Nebraska Law Review

Volume 66 | Issue 3 Article 8

1987

Taxes, Farmers, and Bankruptcy and the 1986 Tax Changes: Much Has Changed But Much Remains the Same

Janet A. Flaccus
University of Arkansas School of Law, jflaccus@uark.edu

Janet A. Flaccus*

Taxes, Farmers, and Bankruptcy and the 1986 Tax Changes: Much has Changed, But Much Remains the Same

TABLE OF CONTENTS

I. INTRODUCTION

Taxes can be generated when a farmer least expects it. Liquidation of assets or forced sales often generate tax liability. In today's economic climate most farm liquidations, either partial or full, are the result of severe economic problems.[1] Any tax liability created by such a transfer of property will be incurred at a time when a farmer can least afford to pay. Yet, taxes are potentially incurred wherever there is a sale or exchange of property, including exchanges forced by bankruptcy. Taxable income due to a low adjusted basis, recapture of investment tax credits and taxable gain due to discharge of indebtedness can create a sizeable financial burden after farm liquidations. Thus, at

* Associate Professor of Law, University of Arkansas; J.D. University of California, Davis (1978); Associate Phebus, Tummelson, Bryan and Knox, Urbana, Illinois (1978-1983); LL.M. University of Illinois (1985). The author wishes to thank her colleague, Lonnie Beard, for his invaluable assistance.

1. See the discussion of the farm problems in Harl, *The Architecture of Public Policy: The Crisis in Agriculture*, 34 U. KAN. L. REV. 425 (1986).

a time when farmers need economic stability to start over, tax liability may preclude a fresh start. The actions the farmer took to create the fresh start, liquidating his or her property, may generate tax liability which undermines starting anew.

The Ninety-ninth Congress passed legislation which modified this tax picture somewhat. The alternative minimum tax, which was the headache of many liquidating farmers in the past, no longer operates. In fact, certain farmers are entitled to refunds of alternative minimum taxes paid in the past.[2] The 1986 Tax Reform Act added to section 108, giving relief from discharge of indebtedness tax liability for certain farm transactions.[3] Yet, despite these changes, liquidation of part or all the farm enterprise can still generate sizeable tax liability.

Nor does it matter that the transfer was involuntary. Foreclosing on farmland with a low adjusted basis will generate recognized income. Replevying farm equipment may still result in recapture of investment tax credits. Whenever a farmer is planning to transfer all or part of the farm property, the tax ramifications should be calculated even if such planning is necessitated by involuntary seizure. If sizeable tax liability will result, bankruptcy should be considered. Bankruptcy has an impact on some of these potential taxes. This Article will analyze the tax picture in and out of bankruptcy.

Since this analysis involves the transfer of property, it will be assumed that the farmer is liquidating the farm enterprise under chapter seven of the Bankruptcy Code. It should be noted, however, that a number of courts, including the Eighth Circuit, have held that a farmer's assets can be liquidated under a creditor's plan in a chapter eleven proceeding if no acceptable plan is forthcoming from the debtor.[4] This has been allowed even over the farmer's objection, and even though a farmer cannot be forced into involuntary bankruptcy.[5] The following discussion is limited, however, to liquidating under chapter seven. Since a liquidation under a chapter eleven plan is not a sale by the bankruptcy estate,[6] the following bankruptcy tax analysis does not apply to a liquidation under a chapter eleven plan. This is true even if the case is later converted to chapter seven.[7] Therefore, farmers probably should avoid liquidation under a creditor's plan in chapter eleven.

Outside of bankruptcy, various tax liabilities are owed for the taxa-

2. Consolidated Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-272, § 13208(a), 100 Stat. 82, 321 (1986) (to be codified at 26 U.S.C. § 57(a)(9)(E)).
3. 1986 Tax Reform Act, Pub. L. No. 99-514, § 405(a), 100 Stat. —, — (1986).
4. *In re* Button Hook Cattle Co., 747 F.2d 483, 486 (8th Cir. 1984); *In re* Jasik, 727 F.2d 1379, 1382 (5th Cir. 1984).
5. 11 U.S.C. § 303(a) (1982).
6. 11 U.S.C. § 1141(b) (1982), vests the property of the estate in the debtor when the plan is confirmed.
7. United States v. Redmond, 36 Bankr. 932, 934 (D. Kan. 1984).

ble year in which the transfer occurred. Inside bankruptcy, the tax picture needs to be placed in categories. Bankruptcy tax liability breaks down into taxes owed before the bankruptcy petition is filed and those occurring after the petition is filed. This breakdown between pre- and post-petition debts is a central one for any bankruptcy analysis,[8] and the same is true for bankruptcy tax analysis. It should be noted, however, that the filing of a bankruptcy petition, which transfers the debtor's property from the debtor to the bankruptcy estate, is not a taxable transfer.[9] This issue was cleared up by the 1980 Bankruptcy Tax Act.[10] Now there is a clearer division between taxes arising before and after the petition.[11] Yet, some questions remain.

II. PREPETITION TAXES

A. Section 501(a)(7) Taxes

Prepetition taxes can take various forms. For purposes of discussion, they will be divided between taxes incurred for tax years ending before the year of the bankruptcy filing and taxes incurred in the year of the bankruptcy filing. For the taxes incurred in years before the bankruptcy petition was filed, the significant taxes are those included in section 507(a)(7) of the Bankruptcy Code.[12] These taxes are given a seventh priority for payment[13] and are not discharged if they are not paid from the bankruptcy estate.[14] If prepetition taxes are not included in section 507(a)(7), then they generally will be discharged along with other prepetition debts.[15]

Section 507 includes many prepetition taxes, both state and federal. The ones most likely to be incurred by a farmer are taxes on or measured by income or gross receipts,[16] and property taxes.[17] Income and gross receipt taxes are included in section 507 for taxable years ending before the date of filing of the petition for taxes due within the three years preceding the bankruptcy filing. Property taxes are included in section 507 if they were assessed before filing and were last due within one year prior to the bankruptcy filing.

Once prepetition taxes are included in section 507 they are changed

8. 11 U.S.C. § 101(9)(A) (1982).
9. I.R.C. § 1398(f)(1) (1982).
10. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 3, 94 Stat. 3389, 3398-99 (1980).
11. I.R.C. § 1398(f)(1) (1982).
12. 11 U.S.C. § 507(a)(7) (Supp. III 1985).
13. *Id.*
14. *Id.* at § 523(a)(1)(A) (1982).
15. It is possible for prepetition taxes not to fall under section 507(a)(7) yet be nondischargeable. If a return is not filed for such taxes or filed late but within the two years preceeding the bankruptcy filing or fraudulently filed, these prepetition taxes are also not discharged. 11 U.S.C. §§ 523(a)(1)(B), (C) (Supp. III 1985).
16. *Id.* at § 507(a)(7)(A) (Supp. III 1985).
17. *Id.* at § 507(a)(7)(B) (Supp. III 1985).

in two significant respects. First, although unsecured, they are given a seventh priority.[18] As priority debts, they are paid immediately after secured creditors receive the value of their collateral. Thus, priority debts must be paid in full before nonpriority unsecured claims are paid at all.[19] Seventh priority means just what it says; the first six priorities must be paid in full before seventh priority taxes are paid. By giving unsecured prepetition taxes seventh priority, the chance this tax liability will be paid in whole or part by the bankruptcy estate is increased. But, since it is only a seventh priority this chance is not great. This is especially true if administration expenses are high, because administrative expenses receive a first priority.

The second significant aspect of section 507(a)(7) treatment is that these taxes are not discharged if they are not paid by the bankruptcy estate.[20] This is because section 507(a)(7) taxes are included in section 523(a)(1)(A).[21] Section 523 specifies which debts are not subject to a Chapter 7 bankruptcy discharge. Most of the debts included in section 523 deal with debtor misbehavior. Section 507(a)(7) prepetition taxes are, however, also included.

