tax liability was not that of the estate. The court interpreted the "termination of estate" language in I.R.C. §1398(f)(2) to be broad enough to include the termination of an estate's **interest** in property and held that there was no tax liability to the estate.

In *In re Lane & Co., Inc.*, the court stated that the courts in *In re Olson* and *In re McGowan* did not recognize (but should have) that the bankrupt estate received a benefit because the secured portion of the debt was discharged. The court also noted the distinction between a pending foreclosure sale, the situation in *Lane*, and a pending negotiated sale.

However, the important distinction was the determination by the court that "the plain meaning of [I.R.C. §1398(f)(2)] is that it applies only to a transfer from the estate to the debtor at the **termination** of the estate" (p. 83,243).

Interestingly, the court used the language of I.R.C. §1398(i) to support its conclusion:

Debtor succeeds to tax attributes of estate. In the case of a termination of an estate, the debtor shall succeed to and take into account the items referred to in paragraphs (1), (2), (3), (4), (5), and (6) of subsection (g) in a manner similar to that provided in such paragraphs (but taking into account that the transfer is from the estate to the debtor instead of from the debtor to the estate). In addition, the debtor shall succeed to and take into account the other tax attributes of

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the estate, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section.

"The design of the statute is clear. The party holding the property, whether the debtor or the estate, is also entitled to any available net operating loss carryover, so that if that party incurs a taxable gain in the disposition of the property he can use the net operating loss carryover to offset the gain. The trustee's proposed abandonment would destroy this symmetry" (p. 83,243).

The interplay between I.R.C. §1398(f)(2) and (i) was not considered in *In re Olson* or *In re McGowan*.

Considering basic bankruptcy policy, the court also concluded "where there is no other overriding policy [which it couldn't find], the fresh start policy is controlling....Taxing the Debtor on the foreclosure following this proposed abandonment creates a clear burden on the Debtor's fresh start, and there is no countervailing policy which overrides this consideration" (p. 83,244).

Other cases: See *In Re Rubin*, 154 B.R. 897 (1992), for a case that follows *Lane In re Burpo, Jr.*, 148 B.R. 918 (1993), criticizes *Lane*.

> **Note.** Regulation §1.1398-1(d) specifically provides that abandonment of estate property to the debtor **is not** a taxable event to the bankruptcy estate. If the tax practitioner relies on *Lane*, the position needs to be disclosed on a tax return by the attachment of Form 8275R.
>
> (d) *Transfers from estate to debtor — (1) Transfer not treated as a taxable event.* If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under §522 of Title 11 of the United States Code and abandonments of estate property to the debtor under §554(a) of such title [1994-1C.B. 231].

REPOSSESSION OF REAL PROPERTY — GENERAL RULES

The rules pertaining to repossession of real property differ from those involving personal property. Because some real property tends to increase substantially in value, it creates a hardship for the seller of such property to determine the gain or loss on repossession from the FMV (as in the repossession of personal property). Not only is FMV often difficult to determine in the case of real property, but the seller might be required to obtain funds to pay taxes on a gain when he/she has received little or no money.

Congress tried to alleviate these hardships by enacting I.R.C. §1038(a). I.R.C. §1038(a) states that if a seller reacquires real property in partial or full satisfaction of a debt that arose from a prior sale, no loss or bad-debt deduction is allowable, and gain on such reacquisition is limited. There is no reference to FMV in computing gain or loss at the time of repossession. The seller is not taxed on any appreciation in value at the time of repossession. **The gain is limited to the original gain on the sale reduced by out-of-pocket costs and previously reported gains.** The seller must report any appreciation in value (after the original sale) when the property is subsequently disposed of in a taxable transaction.

Because I.R.C. §1038 is applicable only when the seller reacquires the property to satisfy the purchaser's debt, it is not generally applicable when the seller repurchases the property by paying the buyer an extra sum in addition to the cancellation of the debt. However, I.R.C. §1038 is generally applicable if the seller reacquires the property when the purchaser has defaulted, or when default is imminent, even if the seller pays additional money.

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COMPUTATION OF RECOGNIZED GAIN OR LOSS

The gain recognized on the reacquisition of real property is the lesser of:

- the gain on repossession under I.R.C. §1038(b)(1) (general rule); or
- the limitation on gain under I.R.C. §1038(b)(2).

