

# Income Tax Consequences Of Farm Financial Distress

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

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

## Recognition of Gain or Loss From the Transfer of Assets

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

## Discharge of Debt

Creditors of financially distressed taxpayers sometimes forgive some or all of the taxpayer's debt because the taxpayer is unable to pay or because the cost of collecting the debt is more than the debt. For income tax purposes, if the creditor forgives debt for any reason other than for the purpose of making a gift to the debtor, the discharged debt is treated as income to the debtor unless one of the following exceptions applies:

1. If the taxpayer had paid the debt that was discharged, the taxpayer would have been allowed to deduct the amount paid [IRC §108(e)(2)].
2. The debtor was in bankruptcy at the time the debt was discharged. [IRC §108(a)(1)(A)].
3. The debt discharged was qualified principal residence debt that was discharged before January 1, 1913.
4. The debtor was insolvent at the time the debt was discharged [IRC §108(a)(1)(B)].
5. The seller of property under an installment contract discharged the debt and the original purchaser under the contract owed the debt discharged [IRC §108(e)(5)].
6. The debt discharged is qualified farm indebtedness [IRC §108(a)(1)(C)].
7. The debtor is not a C corporation and the debt discharged is qualified real property business indebtedness. [IRC §108(a)(1)(D)].

<p><b>Note.</b> If discharged debt qualifies for more than one of the above exceptions, the first applicable exception in the preceding list is applied to the discharged debt.</p>
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## Paying the Price

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

1. NOL. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
2. General Business Credit. Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under I.R.C. §38 (relating to general business credit).
3. Minimum Tax Credit. The amount of the minimum tax credit available under I.R.C. §53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
4. Capital Loss Carryovers. Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under I.R.C. §1212.
5. Basis Reduction. The basis of the property of the taxpayer. See I.R.C. §1017.
6. 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.
7. 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. §27.

#### **Order**

The general rule is that the tax attributes are reduced in the order listed above [I.R.C. §108(b)(2)]. However, the taxpayer can elect to reduce the basis in depreciable property first [I.R.C. §108(b)(5)].

#### **Limit on Bases Reduction**

If the debt discharge is excluded from income under the bankruptcy or insolvency exception, there is a limit on the reduction of the aggregate bases in the taxpayer's assets. The aggregate of the bases in the taxpayer's assets is reduced only down to the remaining debt after the discharge [I.R.C. §1017(b)(2)].

#### **Timing**

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