For most individuals bankruptcy means a fresh start. But, for a farmer with large prepetition tax liabilities, deep indebtedness to the IRS even after receiving a bankruptcy discharge is likely. Thus, the only advantage of bankruptcy over nonbankruptcy with respect to the above prepetition taxes is that, as a priority claim, these taxes might get paid out of the liquidation sale proceeds, while other prepetition debts remain unpaid and are discharged. But, if the farmer does not have many nonexempt, unsecured assets, the impact of bankruptcy on these taxes owing for tax years prior to the year of the filing will not be great. The farmer will still owe the taxes in either situation since seventh priority taxes are not dischargeable.

B. A Short Tax Year Election

The other type of prepetition taxes which need to be analyzed are those generated in the taxable year in which bankruptcy is filed. Assume that the debtor filed bankruptcy July 1, 1986. The Internal Rev-

18. *Id.* at § 507(a)(7) (Supp. III 1985).
19. *Id.* at § 726(a)(1) (1982).
20. *Id.* at § 523(a)(1) (Supp. III 1985). Before the 1984 changes to the Bankruptcy Code, nondischargeable taxes were section 507(a)(6) taxes. When a new priority was added in 1984, and taxes were changed to a seventh priority item, the references in other bankruptcy sections were not also changed. The reference in section 523(a)(1)(A) remained to section 507(a)(6). In the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 283(i)(1), 100 Stat. — (1986), a technical correction was made, and the reference in section 523(a)(1) to section 507(a)(6) was changed to section 507(a)(7).
21. *Id.*

enue Code allows the farmer to elect to treat the 1986 tax year as two short tax years.[22] The first year runs from January 1 through the day before the filing of the petition; that is, from January 1, 1986 through June 30, 1986. The second short tax year runs from the day the petition is filed until the end of the taxable year; from July 1, 1986 through December 31, 1986.

If no short tax year is elected the tax year ends on December 31, 1986. Since such taxes would not be due until the end of the year, the tax would be incurred after the petition was filed. Unlike post-petition taxes discussed below, however, this post-petition tax is not a tax incurred by the estate, so the tax would not be affected by the bankruptcy filing.[23] Therefore, the farmer would owe these income taxes and the assets of the estate would not have paid any part of the liability. If the farmer has significant tax attributes, such as net operating loss carryovers, capital loss carryovers, charitable contribution carryovers, and/or investment credit carryovers, the effect of filing a short tax year could be substantial.

The Tax Code provides that the tax attributes which pass to the bankruptcy estate are those available on the first day of the debtor's taxable year in which the case commences.[24] If the farmer does not elect to divide 1986 into two short tax years, the tax attributes which will pass into the estate are those that are available on January 1, 1986. If, however, short tax years are elected, the attributes which pass to the estate are those available on July 1, 1986. Assume our farmer had $20,000 in net operating loss carryovers and an investment credit carryover of $1,000 from previous years. If short tax years are not elected, $21,000 in tax attributes will pass to the estate and be used by the estate in calculating the estate's tax liability. Assume the farmer sold grain in February for $70,000. If no short tax year has been elected the tax liability arising from the receipt of this income is not a prepetition debt because it does not accrue until the end of 1986. Such tax liability will not be offset by the $21,000 in attributes used by the estate, because the estate succeeded to tax attributes available on January 1, 1986. Nor will this tax liability be paid even in part from the income generated in bankruptcy by the liquidation of the farmer's property. Thus, the farmer could be left owing taxes on income generated prepetition which is not offset by the tax attributes existing prepetition. Moreover, the $70,000 in income giving rise to the tax lia-

22. I.R.C. § 1398(d)(2) (1982).

23. Creditor is defined in § 101(9) of the Bankruptcy Code as an entity that has a claim against the estate that arose before the order for relief. 11 U.S.C. § 101(9) (1982). Section 301 fixes the order for relief in voluntary cases at the petition filing. *Id.* at § 301.

24. I.R.C. § 1398(g) (1982).

bility became property of the estate.[25] Thus, if no short tax year is elected, a farmer will owe the taxes on the $70,000 income yet not be able to offset it by the tax attributes or use the $70,000 on which the tax was based. The situation changes fundamentally, however, if a short tax year election is made.

By electing short tax years, the first taxable year is from January 1 through June 30, 1986. During this tax year, the farmer has $70,000 in income and $21,000 in net operating loss carryovers and investment credit carryovers. Since these tax attributes will be used up in calculating taxes due for the January 1 to June 30 tax year, no attributes will be available to pass to the estate when the case commences. Recall that the attributes that pass to the estate are the ones available on the first day of the debtor's tax year in which the bankruptcy proceeding commenced.[26] This tax year commenced July 1, 1986. Moreover, even if there is a tax liability for the first short tax year, this tax liability is a seventh priority, prepetition debt which may be paid in part or in full by assets of the bankruptcy estate.

As can be seen, the election of a short tax year is important in some circumstances. It should be noted that this election needs to be made relatively quickly after the bankruptcy filing. This election must be made on or before the fifteenth day of the fourth full month following the commencement of the bankruptcy case.[27] This is when the return for the first short tax year is due, and the election can be made with the return. Once made, this election is irrevocable.[28] Moreover, the election cannot be made if the debtor has no assets other than exempt assets. If the debtor has an operating loss in the year the bankruptcy petition is filed, however, a short tax year should probably not be elected.

III. POST-PETITION TAX LIABILITY

When an individual files a chapter seven or chapter eleven bankruptcy petition a separate taxable entity is formed: the bankruptcy estate.[29] As noted, the creation of this bankruptcy estate and the transfer of farm property to it is not a taxable transfer.[30] Section 505 of the Bankruptcy Code sets out the procedures for the filing of a tax return by the estate.[31] This section covers taxable activity of the estate and is separate from the second short tax year of the individual which runs from the first day of the bankruptcy estate as well. The

25. 11 U.S.C. § 541(a)(1) (1982 & Supp. III 1985).
26. I.R.C. § 1398(g) (1982).
27. *Id.* at § 1398(d)(2)(D) (1982).
28. *Id.*
29. *Id.* at §§ 1398(a); 1399 (1982).
30. *Id.* at § 1398(f)(1) (1982).
31. 11 U.S.C. § 505 (1982 & Supp. III 1985).

primary tax advantage in filing bankruptcy is that the taxes incurred by the liquidation of the farm property will be incurred by the estate and not the farmer. For the most part, this tax liability receives first priority,[32] and to the extent it is not paid it is an estate liability, not a liability of the debtor. Thus, if the amount of post-petition tax liability is going to be large, bankruptcy should be considered.

A. Alternative Minimum Tax

The aforementioned advantage of filing bankruptcy is no longer applicable to the alternative minimum tax. Even though the new tax legislation eliminates the preferential treatment of capital gains,[33] and therefore the alternative minimum tax in most farm transactions, the alternative minimum tax was a major thorn in the side of farmers liquidating in the past if the transfers involved sizeable capital gains. Sizeable capital gains used to be a tax preference which the alternative minimum tax recaptured. Now that capital gains are no longer given preferential tax treatment, there is no reason to have an alternative minimum tax for capital gains. Accordingly, the Tax Reform Act of 1986 no longer lists capital gains as a tax preference in the alternative minimum tax section.[34]

But, even before the Tax Reform Act, Congress acted to protect certain farm transactions from the alternative minimum tax bite. In the spring of 1986, Congress passed legislation to eliminate certain farm transactions from the alternative minimum tax calculations.[35] The legislation was made applicable to transfers after December 31, 1981.[36] Even though capital gains preferences have been eliminated, this provision is still important since it was made retroactive to years when alternative minimum taxes were paid by many farmers. Thus, farmers will want to file amended returns if their transaction qualified. It should be noted that the IRS rule which bars amended returns for tax years more than three years old would preclude an amended return for 1982.[37] Two bills were introduced in the Ninety-ninth Congress to provide an exception to this rule and allow amended returns

32. *Id.* at § 503(b)(1)(B) (1982).

33. Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 301, 302, 311, 100 Stat. —, — (1986).

34. *Id.* at § 701, 100 Stat. —, — (1986).

35. Consolidated Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-272, § 13208(a), 100 Stat. 82, 321 (1986) (to be codified at 26 U.S.C. § 57(a)(9)(E)).

36. Section 701, which eliminates capital gain as an alternative minimum tax item, does not become effective until December 31, 1986. Tax Reform Act of 1986, Pub. L. No. 99-514 § 701(f), 100 Stat. —, — (1986). Section 13208 of the Consolidated Omnibus Budget Reconciliation Act will control transactions after December 31, 1981 up to December 31, 1986. Consolidated Omnibus Budget Reconciliation Act of 1986, § 13208(b), 100 Stat. 82, 322 (1986).

37. I.R.C. § 6511 (1982).

to be filed for 1982.[38] Neither bill passed.

Not all farmers will be able to file amended returns. In order to qualify, the taxpayer must have been a farmer when the transfer occurred. Thus, the taxpayer must have generated for the past three years fifty percent or more of his or her annual gross income from farming.[39] The taxpayer must also have been insolvent at the time of the transfer and the transfer must have involved farmland.[40] Moreover, the exclusion of capital gains for alternative minimum tax calculations operates only to the extent of the farmer's insolvency.[41] This is because section 57(a)(9)(E)(ii) added by the Act, eliminates the capital gains preference for alternative minimum tax calculations only to the extent of the farmer's insolvency.[42]

For example, assume farmer Brown sold land which resulted in $100,000 capital gain in 1984. The capital gains preference in this transaction was sixty percent or $60,000. Assume at the time, farmer Brown's liabilities exceeded his assets by $20,000. Since farmer Brown's insolvency was only $20,000, the tax preference of $60,000 would only be reduced by $20,000, and $40,000 in tax preference would still be used for alternative minimum tax calculations. Even though the new tax bill eliminates capital gains and therefore the alternative minimum tax on most farm transactions, farmers will want to file amended returns if their past transaction qualified.

There is a question, however, whether section 13208 applies to property transfers which occurred in bankruptcy. The question arises because section 13208 is limited to transfers made by farmers. "Farmer" is defined as someone who generated at least fifty percent of his or her gross annual income from farming during the past three years.[43] When the estate transfers property pursuant to bankruptcy proceedings, however, it is the estate that is making the transfer, and an "estate" is not a "farmer" as defined by the Act. Yet, there is no reason this relief from alternative minimum taxes should apply only for transfers in insolvency situations outside of bankruptcy. The bankruptcy estate succeeds to all of the debtor's tax attributes pursuant to section 1398(g).[44] Under 1398(g)(6) the estate succeeds to the

---

38. H.R. 4617, 99th Cong., 2d Sess., 132 CONG. REC. H1985 (daily ed. April 17, 1986) and S. 2350, 99th Cong., 2d Sess. 132, CONG. REC. S4663 (daily ed. April 17, 1986), were introduced in the 99th Congress to provide a "window" in the statute of limitations and allow amended returns to be filed for 1982.
39. Consolidated Omnibus Budget Reconciliation Act of 1983, Pub. L. No. 99-272, § 13208, 100 Stat. 82, 321 (1986) (to be codified at 26 U.S.C. § 57(a)(9)(E)(vii)).
40. *Id.* (to be codified at 26 U.S.C. § 57(a)(9)(E)(iii)).
41. *Id.* (to be codified at 26 U.S.C. § 57(a)(9)(E)(i)).
42. *Id.* (to be codified at 26 U.S.C. § 57(a)(9)(E)(ii)).
43. *Id.* (to be codified at 26 U.S.C. § 57(a)(9)(E)(vii)).
44. I.R.C. § 1398(g) (1982).

basis, holding period, and other characteristics of the assets.[45] Given this fact, an argument can be made that the estate should also succeed to the status of farmer as well. Section 1398(g)(8) allows regulations to prescribe other attributes to which the estate would succeed.[46] Such regulations could be promulgated to allow the estate to assume the attributes of the farmer debtor for purposes of section 13208. Until then, however, it will be difficult to argue that the estate can claim the benefit of section 13208 for purposes of its own tax return.

B. Gains Realized and Investment Tax Credit Recapture

There are several types of tax liability which can be affected by the filing of bankruptcy. Several types of tax liability can be generated by the sale or exchange of property. When the estate sells the farm assets this tax liability will be incurred. Before the Tax Reform Act of 1986, capital gains, recapture of investment tax credits, depreciation, and soil and water conservation deductions were likely to create tax liability when the property was sold. Even though the new tax bill eliminates capital gains and therefore any need for recapture of depreciation, the sale of property will still generate tax liability if a gain is realized. The elimination of capital gains treatment of a gain will in fact increase the tax liability. Moreover, even though the new tax bill eliminates the investment tax credit, the recapture provisions for credits taken earlier are retained.[47] Therefore, even under the Tax Reform Act, significant tax liability can arise when farm property is transferred.

The important part of bankruptcy treatment of post-petition taxes is the fact that most of these taxes are treated as administrative expenses. Section 503 of the Bankruptcy Code describes what constitutes administrative expenses. Sections 503(b)(1)(B), and (C) state that administrative expenses include:

> . . .
> (B) any tax —
> (i) incurred by the estate, except a tax of a kind specified in section 507(a)(6) [should be section 507(a)(7)] of this title, or
> (ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates ended before or after commencement of the case; and
> (C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph;[48]

The relevant language is "any tax — incurred by the estate". Since the bankruptcy estate is a separate taxable entity, when the estate sells the farmer's property the estate incurs the resultant taxes. The

45. *Id.* at § 1398(g)(6) (1982).
46. *Id.* at § 1398(g)(8) (1982).
47. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. —, — (1986).
48. 11 U.S.C. § 503(b)(1)(B),(C) (1982 & Supp. III 1985).

estate must include such tax liability on its tax return.[49] Although section 503(b)(1)(B)(i) is usually used to cover taxes incurred by a business which continues to operate after the petition is filed, it is clear that it covers what was capital gain tax liability and is now ordinary income tax liability generated by the sale or exchange of property. The Senate Report discussing the types of taxes covered by section 503(b)(1)(B)(i) mentions capital gains,[50] and the one bankruptcy court decision on point so holds.[51] Thus, the tax generated by gain realized by the sale of property is an administrative expense. It should make no difference that capital gain treatment of gains realized has been eliminated by the Tax Reform Act of 1986. The taxes calculated under the old capital gain rules and the taxes calculated under current tax law are both income taxes generated upon the transfer of property with a low adjusted basis. The elimination of capital gains treatment only eliminates a preference. It does not change the transaction which gives rise to the tax. The elimination of capital gains treatment will often serve to increase any tax liability.

As an administrative expense, this tax receives a first priority in payment. Administrative expenses get paid first after secured parties receive the value of their collateral. Thus, there is a relatively good chance that these administrative expense taxes will be paid. Moreover, unlike seventh priority prepetition taxes which are not discharged if unpaid, if administrative expense taxes are not paid during the bankruptcy proceedings, the debtor is not liable for them. This is because the estate, not the debtor, has incurred the tax. The freedom from liability is, however, not based on the fact that these taxes are discharged.

Administrative expenses are not discharged by the bankruptcy discharge. Section 727(b) provides that, except for items listed in section 523, all prepetition debts and post-petition debts turned into prepetition debts by section 502 are discharged.[52] Taxes incurred by the estate arise after the commencement of the case and are therefore not prepetition debts. Nor does section 502 turn administrative expenses into prepetition debts.[53] Moreover, section 523 does not make admin-

49. I.R.C. § 1398(e) (1982).

50. S. REP. NO. 989, 95th Cong., 2d Sess. 66, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5811, 5852.

51. *In re* Lambdin, 33 Bankr. 11, 12 (Bankr. M.D. Tenn. 1983).