To compute this gain, add the money and the FMV of other property (other than interest income and notes of the purchaser arising from the sale) **received from the purchaser before the reacquisition**; then subtract the gain on the sale **reported as income before the reacquisition.** This figure represents the gain on repossession, which, without the limitation of I.R.C. §1038(b)(2), would have to be reported by the seller.

Example 22. On January 2, 2000, Luke sold a lot for $25,000. He received a $5,000 down payment plus a $20,000 mortgage payable at $4,000 annually, starting January 2, 2001. The adjusted basis of the lot was $20,000, and Luke used the installment sale method of reporting income. His gross profit percentage was 20% ($5,000 profit for $25,000 selling price). In 2000, Luke included $1,000 (20% of $5,000 down payment) in income. In 2001, he included $800 (20% of $4,000 payment received) in income. The purchaser defaulted on January 2, 2002, and Luke repossessed the lot. The cost of repossession was $500. The FMV at the time of repossession was $30,000.

The amount of gain on repossession, computed under the general rule [I.R.C. §1038(b)(1)], would be:

Amount of money received ($5,000 + $4,000)	$9,000
Amount of gain taxed ($1,000 + $800)	(1,800)
Gain	$7,200

The second element in computing the recognized gain is the determination of the limitation on the gain produced by the repossession. I.R.C. §1038(b)(2) states such gain may not exceed the gain on the original sale reduced by:

- the amount of gain reported as income before the reacquisition; and
- the repossession costs, i.e., the amount of money plus the FMV of other property paid or transferred by the seller in connection with the reacquisition of the property.

Based on the facts in **Example 22**, the $7,200 gain on reacquisition would be limited as follows:

Original sale price	$25,000	
Adjusted basis of property	(20,000)	
Gain on original sale		$5,000
Reduced by:		
Taxable gain reported as income	($1,800)	
Costs of repossession	(500)	(2,300)
Gain on repossession		$2,700

Final Answer — Comparison. Comparing the gain under the general rule of I.R.C. §1038(b)(1) with the gain as limited by I.R.C. §1038(b)(2), we find the lower gain of $2,700 is the recognized gain on repossession.

Example 23. On January 1, 1998, Dave sold unimproved development land for $250,000 on contract. His tax basis was $125,000. (Gross profit percentage is 50% = $125,000 profit divided by $250,000 selling price). Dave received payments and repossessed the farmland as shown on the next page:

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- January 1, 1998 — $25,000 down payment
- January 1, 1999 — $10,000
- January 1, 2000 — $10,000
- January 1, 2001 — $10,000
- January 1, 2002 — purchaser defaulted and Dave repossessed the property without cost

FMV at time of repossession was $180,000.

a. Computation under General Rule of I.R.C. §1038(b)(1):		
Amount of money received		$55,000
Less: amount of gain taxed		(27,500)
Gain		$27,500
b. Computation under Limitation Rule of I.R.C. §1038(b)(2)		
Original sale price		$250,000
Less: adjusted basis of property		(125,000)
Gain on original sale		$125,000
Reduced by:		
Taxable gain reported as income	$27,500	
Costs of repossession		(27,500)
Gain on repossession		$97,500
c. Lower of a or b is recognized gain on reposession		$27,500

Basis of repossessed real property

Refer to Facts in Example 23 (Dave)

1. Original contract price		$25,000
2. Less: payments received		(9,000)
3. Balance due		$16,000
4. Less: unrealized profit (line 3 × gross profit percentage of 20%)		(3,200)
5. Seller's adjusted basis in contract given up		$12,800
6. Plus:		
a. Taxable gain on repossession	$2,700	
b. Repossession costs	500	3,200
7. **New basis in property**		$16,000

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Proof:

Total cash received		$9,000
FMV at repossession		30,000
Total cash received		$39,000
Less:		
Original cost	$20,000	
Paid on reacquisition	500	
Total cash expended		(20,500)
Total gain		**$18,500**
Gain reported before repossession		$1,800
Gain on repossession		2,700
Gain if sold now		
FMV at $30,000		
Less new basis or $16,000		14,000
Total gain		**$18,500**

Refer to Facts in Example 23 (Dave)

1. Original contract price	$250,000
2. Less: payments received	(55,000)
3. Balance due	$195,000
4. Less: unrealized profit (line 3 × gross profit percentage of 50%)	(97,500)
5. Seller's adjusted basis in contract given up	$97,500
6. Plus:	
a. Taxable gain on repossession	$27,500
b. Repossession costs	0
7. **New basis of property**	**$125,000**