52. Section 727(b) refers to debts incurred before the order for relief. 11 U.S.C. § 727(b) (1982). In voluntary cases, the order for relief occurs at the time the petition is filed. This is also the time the case commences pursuant to § 301. *Id.* at § 301.

53. Section 502 turns a number of post-petition debts into pre-petition debts. Such debts include reimbursement claims, *id.* at § 502(e)(2), breach of contract claims for contracts rejected under § 365, *id.* at § 502(g), claims arising when the trustee recovers property from a creditor, *id.* at § 502(h), and post petition § 507(a)(7) tax

istrative expense taxes nondischargeable. It only refers to section 507(a)(2) and (a)(7) debts. Administrative expense taxes are section 507(a)(1) taxes. Therefore, section 727(b) does not discharge administrative expense taxes.

However, the fact that the post-petition taxes are not discharged does not create liability on the debtor for these post-petition taxes incurred by the estate. Since the estate is a taxable entity and the estate incurred the tax, the estate is liable for the tax. Even if the estate cannot pay the tax liability, the debtor will still be immune from tax liability.

There is only one section of the Bankruptcy Code which suggests that the debtor has any liability for taxes incurred by the estate during the administration of the estate. Section 505 sets out the procedure a trustee must follow in filing a tax return for the estate.[54] The section sets up a procedure for obtaining a prompt audit of the return.[55] The section provides that the trustee can ask for a quick audit of the filed tax return and "the trustee, debtor or any successor of the debtor is discharged from any liability for such tax" once it is paid.[56] Such discharge will only take place, however, if such return is not fraudulent and does not contain a material misrepresentation,[57] and presumably it does not occur if the tax is not paid. This suggests that there is some potential liability of the debtor for taxes incurred by the estate during the administration of the estate.

An examination of the legislative history of the section demonstrates the intention of the drafters. The tax liability of the debtor that section 505(b) concerns is transferee tax liability in the unusual case that assets are remaining at the end of bankruptcy and are turned over to the debtor. Extensive comments were made in the House on September 28, 1978 and the Senate on October 6, 1978 when the Bankruptcy Bill was finally passed. The comments in both houses were identical when discussing the quick audit procedure set up in section 505(b): "if the trustee does not request a prompt audit, then the debtor would not be discharged from possible transferee liability if any assets are returned to the debtor."[58] As a transferee of such assets, the debtor would be liable for any tax for which the transferor, here the bankruptcy estate, was liable.[59] This same rule applies throughout tax law. When a decedent's estate files the estate's tax

---

claims, *id.* at § 502(i). No section treats administration claims as prepetition claims. Therefore, they are not subject to the § 727(b) bankruptcy discharge.

54. *Id.* at § 505(b).
55. *Id.* at § 505(b)(1).
56. *Id.* at § 505(b).
57. *Id.*
58. 124 CONG. REC. 32,414 (1978) (statement of Rep. Edwards); *id.* at 34,014 (1978) (statement of Sen. DeConcini).
59. I.R.C. § 6901 (1982) creates transferee liability.

return, a quick audit is provided like the one provided in section 505(b). If the estate does not pay all of the tax owing, then the beneficiaries, the recipients of the estate's property, will be liable for the unpaid taxes under transferee liability.[60] Thus, section 505(b) should not be used to create liability where none exists. Transferee liability is the only liability discussed in the legislative history. Apart from this transferee liability, the debtor is not liable for taxes incurred by the estate.

Personal tax immunity is the primary benefit of bankruptcy on the farmer's tax picture. Outside of bankruptcy the transfer of property generates the same taxes. The farmer will have lost all or much of his or her property and could still owe a considerable amount of taxes. Inside bankruptcy these transfer taxes will be incurred by the estate as an administrative expense and, even though tax liability remains unpaid after the bankruptcy payout, the debtor is not liable for them.

However, this benefit of bankruptcy is less clear with respect to taxes generated by investment tax credit recaptures. Although the Tax Reform Act of 1986 repeals the regular investment tax credit for property placed in service after December 31, 1985, the recapture of credits taken on property placed in service before December 31, 1985 is still very much alive.[61] Fortunately, this recapture declines relatively quickly over time. In general, the amount recaptured is decreased 20% per year for "five year property" and approximately one third per year for "three year property".[62]

As was true with respect to taxes on capital gain and alternative minimum taxes, this recapture-generated tax is incurred after the petition is filed, when the trustee liquidates the debtor's property. It seems to be a tax incurred by the estate. Moreover, the statutory language in section 503(b)(1)(C) specifically refers to any "reduction in credit", which includes recapture of an investment tax credit.[63] But, the reduction in credit must be "relating to a tax of a kind specified in subparagraph (B) of this paragraph", meaning it must be related to a tax incurred by the estate.[64] The problem is that a recapture of investment tax credits really relates to a tax incurred earlier by the farmer, which the farmer did not have to pay because the credit was taken. When the recapture occurs, this in essence gives rise to the taxes which were not paid at the time the farmer took the credit. Recapture of investment tax credit taxes are added directly to the farmer's tax

60. *Id.*

61. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. —, — (1986) (to be codified at 26 U.S.C. § 49(e)).

62. I.R.C. § 47(a)(1) (1982).

63. 11 U.S.C. § 503(b)(1)(C) (1982 & Supp. III 1985).

64. *Id.*

liability. If a farmer has a $5,000 investment tax credit recapture, that farmer owes at least $5,000 in taxes.

This is in part the reasoning behind one court's holding that recapture of investment tax credit taxes are not an administrative expense. There are only two cases on point, and both of them hold that such taxes are not administrative expenses. The first of these two decisions was *In re Higgins*, where the court gave a number of explanations for its decision.[65] The second case, *In re Davidson Lumber Co.*, merely followed the *Higgins* case.[66]

The *Higgins* court provided a number of reasons to justify its holding. First, the tax generated by investment tax credit recapture is not a tax incurred by the estate, as is required by section 503(b)(1)(B).[67] The court explained that although the recapture arguably did not take place until after the petition was filed, the resulting tax represented the tax not paid by the debtor when the investment tax credit was taken. Therefore, the court concluded, the tax was a prepetition tax, not a tax incurred by the estate. The court stressed that the estate did not get any benefit from the credit taken.

The second line of reasoning used by the *Higgins* court was that the investment tax credit recapture tax was a section 507(a)(6)(iii) tax [now 507(a)(7)(iii)].[68] Recall that section 503(b)(1)(B)(i) states that taxes incurred by the estate are not administrative claims if the tax is a kind which falls under section 507(a)(6)[now(a)(7)]. Section 507(a)(7)(iii) taxes include "a tax on or measured by income or gross receipts . . . not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case."[69] The *Higgins* court did not discuss how the investment tax credit recapture tax was a tax on or measured by income or gross receipts. It did note, however, that the Bankruptcy Code provided for the prepetition treatment of taxes which arise after the petition. Claims which arise postpetition and are entitled to section 507(a)(7) priority are treated as prepetition taxes by section 502(i). Since the court held that recapture of investment tax credit taxes were included under section 507(a)(7), section 502(i) was used by the court to make them prepetition debts.[70] Note that once a court holds that taxes are section 507(a)(7) taxes, then such taxes will not be discharged to the extent they are not paid.