Proof:

Total cash received		$55,000
FMV at repossession		180,000
Total cash received		$235,000
Less:		
Original cost	$125,000	
Paid on reacquisition	0	
Total cash expended		($125,000)
Total gain		**$110,000**
Gain reported before repossession		$27,500
Gain on repossession		27,500
Gain if sold now		
FMV at $30,000		
Less new basis or $16,000		55,000
Total gain		**$110,000**

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> **Note.** The character of a gain or loss on repossession of property sold under an installment sale is determined by the character of the property at the time of its original sale. The holding period is the sum of the period held prior to sale and the period held after the repossession.

REPOSSESSION OF PERSONAL PROPERTY — INSTALLMENT SALE

INTRODUCTION

When the seller repossesses personal property, originally sold under the installment method, the seller realizes gain or loss just as though the note, mortgage, or other installment obligation had been sold. Gain or loss must be recognized in the year of repossession.

The repossession may be voluntary or involuntary. If involuntary, the foreclosure sale may involve bidding by the original seller or by a third party to reacquire such property. A voluntary repossession occurs when the purchaser, unable to make payments, voluntarily agrees to return the property to the seller in full satisfaction of the outstanding debt.

COMPUTATION OF RECOGNIZED GAIN OR LOSS ON VOLUNTARY REPOSSESSION

The gain or loss is determined by the difference between the:

- FMV of the repossessed personal property (determined at the date of repossession); and
- seller's basis in the purchaser's note that is satisfied by the repossession.

The seller's basis of these obligations is the face value of the purchaser's note (contract price less principal payments made under the contract) minus the unrealized profit (the percentage of profit times the unpaid principal balance). The seller must adjust this basis for any other amounts collected or costs incurred in repossession. This computation is illustrated by the worksheet at the end of the chapter.

CHARACTER OF GAIN OR LOSS

The character of the gain or the loss remains the same as it was at the original sale.

If the obligation arose from a sale by a dealer to a customer, gain or loss on repossession is ordinary income. The amount can be reflected in the dealer's books and tax return as an adjustment to cost of goods sold schedule. In the case of a gain, the amount would decrease purchase costs; for a loss, the amount would increase purchase costs.

If the original sale was of a nonbusiness capital asset, it would be shown on Schedule D, with the computation of gain or loss shown on a separate schedule.

If the original sale was I.R.C. §1231 property, it would be shown on Form 4797, again with a separate schedule showing the computation of gain or loss.

> **Example 24.** Kim, a construction equipment dealer, sold a machine for $15,000. Her tax basis was $9,000. Her gain of $6,000 was reported on the installment method (40% gross profit percentage). The purchaser defaulted when the outstanding balance was $10,000 and the FMV of the property was $8,000. Kim offered to cancel the entire outstanding obligation if the purchaser would return the machine, which he did. Kim paid $600 in legal fees on the repossession.

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1. FMV of property when repossessed		$8,000
2. Less: seller's basis in obligation given up:		
a. Original contract price	$15,000	
b. Less: payments received	(5,000)	
c. Balance	$10,000	
d. Less: deficiency judgements	0	
e. Balance	$10,000	
f. Less: unrealized profit ($10,000 × .40)	(4,000)	(6,000)
3. Less: repossession costs		(600)
4. Recognizable gain		$1,400

Because Kim is a dealer, the gain is **ordinary** income to her. The $1,400 gain would be reflected in Kim's cost of goods sold as a decrease to purchase costs.

COMPUTATION OF RECOGNIZED GAIN OR LOSS ON FORECLOSURE — INVOLUNTARY REPOSSESSION

Foreclosure does not necessarily eliminate all outstanding debts to the seller. A deficiency judgment for the difference between the proceeds of the foreclosure sale and the outstanding debt to the seller may result. In such cases, the seller receives only a partial payment of the debt, and the original purchaser remains liable for the balance as evidenced in the deficiency judgment. The gain or loss is computed **using the same rules as in a voluntary repossession.**

Example 25. Assume the same facts as **Example 24**, except the original purchaser did not return the property voluntarily. Kim foreclosed, and a third party purchased the property for $8,000 (FMV on sale). The $8,000 proceeds were turned over to Kim in partial satisfaction of the $10,000 outstanding balance of the obligation. A deficiency judgment in favor of Kim for $2,000 was also obtained for the remaining debt.

The amount realized is the $8,000 cash received. Kim received only $8,000 of the $10,000 due. (The original purchaser still owed $2,000, evidenced by the deficiency judgment.) Her basis in the amount received was $4,800 (60% of the $8,000 face value), which was adjusted for the $600 cost of repossession. Kim's gain on the repossession is $2,600.

1. FMV of property when repossessed		$8,000
2. Less: seller's basis in obligation given up:		
a. Original contract price	$15,000	
b. Less: payments received	(5,000)	
c. Balance	$10,000	
d. Less: deficiency judgements	(2,000)	
e. Balance	$8,000	
f. Less: unrealized profit ($10,000 × .40)	(3,200)	(4,800)
3. Less: repossession costs		(600)
4. Recognizable gain		$2,600

In comparing the effect of the voluntary repossession with the involuntary or foreclosure type of repossession, it is apparent that a greater gain resulted from the latter form of repossession. In **Example 25**, the involuntary repossession resulted in a recognized gain of $2,600, whereas the voluntary repossession in **Example 24** resulted in a recognized gain of only $1,400.

The difference in gain resulted from the seller canceling the entire outstanding debt of $10,000, in the voluntary repossession, but canceling only $8,000 of the outstanding debt in the involuntary repossession. The original purchaser in the involuntary repossession remained liable for the $2,000 balance of the outstanding obligation because of the deficiency judgment. When the deficiency judgment is paid, Kim must report $800 of ordinary income. That is the $2,000 received, reduced by the $1,200 basis in the deficiency judgment (60% of $2,000).

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BASIS OF REACQUIRED PROPERTY

The basis of reacquired property in the hands of the seller for purposes of a subsequent disposition (or for depreciation) is the FMV at the time of repossession. This basis would be the same regardless of whether a voluntary or involuntary repossession occurred. In **Examples 24** and **25** the basis would be $8,000, which is the FMV of the machine at repossession.

ALLOWANCE OF BAD-DEBT DEDUCTION

When an involuntary or voluntary repossession occurs, a bad-debt deduction is allowable if the outstanding debt is greater than the FMV of the item repossessed by the seller. The timing and nature of the bad-debt deduction depends on whether the excess debt over the FMV of the item received is uncollectible, and whether the seller is a dealer in personal property. I.R.C. §166 governs the timing and nature of the bad-debt deduction.

If the seller is not a dealer in personal property, a bad-debt deduction is allowed in the year the remaining debt becomes completely worthless. A bad-debt deduction is allowed to a dealer only if the property is not repossessed.

Review the facts of **Example 25**. In the involuntary repossession, Kim obtained a deficiency judgment for the remaining indebtedness of $2,000. Of the balance due, 40% represented unrealized income and 60% represented Kim's basis. If the remaining balance of $2,000 is determined to be uncollectible, then $1,200 (60% of $2,000), Kim's basis in the obligation, will be a bad-debt deduction.

Note. The $1,200 bad-debt deduction is equal to the difference between the recognized gain in **Example 24** ($1,400) and the recognized gain in **Example 25** ($2,600). Therefore, the final tax consequences are the same for a voluntary repossession and for an involuntary repossession that is followed by a bad-debt deduction.

DEBT REDUCTIONS UNDER THE AGRICULTURAL CREDIT ACT OF 1987

The Agricultural Credit Act of 1987 (P.L. 100-233) created new rules for reducing the farmer's obligation to repay Farmers Home Administration (FmHA) debts. The rules require the farm borrower to transfer one or more rights to the FmHA at the time of the debt reduction.

Three of the rights that are transferred in some workouts are:

- a shared appreciation agreement;
- a recapture agreement; and
- a conservation easement.

The tax consequences of the debt reduction and the transfer of these rights are discussed below.

INCOME TAX CONSEQUENCES OF REDUCING DEBT

When a borrower's obligation to repay a debt is **reduced**, there may be income tax consequences, depending on the reason for the debt reduction and the status of the borrower at the time of the debt reduction.

In many transactions, debt is reduced because the borrower "paid" part or all of the debt by transferring something of value to the lender. If the debt is reduced because the borrower transferred something of value to the lender, such as an interest in property, then the borrower is treated as if the lender bought the property interest with cash and the borrower then used the cash to pay the debt [*Danenberg v. Commissioner*, 73 T.C. 370 (1979)]. There are no tax consequences to paying the debt, but there may be tax consequences from the transfer of property interest.