The *Higgins* case was relatively easy to distinguish before *In re Davidson Lumber Co.* was decided. The bankruptcy petition in the *Higgins* case was filed on April 28, 1980. The Bankruptcy Tax Act did not

65. *In re* Higgins, 29 Bankr. 196 (Bankr. N.D. Iowa 1983).
66. *In re* Davidson Lumber Co., 47 Bankr. 597 (Bankr. S.D. Fla. 1985).
67. *In re* Higgins, 29 Bankr. 196, 201 (Bankr. N.D. Iowa 1983).
68. *Id.* at 200-01.
69. 11 U.S.C. § 507(a)(7)(iii) (Supp. III 1985).
70. *In re* Higgins, 29 Bankr. 196, 201, n.7 (Bankr. N.D. Iowa 1983).

come into effect until early 1981. Prior to the Bankruptcy Tax Act, the IRS took the position that the transfer of assets to the estate when the bankruptcy petition was filed was a "disposition" of the assets for the purpose of triggering investment tax credit recapture.[71] This makes it much easier to view the recapture as a prepetition event and not a tax incurred by the estate. The Bankruptcy Tax Act changed this rule. It states that the transfer of assets into a bankruptcy estate is not a taxable transfer.[72] *Higgins* takes note of this provision, but suggests that recapture of a credit taken prepetition may still be a prepetition debt despite the Bankruptcy Tax Act.[73] Yet *Higgins* is a pre-Tax Act case and therefore can be distinguished.

The bankruptcy petition in *In re Davidson Lumber Co.* was filed March 2, 1982 and, although not discussed by the court, the Bankruptcy Tax Act had come into effect.[74] The court's holding that the $62,746 in taxes generated by the recapture of investment tax credits were not administrative claims cannot be distinguished on the basis of the Tax Act. Yet, the *Davidson* decision does not even address the fact that the transfer which generated the recapture in *Higgins* was arguably prepetition since it occurred with the filing of the petition.[75] The transfer which generated the tax in the *Davidson* case was clearly post-petition since it was the trustee's sale or transfer of the assets on which the credit had been taken which generated the tax. This is a weakness in the case.

The question remains whether these two decisions, the only ones on point, were correctly decided. Should taxes generated by the recapture of investment tax credits be classified as administrative claims or as prepetition nondischargeable debts? The *Davidson* decision recognizes that both the House and Senate Reports on the 1978 Bankruptcy Reform Act discuss investment tax credit recapture. The court remained unpersuaded that the legislative history indicated that recapture taxes were to be treated as administrative claims.[76]

The original House bill, H.R. 8200, had a section which the House Report said treated "the recapture of an investment tax credit in connection with the transfer of property in a bankruptcy case as a prepetition claim, even though the recapture may have occurred after the filing of the petition."[77] This section, section 502(i), was taken out of the bill by the Senate. The explanation for such action provided in the Senate Report is somewhat unclear.

71. Rev. Rule 26, 1974-1 C.B. 7; Mueller v. Commissioner, 60 T.C. 36, 46-47 (1973).
72. I.R.C. § 1398(f)(1) (1982).
73. *In re* Higgins, 29 Bankr. 196, 202 (Bankr. N.D. Iowa 1983).
74. *In re* Davidson Lumber Co., 47 Bankr. 597, 598 (Bankr. S.D. Fla. 1985).
75. *Id.* at 599.
76. *Id.*
77. H.R. REP. NO. 595, 95th Cong., 1st Sess. 355, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6310.

> The bill, as reported, deletes a provision in the bill as originally introduced [(former sec. 502(i))] requiring a tax authority to file a proof of claim for recapture of an investment credit where, during title 11 proceedings, the trustee sells or otherwise disposes of property before the title 11 case began. The tax authority should not be required to submit a formal claim for a taxable event (a sale or other disposition of the asset) of whose occurrence the trustee necessarily knows better than the taxing authority. For procedural purposes, the recapture of investment credit is to be treated as an administrative expense, as to which only a request for payment is required.[78]

Note that this says that recapture of investment tax credits was to be considered an administrative expense for procedural purposes. This does not mean that the Senate intended to treat such tax liability as an administrative claim. Although no conference committee report was filed on the Bankruptcy Reform Act, there were explanations of the bill's provisions provided by the Chairs of the relevant subcommittees, Senator DeConcinni and Representative Edwards. These comments note that "[s]ection 502(i) of H.R. 8200 as passed by the House, but was [sic] not included in the Senate amendment, is deleted as a matter to be left to the bankruptcy tax bill next year."[79]

The Bankruptcy Tax Act of 1980 fails to address the question directly. The Act did, however, make it clear for the first time that the transfer to the bankruptcy estate by the filing of the petition was not a disposition or transfer for tax purposes.[80] The legislative history of the Tax Act indicates that this nondisposition rule was intended to apply to recapture of credits as well as other transfer taxes.[81] An argument can thus be made that the Bankruptcy Tax Act did address the question by clearly making the disposition for credit recapture occur post-petition.

Another argument based on the legislative history of the Bankruptcy Code can be made to limit the persuasiveness of the *Higgins* and *Davidson* cases. It is clear that the House initially wanted to treat investment credit recapture as a prepetition debt.[82] Although the Senate's reason for deleting section 502(i) of H.R. 8200 is unclear, the act of removing section 502(i) from the Code shows that the treatment of investment credit recapture is not covered by current Code language. The statement in the *Congressional Record* indicates that the treatment of recapture of investment tax credits was to be left to future action by Congress. Thus, it cannot be argued that recapture taxes are made prepetition debts by other sections of the Bankruptcy Code.

---

78. S. REP. NO. 989, 95th Cong., 2d Sess. 65, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5851.
79. 124 CONG. REC. 32,397 (1978); *id.* at 33,997.
80. I.R.C. § 1398(f)(1)(1982).
81. H.R. REP. NO. 833, 96th Cong., 2d Sess. 19-27 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess. 24-32, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS 7017, 7038-45.
82. H.R. 8200, 95th Cong., 2d Sess., § 502(i) (1978), 124 CONG. REC. 32,359 (1978).

The current version of section 502(i) was originally section 502(j) of H.R. 8200. Recall that one of the reasons for the *Higgins* court's decision was that recapture taxes were prepetition debts under the then existing Code. In reaching this conclusion, the court relied on section 502(i) to turn the tax generated by the post-petition transfer of property into a prepetition debt.[83] Although recapture taxes may have been included under this language when the House initially passed H.R. 8200, the Senate deleted both 502(i) and 502(j) in its version of the bill.[84] Section 502(j) was put back into the bill under section 502(i) in the final version of the bill. While explaining the origin of the 502(i) language, the joint statement in the *Congressional Record* also explains that the treatment of investment tax credit recapture was to be left to a future Congress.[85] Thus, it cannot be argued that the inclusion of section 502(i) in the Bankruptcy Code indicates that recapture taxes are to be treated as prepetition claims.

The second statutory section used by the *Higgins* court to justify its decision is section 507(a)(7)(A)(iii). Recall that this section includes taxes "on or measured by income or gross receipts . . . not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case".[86] Also recall that taxes included under section 507(a)(7) are excluded from administrative expense treatment under section 503(b)(i)(B). The language of this section is broad enough to cover any transfer tax liability, including the direct tax on any gain realized. Yet, the Senate Report describing the types of taxes included under section 503(b)(1)(B) as administrative expense taxes states "[i]n general, administrative expenses include taxes which the trustee incurs administering the debtor's estate, including taxes on capital gains from sales of property by the trustee. . . ."[87] In fact, it is easier to fit taxes on capital gains under this language than it is to fit recapture of investment tax credit taxes.

A recapture of investment tax credit tax is not "a tax on or measured by income or gross receipts".[88] It is a tax measured by the amount of credit taken, reduced by the number of years the property was held.[89] The only way recapture taxes can fall within such language is to view such taxes as the taxes which were owed by the farmer when the credit was taken. These would be taxes measured by income or gross receipts. Because the credit was taken, the income taxes then owing were not paid. Only by reading the word "tax" in

83. *In re* Higgins, 29 Bankr. 196, 201 n.7 (Bankr. N.D. Iowa 1983).
84. S. 2266, 95th Cong., 2d Sess. (1978), 124 CONG. REC. 33,997 (1978).
85. 124 CONG. REC. 32,397 (1978); *id.* at 33,997.
86. *Id.*
87. 11 U.S.C. § 507(a)(7)(A) (Supp. III 1985).
88. *Id.*
89. I.R.C. § 47(a)(5) (1982 & Supp. III 1985).

section 507(a)(7)(A) to refer to this farmer's tax, which was unpaid because the credit was used, can the recapture of investment tax credit taxes be considered "a tax on or measured by income or gross receipts".[90] Yet, this is not the apparent meaning of the word "tax" as used in section 507(a)(7)(A).

The taxes covered in sections 507(a)(7)(A)(i) and (ii) are clearly prepetition. Subsection (i) deals with returns due within the three years before the petition, and subsection (ii) covers taxes assessed within the 240 days before the petition. Senator DeConcinni and Representative Edwards's statements in the *Congressional Record* describe subsection (iii) as covering prepetition taxes which, for some reason, were not assessed before the petition but, under the statutes of limitation, could be assessed after the petition.[91] The statements indicate that subsection (iii) would include the type of taxes included in the Senate bill which were precluded from being assessed or collected before the petition because of pending judicial or administrative action.

The tax in the only case discussing section 507(a)(7)(A)(iii) fits this description. In *In re Easton* the taxes that fell into this section were from tax years 1978 and 1979.[92] The bankruptcy petition had been filed in March of 1985. An audit in 1984 led to the assessment of additional taxes for 1978 and 1979. The assessment came twenty-one days after the bankruptcy filing. These taxes did not fall under subsections (i) and (ii) of the section 507(a)(7)(A), but the court held that these taxes were of the type included in subsection (iii) because they were prepetition taxes not assessed before the petition. There is no indication in the legislative history or the cases that subsection (iii) was intended to reach taxes generated post-petition.

Thus, it is possible that recapture of investment tax credit taxes are prepetition debts which receive a seventh priority and are not discharged if unpaid by the bankruptcy trustee. Persuasive arguments exist, however, that the *Higgins* and *Davidson Lumber* cases should not be followed and such taxes should be treated as administrative expenses that are not obligations of the debtor to the extent not paid.

C. Discharge of Indebtedness Income

There is one other type of tax potentially incurred by the transfer of property. This is the tax on income generated by the discharge of indebtedness. The discharge of indebtedness is not itself a tax but can cause a gain to be recognized on the transfer property and can therefore result in tax liability. To understand this gain, recall that when a

90. *Id.*
91. 124 CONG. REC. 32,415 (1978); *id.* at 34,015.
92. *In re* Easton, 59 Bankr. 714 (Bankr. C.D. Ill. 1986).

farmer gets a loan, he or she does not have to include the amount of the loan as ordinary income for that year because the farmer is obligated to pay the loan back. If, however, any part of that obligation to pay the loan back is forgiven, the farmer is obliged to pay ordinary income tax for the tax year in which the debt is forgiven. When a farmer is in financial trouble, he or she may arrange with a creditor to transfer property in order to pay off the debt. If the property is worth less than the indebtedness extinguished, this will result in ordinary income to the farmer of the amount by which the debt discharged exceeds the fair market value of the property.[93]

Assume, for example, that farmer Brown transferred $200,000 worth of property to discharge $400,000 worth of indebtedness. Before the Tax Reform Act of 1986, outside of bankruptcy, if the farmer were solvent, he or she had to add $200,000 to his or her ordinary income. If, on the other hand, the debt could be classified as qualified business indebtedness, the farmer would be allowed to reduce his basis in depreciable property dollar for dollar for each dollar of discharged indebtedness which would otherwise have been added to his ordinary income.[94] This allowed a deferral of recognition of the gain. However, to the extent that the discharged indebtedness exceeded the basis of depreciable property, it would be ordinary income to the farmer.[95] Moreover, if the indebtedness was not qualified business indebtedness then the entire amount of the discharged indebtedness would have to be added to the solvent farmer's ordinary income.[96]

If the farmer were insolvent when the debt was discharged but made solvent by the discharge of indebtedness then different rules applied. The then solvent farmer would have recognized ordinary income only to the extent of the discharge of indebtedness income that was received once the farmer became solvent.[97] So, for example, when farmer Brown transfers $200,000 worth of property to extinguish a $400,000 debt, there is a $200,000 of discharge of indebtedness income. If farmer Brown were insolvent at the time of the transfer by $100,000, then only $100,000 of the discharged indebtedness income would have been recognized as ordinary income. Moreover, if this indebtedness qualified as qualified business indebtedness, then the same rules would have applied to this insolvent-rendered-solvent farmer as applied to the solvent farmer. By contrast, in bankruptcy no discharged indebtedness would be recognized as ordinary income.[98]

93. United States v. Kirby Lumber Co., 284 U.S. 1 (1931). The farmer must have been personally liable for the original debt as a prerequisite to the ordinary income tax liability discussed.
94. I.R.C. § 108(c) (1982).
95. *Id.* at § 108(c)(2).
96. *Id.* at § 108(a)(1).
97. *Id.* at §§ 108(a)(1)(B); 108(a)(3).
98. *Id.* at § 108(a)(1)(A).

The rules in bankruptcy with respect to discharge of indebtedness are the same as the rules applying to insolvent farmers who remained insolvent after the transfer.[99] In both situations, any discharge of indebtedness income is not recognized. This forgiveness in bankruptcy or non-recognition for an insolvent farmer of the taxable income which would otherwise result from discharge of indebtedness does have a slight hitch. To the extent the farmer has tax attributes such as net operating losses, credit carryovers, capital loss carryovers and basis of property, other than exempt property, retained after bankruptcy, the discharged indebtedness income will reduce these tax attributes.[100] This requirement that tax attributes be reduced is also applicable outside of bankruptcy to insolvent debtors who transfer property creating discharge of indebtedness.[101] Thus, to the extent these tax attributes could have been used to reduce taxes, the discharge of indebtedness does have some cost, even in bankruptcy. To the extent the indebtedness exceeds these attributes, however, there is no reported gain. Moreover, the basis of retained property, if there is any, will not be reduced below the amount of the farmer's total debts remaining after the discharge.[102] The main benefit of bankruptcy was that to the extent discharged indebtedness exceeded tax attributes it was not recognized, whereas it would have been recognized by a solvent farmer or a farmer who was rendered solvent by the indebtedness discharge.

The Tax Reform Act of 1986 changes this treatment of discharge of indebtedness income for certain types of nonbankruptcy farm transactions for tax years ending after April 9, 1986.[103] Section 405 of the Tax Reform Act of 1986 changes sections 108 and 1017 of the Tax Code. Section 108 now provides protection from discharge of indebtedness income received by a solvent farmer. It does this by treating the discharge of indebtedness income incurred by agreement between a solvent farmer and an unrelated person, presumably a creditor, as discharge of indebtedness income received by an insolvent individual.[104] Recall that discharge of indebtedness income received by an insolvent individual who remains insolvent after the discharge is not recognized for tax purposes outside the reduction in tax attributes. If the transfer is not entitled to section 405 protection, however, it will no longer receive protection under the qualified business indebtedness exception. The 1986 Tax Act eliminates the qualified business indebtedness exception in section 108.[105]

---

99. *Id.* at §§ 108(a)(1)(B); 108(a)(3).
100. *Id.* at § 108(b)(1),(2).
101. *Id.* at § 108(b)(1).
102. *Id.* at § 1017(b)(2).
103. Tax Reform Act of 1986, Pub. L. No. 99-514, § 405(c), 100 Stat. —, — (1986).
104. *Id.* at § 405.
105. *Id.* at § 822.

Once the discharge of indebtedness income is treated as if received by an insolvent taxpayer, then the difference between treatment inside of bankruptcy and outside of bankruptcy is eliminated. In order to receive this protection, however, the indebtedness discharged must be qualified farm indebtedness and the creditor who is discharging the debt must be a qualified person. Both phrases are defined in the statute.[106] In order to qualify as farm indebtedness three requirements must be met. First, the indebtedness must have been in connection with the operation of the farm or must have been secured by farm lands or farm equipment used in the farming business. Second, the taxpayer must have received, for the three years immediately preceding the tax year in which the discharge of indebtedness occurs, at least fifty percent of his or her average annual gross receipts from the trade or business of farming. Third, immediately before such discharge occurs the taxpayer must have been solvent.