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If the lender receives **no consideration** for part or all of the debt reduction, the reduction is treated as **either a gift or a discharge of indebtedness.** If it is a gift, the amount of the reduction is not treated as income to the borrower [I.R.C. §102(a)]. If the reduction is discharge of indebtedness, it is treated as **income to the borrower [**I.R.C. §61(a)(12)], unless one of the following exceptions applies [I.R.C. §108]:

1. Payment of the debt would have allowed the borrower to claim a deduction;
2. The borrower was in bankruptcy at the time of the debt reduction;
3. The borrower was insolvent at the time the debt was reduced;
4. The debt discharged was qualified farm indebtedness; or
5. The debt was between the original seller and original buyer under a seller-financed transaction.

The borrower is required to reduce his/her tax attributes to account for the discharged debt that does not have to be reported as income because of the bankruptcy, insolvency, or solvent farmer exceptions. Net operating losses, capital loss carryovers, and basis are reduced one dollar for each dollar of discharged debt. General business credits and foreign tax credits are reduced 33 $^{1}/_{3}$ cents for each dollar of discharged debt.

If the borrower is under the **bankruptcy or insolvency exception** and runs out of tax attributes before all the discharged debt is accounted for, **the remaining discharged debt is "not" income**. Furthermore, for bankruptcy and insolvency exceptions, unless the borrower makes the election to **reduce basis** in depreciable property first, basis in the borrower's assets does not have to be reduced below the debt that remains after the principal has been deducted [I.R.C. §1017(b)(2)].

DEBT REDUCED WITH CONSERVATION EASEMENT

If the value of the conservation easement transferred by the borrower equals the amount of debt reduction, there is no discharge of indebtedness, and the only tax consequences to the borrower result from the transfer of the conservation easement.

Because the borrower has received a benefit from the transfer, the borrower is treated as if he/she sold the conservation easement for an amount equal to the debt reduction. Neither the courts nor the IRS has ruled on the character of income from such a sale, but it is very similar to the sale of a right-of-way or other easement. Therefore, it is likely that the amount received from the sale of the conservation easement (the amount of the debt reduction) will first reduce basis in the land subject to the easement and then be treated as gain from the sale of the land to the extent the amount received exceeds the basis in the land [*Conway v. U.S.*, 31 AFTR2d 73-1028 (Dist. Ky. 1973); Rev. Rul. 73-161, 1973-1 C.B. 366].

DEBT REDUCED WITH A RECAPTURE AGREEMENT OR SHARED APPRECIATION AGREEMENT

There are **three potential positions** for the treatment of debt reduction in exchange for a recapture agreement or a shared appreciation agreement.

Transfer of an interest in property (weakest position). One position is the borrower **has transferred** an interest in his/ her property to the lender. The interest transferred is the **right to share** in the **increase** in the value of the property. **The transfer of the interest could be treated like the transfer of an easement**. That is, the basis in the property subject to the agreement would be reduced by the amount of the debt reduction. **If the debt reduction exceeded the basis in the property, the excess would be treated as gain from the transfer of the property.**

True debt (some case authority for this position). The second position is the parties have replaced the original debt obligation with a **new** debt obligation — the obligation to pay under the recapture agreement or the shared appreciation agreement. Under this position, **there is discharge of indebtedness** at the time of the workout to the extent the original debt is not replaced by the new debt. If part or all of the new debt does not have to be paid under the agreement, **the amount that is not paid** is discharge of indebtedness at the end of the agreement.

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Example 26. Matthew Horton entered into a buy-out agreement with FmHA under which he paid $125,000, and the FmHA terminated his obligation to pay his $150,000 farm loan. A condition of the agreement was that if Matthew sold the farm within two years of the buy-out agreement, he would have to pay the FmHA the lesser of:

- the excess of the amount he received for the farm over the $125,000 he paid under the agreement; or
- $15,000 — the difference between the $140,000 FMV of the farm on the date of the buy-out agreement and the $125,000 that he paid under the buy-out agreement.