This change provides relief for farmers who were solvent at the time of the discharge. Without this relief, the full amount of the discharged indebtedness would be ordinary income. The interrelationship of this new section with other provisions in section 108 creates a potential problem. Recall that if a debtor were insolvent at the time of the discharge but became solvent because of the discharge, income will be recognized to the extent of the solvency.[107] Yet under section 405 of the Tax Reform Act, which became section 108(g) of the Code, if a farmer is solvent at the time of the discharge, no income is recognized. Thus a farmer who is $5,000 insolvent at the time $100,000 of indebtedness is discharged will have $95,000 of recognized income. Yet if that farmer had $5,000 in equity and was thus solvent at the time of the $100,000 discharge, no income would be recognized. There is only $10,000 difference in the financial status of the two farmers, yet there is a substantial difference in the way they will be treated under section 108. The more financially distressed farmer may have a much greater tax liability. This result does not make sense from a policy standpoint.

Requiring the farmer to receive at least fifty percent of his or her gross income from the farming enterprise for the three years immediately preceding the discharge may cause additional problems. This fifty percent rule allows the farmer to earn some income outside of farming, something distressed farmers often do. However, certain settlement agreements with the Farmer's Home Administration ("FmHA") involving discharge of indebtedness may not fall under the protection of section 405 because the discharge of indebtedness may occur up to five years after the agreement.[108] By this time the farmer

106. *Id.* at § 405(a).
107. I.R.C. § 108(a)(3) (1982).
108. 51 Fed. Reg. 45,434 (1986) (to be codified at 7 C.F.R. § 1956.57(c)).

may have left farming; well over fifty percent of his income for the previous three years will have been non-farming income.

The regulations proposed by FmHa allow several different types of debt settlements.[109] The first of these, "debt adjustments", are defined as agreements to reduce the amount owed when a farmer contracts to pay an agreed sum in monthly payments over a period of time not to exceed five years.[110] "Cancellation" of debt, on the other hand, is a final discharge of a debt without receipt of any payment from the farmer.[111] Cancellation will not occur often since it can be done only when FmHA has no security for its loan and the debtor is unable to pay any part of the debt.[112] Third, FmHA could "chargeoff" a debt. This does not involve any release of personal liability, so no discharge of indebtedness occurs.[113] Finally, the debt can be "compromised", which involves a reduction of the debt in exchange for a payment by the farmer of a lump sum.[114] Adjustment of a debt seems the most likely scenario. Many farmers would find it difficult to come up with a lump sum payment required for a compromise, chargeoff does not discharge indebtedness, and cancellation is not attractive to FmHA. Debt adjustment, allowing the farmer to pay a scaled down debt over time, may be the most viable option.

Yet adjustment of debts may not fall under section 405. The proposed regulations state that an adjustment is not a final settlement of a debt until the last monthly payment is made.[115] Payment periods can extend up to five years. If the farmer does not generate fifty percent of his or her gross receipts for the last three years of the adjusted payment schedule from farming, the farmer will be in tax trouble. Section 405 will not apply to the discharged indebtedness, and the qualified business exception has been eliminated. Therefore, the farmer will have for that year taxable income to the extent of the indebtedness discharged. The only way to avoid this recognition would be bankruptcy, unless the farmer were insolvent before and after the discharge of the indebtedness. If the amount of the discharge is at all large, considerable tax liability could result. Thus, farmers should be aware of the inherent tax problems in a debt adjustment with the FmHA.

If a cash sale of farm real estate is involved, then a different regulation applies.[116] If farm property, both real and personal, is trans-

109. These regulations only cover the settlement of farmer program loans and single family housing loans.
110. 51 Fed. Reg. 45,434 (1986) (to be codified at 7 C.F.R. § 1956.54(a)).
111. *Id.* (to be codified at 7 C.F.R. § 1956.54(b)).
112. *Id.* at 45,437 (to be codified at 7 C.F.R. § 1956.70).
113. *Id.* at 45,434 (to be codified at 7 C.F.R. § 1956.54(c)).
114. *Id.* (to be codified at 7 C.F.R. § 1956.54(d)).
115. *Id.* (to be codified at 7 C.F.R. § 1954.54(a)).
116. *Id.* at 4149-50, 45,440 (to be codified at 7 C.F.R. § 1965.26).

ferred, and FmHA debt is assumed, still different regulations apply.[117] Under both circumstances, indebtedness can be discharged.[118] If in the cash sale, the proceeds do not pay off the loan, FmHA may discharge the remaining indebtedness in certain situations. Discharge of indebtedness can occur even when FmHA debt is assumed, since the regulations allow an assumption of debt equal to the fair market value of the property. If the fair market value of the property is lower than the outstanding debt, this debt too can be discharged under certain circumstances. Therefore, section 405 is relevant. The release of liability must be processed through the county committee, but any discharge of indebtedness requires approval of either the State Director or FmHA administrator.[119] As long as such a request is processed in time for the discharge to be within a year after the liquidation, section 405 should apply. Section 405 requires the fifty percent rule to be met for the three years immediately preceding the taxable year in which the discharge of indebtedness occurs. Thus, care should be taken when dealing with FmHA.

The term qualified person as used in the section 405 also creates problems. Section 405(a) of the Tax Reform Act says "qualified person" means a person described in section 46(c)(8)(D)(iv) of the Internal Revenue Code.[120] Section 46(c)(8)(D)(iv) states that a "qualified person" is someone who is actually engaged in lending money other than someone who is related to the taxpayer, or a person from whom the taxpayer acquired the property, or someone related to such a person.[121] This means that if a debt is forgiven by someone related to the taxpayer or someone from whom the taxpayer acquired the property, then section 405 of the Tax Reform Act will not cover the transaction. The Senate Report accompanying the Senate bill which included the language now found in section 405, states that people related to the taxpayer were intended to be excluded.[122] The report does not suggest that purchase money lenders were also intended to be excluded.

117. 7 C.F.R. § 1962.34 (1986); 51 Fed. Reg. 4150-56, 45,439-40 (to be codified at 7 C.F.R. § 1962.34, 1965.37).

118. 51 Fed. Reg. 45,439-40 (to be codified at 7 C.F.R. §§ 1962.34(d), 1965.26(f)(5), 1965.27(f)). The rules are different for cash sales of personal property. 7 C.F.R. § 1962.41(e) (1986). To the extent the cash sale does not extinguish FmHA debt, the regulations provide that release of liability can only occur under a debt settlement. This means such liability release must come under section 1956. If the amount is partially paid off under a debt adjustment, with debt being discharged, then the debtor may have trouble fitting under section 405 since the discharge of indebtedness occurs at the end of the payment period. 51 Fed. Reg. 45,434 (1986) (to be codified at 7 C.F.R. § 1956.57(c)).

119. 51 Fed. Reg. 45,439-40 (to be codified at 7 C.F.R. §§ 1962.34(h), 1965.26(f)(5)(ii), 1965.27(f)).

120. Tax Reform Act of 1986, Pub. L. No. 99-514, § 405(a), 100 Stat. — , — (1986).

121. I.R.C. § 46(c)(8)(D)(iv) (Supp. III 1985).

122. S. REP. NO. 313, 99th Cong., 2d Sess. 272 (1986).

Yet this is the effect of the definition of "qualified person". Thus, for example, a seller of land who finances the sale would not be included as a "qualified person". Nor would the equipment dealer be included. Many credit purchases of farm equipment, however, are financed by the manufacturer or a related corporation. Unless the seller and the manufacturer are part of a common control group as defined in section 1563 of the Internal Revenue Code,[123] this transaction should not be excluded since the seller would not be the entity forgiving the debt.