On the date of the buy-out agreement, Matthew had $10,000 of discharge of indebtedness because the maximum recapture is $15,000 of the $25,000 difference between the amount owed on the original loan and the amount he paid for the buy-out. Two years from the date of the buy-out agreement, Matthew has $15,000 discharge of indebtedness if he has not sold or conveyed the farm. If he sells or conveys the farm within the two-year period, his discharge of indebtedness on the date of sale would be $15,000 reduced by the amount recaptured by the FmHA.

Contingent liability (IRS position). The third argument is that the borrower's obligation under the recapture agreement or shared appreciation agreement is so contingent that it should be ignored for income tax purposes. Under this argument, the borrower has discharge of indebtedness at the time of workout equal to the full debt reduction.

Example 27. Assume the same facts as **Example 26**. If Matthew's potential obligation to repay the $15,000 is treated as a contingent liability, then he has $25,000 of discharge of indebtedness at the time he enters into the buy-out agreement. If he is required to repay part of the discharge, he should receive a tax benefit from the repayment in the form of a deduction or an increase in basis.

WHICH POSITION IS BEST FOR THE TAXPAYER?

The position that is best for the taxpayer depends upon his/her status at the time of the workout. If the taxpayer is in bankruptcy or is insolvent at the time of the workout and has no tax attributes that will be reduced under I.R.C. §108, the **contingent liability** position is best for the taxpayer since it removes all the income tax consequences from the debt reduction without any cost to the taxpayer.

By contrast, the **true debt position** may require the taxpayer to recognize discharge of indebtedness income if he/she is solvent, not in bankruptcy, and not a qualified farmer at the end of the recapture agreement or shared appreciation agreement. Even if one of the exceptions applies, the taxpayer may lose tax attributes that were acquired between the date of the workout and the termination of the agreement.

Under the property interest position, the taxpayer would at least lose basis and may have to recognize gain.

If the taxpayer's status would require him/her to lose tax attributes or recognize discharge of indebtedness income at the time of the workout, then the **contingent liability position** is likely to be the **worst** for the taxpayer. By comparison, the **true debt position** allows the taxpayer to postpone the consequences of discharge of indebtedness. To the extent recognition of income is postponed, the taxpayer has an interest-free loan from the IRS. If attribute reduction is postponed, the taxpayer may be able to use the attributes to reduce tax liability during the term of the agreement and thereby avoid paying the price for not recognizing discharge of indebtedness.

If the taxpayer has enough basis in the property to absorb the full debt reduction and plans to make use of the I.R.C. §1014(a) date-of-death basis adjustment, the **property interest position** is best for the taxpayer because it removes all the income tax consequences from the debt reduction without any cost to the taxpayer.

WHICH POSITION IS LIKELY TO PREVAIL?

In a letter to the Farmers Home Administration, Peter Scott, Acting Chief Counsel of the IRS, states the third position **is correct**. The letter states that "Because the SAA (shared appreciation agreement) is fundamentally different from

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the old debt and is so contingent that it is impossible to estimate whether and when any amount will be paid under the SAA, the SAA is not an indebtedness substituted for the amount of the FmHA debt written down."

Having treated the debt write-down as income at the time of the workout, the IRS must then deal with the consequences of a repayment of the debt that has been treated as discharged. In his letter to the FmHA, Mr. Scott states the taxpayer is permitted an adjustment that reverses the tax treatment accorded under I.R.C. §108 if part or all of the debt write-down is repaid.

Example 28. Assume that Matthew in **Example 26** had the following tax consequences at the time of the workout.

- NOLs were reduced by $16,000 and basis was reduced by $4,000 under the insolvency rules.
- Another $3,000 of discharged debt was not recognized under the insolvency rules, but no attribute reduction was required.
- The remaining $2,000 of discharged debt was recognized as income.

The IRS would reverse those tax consequences for the $15,000 that is repaid by allowing Matthew to claim the following:

- A deduction against ordinary income for the first $2,000 that was repaid.
- No adjustment for the next $3,000 that was repaid since there was no tax consequences to that discharge of indebtedness.
- A $4,000 increase in basis and a $6,000 addition to NOL carryovers for the remaining $10,000 that was repaid.

CONCLUSION

Taxpayers might consider using the uncertainty of the tax consequences of debt reduction under the Agricultural Credit Act of 1987 to their advantage. If the **contingent liability argument** is best for a particular taxpayer's situation, that position can be taken on the tax return and is not likely to be challenged since it is the stated position of the IRS. If the **true debt position** is best for a taxpayer's situation, that position can be taken on a tax return without fear of being subjected to underreporting penalties since there is case law to support that position. If the IRS challenges the **true debt position**, the taxpayer has a "chance" of prevailing on that argument in court. The **property interest position** is the "weakest" of the three positions and is "not likely" to survive a challenge by the IRS.