The exclusion of seller financed land purchases is potentially large. This exclusion may be offset, however, by the inclusion of such a transaction under section 108(e)(5) of the Internal Revenue Code. Section 108 in general removes certain transactions from the regular discharge of indebtedness rules. Section 108(e)(5) states that a debt arising out of the purchase price owing to the seller which is reduced outside of bankruptcy and not while the debtor is insolvent is not discharge of indebtedness but merely a reduction in the purchase price.[124] The cases on which this statutory language is based supply an illustration.

Most of the cases arose out of the depression of the 1930's and involved real estate which had depreciated in value. The cases involved negotiations with the purchase money lender which resulted in the debtor keeping the property and the lender agreeing to accept less in order to pay off the indebtedness. The IRS argued that such agreements constituted discharge of indebtedness to the taxpayer. Three circuit courts of appeal disagreed.[125] All emphasized that no gain had occurred. The courts pointed out that there had merely been a reduction in capital loss. The *Hirsch* case, followed in the other cases, emphasized that no disposition had taken place. The courts held that the reduction in purchase price merely reduced the basis of the property.

A question exists whether a transaction in which property is exchanged for cancellation of indebtedness is covered by section 108(e)(5). By reducing the basis in the property by the amount of the discharged indebtedness, gain is deferred. But when the property is simultaneously being transferred at the time the debt is discharged, section 108(e)(5) may not apply. If such is the case, then forgiveness of debt by the seller of land could result in discharge of indebtedness income despite section 405 of the Tax Reform Act. Moreover, if no discharge in indebtedness income is recognized, the basis reduction will result in greater taxable gain.

If a discharge of indebtedness does not fall under section 405 and the transfer is not in bankruptcy, then any discharged indebtedness

123. I.R.C. § 1563 (1982 & Supp. III 1985).

124. *Id.* at § 108(e)(5).

125. Hirsch v. Comm'r., 115 F.2d 656 (7th Cir. 1940); Helvering v. A.L. Killian Co., 128 F.2d 433 (8th Cir. 1942); Commissioner v. Sherman, 135 F.2d 68 (6th Cir. 1943).

occurring after December 31, 1986 will result in recognized income. The Tax Reform Act of 1986 repealed as of December 31, 1986 the qualified business exception included in section 108.[126] Recall that if the indebtedness were qualified business indebtedness, recognition of income could be deferred by reducing the basis of depreciable property.[127] This allowed the taxpayer to defer recognition of income until such property was sold, although it also reduced depreciation deductions. The Senate version of the Act deleted the qualified business debt exceptions and the House accepted the deletion in conference. The Senate Report indicates that the qualified business debt exception was considered too generous.[128] Thus, only bankrupt debtors and insolvent debtors who remain insolvent after the transfer will receive the special section 108 treatment of discharge indebtedness income after December 31, 1986 if section 405 does not apply. It is, therefore, especially important for a nonbankrupt farmer to fit under the special exception created by the Tax Reform Act in section 405. Otherwise, as long as that farmer is solvent or becomes so as the result of the debt discharge, taxable income will be realized to the extent of the discharged indebtedness.

D. Procedural Considerations

There is one procedural caution that needs to be made other than a reminder to make various tax elections on time. If a piece of property is fully encumbered by creditor liens, the bankruptcy trustee may abandon the property. Since the property is completely encumbered it is of no benefit to unsecured creditors. Section 554(a) of the Bankruptcy Code permits the trustee to abandon any property that "is of inconsequential value and benefit to the estate."[129] The legislative history indicates that the abandoned property is to be turned over to the person with a possessory interest.[130] The person with the possessory interest at this point in the bankruptcy proceeding is usually the debtor. If the trustee abandons property to the debtor, the creditor with the lien on the property will shortly thereafter ask for relief from the stay.[131] Once the stay is lifted, the creditor is free to initiate or continue state collection proceedings. For land this usually involves foreclosure and redemption periods. This means that the transfer to the creditor will probably not take place until after the bankruptcy proceeding is closed. This has two possible repercussions.

126. Tax Reform Act of 1986, Pub. L. No. 99-514, § 822, 100 Stat. —, — (1986).
127. I.R.C. § 108(c) (1982).
128. S. REP. NO. 313, 99th Cong., 2d Sess. 161-62 (1986).
129. 11 U.S.C. § 554(a) (Supp. III 1985).
130. H.R. REP. NO. 595, 95th Cong., 1st Sess. 337 (1977); S. REP. NO. 989, 95th Cong., 2d Sess. 92 (1978).
131. 11 U.S.C. § 362(c), (d) (1982 & Supp. III 1985).

The first concern is that this transfer will now be made by the debtor, not the estate. Any of the transfer taxes discussed above might be generated by the transfer, but these taxes will not be incurred by the estate. They will be post-petition taxes that are not administrative expenses. Nor will the bankruptcy assets be used to pay off the tax debt as they would have been had they been given a first or seventh priority. Instead, the farmer will have to pay these taxes with post-bankruptcy assets.

On the other hand, if the trustee does not abandon the asset, but turns it over to the creditor, then the trustee may be making the transfer inside of the bankruptcy proceeding. The transfer taxes would then have a good chance of being considered an administrative expense. Thus, the abandonment of property to the debtor may result in taxes being owed after the bankruptcy when this could have been avoided.

In addition, abandonment of property to the debtor may have another negative effect on the amount of tax owed by the farmer after bankruptcy. Recall that when debt is discharged one of the attributes which has to be reduced is the basis of property retained by the debtor. The question remains as to when the basis is to be reduced and on what property. Section 1017(a) of the Internal Revenue Code states that basis is reduced in any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.[132] Recall that a separate taxable entity is created when an individual files a chapter seven petition. At the earliest, the basis could be reduced when property is turned over from the bankruptcy trustee to the debtor, a time frame suggested by the legislative history.[133]

Even if the basis reduction only occurs in property held by the debtor when the estate closes, or in the year after the estate closes, abandoned property may be still held by the debtor at this time. The risk resulting from abandoning property to the debtor is that its basis will be reduced, thereby increasing the amount of taxable gains generated when the property is eventually transferred to the creditor, as it inevitably will be. As can be seen, the statutory language and the legislative history seem to conflict. If abandoned property is held long enough, however, then under either interpretation the basis could be reduced. This too is something the farmer should avoid. As can be seen, abandonment of property to the farmer may be costly and should be undertaken only with care.

The IRS is currently considering a revenue ruling which would change the above analysis. Under consideration is a ruling that would

132. I.R.C. § 1017(a) (1982).
133. H.R. REP. NO. 833, 96th Cong., 2d Sess. 11, 12 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess. 14, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS 7017, 7029.

treat the abandonment of property from the estate as a taxable exchange.[134] This would make any resultant taxes a tax liability of the estate and not a tax liability of the debtor. This would certainly affect any tax on gain realized.

Section 1398(f)(2) of the Internal Revenue Code states that transfers from the estate to the debtor in the case of the termination of the estate are not taxable transfers.[135] Any revenue ruling would have to be based on the assumption that an abandonment of property by the trustee will occur before the estate is terminated, and therefore section 1398(f)(2) would not apply. Only time will tell whether such a ruling will be adopted. In the meantime a debtor can try to persuade the trustee that a taxable transfer has occurred.

IV. CONCLUSION

This discussion should alert the practitioner to the importance of tax planning before any exchange of property takes place. Tax planning should precede even involuntary dispositions of property. Tax considerations may be a reason for liquidating inside bankruptcy. Most importantly, planning needs to be done before any decision on how to dispose of property is made. Otherwise, tax liability may exist where such could have been avoided.

---

134. Cooperative Extension Serv., Dep't. of Agricultural Economics, Univ. of Ill. *1986 Farm Income Tax School* at 192-93.

135. I.R.C. § 1398(f)(2) (1982).