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APPENDIX

Form **982**
(Rev. September 2000)
Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ **Attach this form to your income tax return.**

OMB No. 1545-0046
Attachment Sequence No. **94**

Name shown on return | **Identifying number**

Part I **General Information** (see instructions)

1	Amount excluded is due to (check applicable box(es)):		
a	Discharge of indebtedness in a title 11 case		☐
b	Discharge of indebtedness to the extent insolvent (not in a title 11 case)		☐
c	Discharge of qualified farm indebtedness		☐
d	Discharge of qualified real property business indebtedness		☐
2	Total amount of discharged indebtedness excluded from gross income	**2**	
3	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?		☐ Yes ☐ No

Part II **Reduction of Tax Attributes** (You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	**4**	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	**5**	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	**6**	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	**7**	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	**8**	
9	Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge	**9**	
10	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	**10**	
11	For a discharge of qualified farm indebtedness, applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5	**11a**	
b	Land used or held for use in a trade or business of farming	**11b**	
c	Other property used or held for use in a trade or business, or for the production of income	**11c**	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	**12**	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	**13**	

Part III **Consent of Corporation to Adjustment of Basis of its Property Under Section 1082(a)(2)**

Under section 1081(b), the corporation named above has excluded $ ______________ from its gross income for the tax year beginning ______________ , and ending ______________ .
Under that section the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ______________ .
(State of incorporation)

Note: *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of form. Generally, the amount by which you benefit from the discharge of indebtedness is included in your gross income. However, under certain circumstances described in section 108, you may exclude the amount of discharged indebtedness from your gross income. Unless you check the box on line 1d or make the election on line 5, the amount excluded from gross income reduces certain tax attributes either dollar for dollar or 33⅓ cents per dollar (see below).

Use **Part I** of Form 982 to indicate why any amount received from the discharge of indebtedness should be excluded from gross income.

Use **Part II** to report your reduction of tax attributes. The reduction must be made in the following order:

- Any net operating loss (NOL) for the tax year of the discharge (and any NOL carryover to that year) (dollar for dollar);
- Any general business credit carryover to or from the tax year of the discharge (33⅓ cents per dollar);
- Any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge (33⅓ cents per dollar);
- Any net capital loss for the tax year of the discharge (and any capital loss carryover to that tax year) (dollar for dollar);
- Basis of property (dollar for dollar);
- Any passive activity loss (dollar for dollar) and credit (33⅓ cents per dollar) carryovers from the tax year of the discharge; and
- Any foreign tax credit carryover to or from the tax year of the discharge (33⅓ cents per dollar).

Use **Part III** to exclude from gross income under section 1081(b) any amounts of income attributable to the transfer of property described in that section.

Definitions. A "title 11 case" is a case under title 11 of the United States Code (relating to bankruptcy), but only if you are under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is under a plan approved by the court.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 17066E Form **982** (Rev. 9-2000)

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☐ CORRECTED (if checked)

LENDER'S name, street address, city, state, ZIP code, and telephone no.			OMB No. 1545-0877 2002 Form 1099-A	Acquisition or Abandonment of Secured Property
LENDER'S Federal identification number	BORROWER'S identification number	1 Date of lender's acquisition or knowledge of abandonment	2 Balance of principal outstanding $	Copy B For Borrower
BORROWER'S name		3	4 Fair market value of property $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.)		5 Was borrower personally liable for repayment of the debt? ☐ Yes ☐ No		
City, state, and ZIP code		6 Description of property		
Account number (optional)				

Form **1099-A** (keep for your records) Department of the Treasury - Internal Revenue Service

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code			OMB No. 1545-1424 2002 Form 1099-C	Cancellation of Debt
CREDITOR'S Federal identification number	DEBTOR'S identification number	1 Date canceled	2 Amount of debt canceled $	Copy B For Debtor
DEBTOR'S name		3 Interest if included in box 2 $	4	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.)		5 Debt description		
City, state, and ZIP code				
Account number (optional)		6 Bankruptcy (if checked) ☐	7 Fair market value of property $	

Form **1099-C** (keep for your records) Department of the Treasury - Internal Revenue Service

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