

5. Planning for Income Tax Consequences for Farm Financial Distress Transactions

Bryan Manny

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Bryan Manny has been an extension agricultural economist in the South Central Kansas Farm Management Association located in Hutchinson since 1988. Bryan is a native of Iowa and his family farm was a diversified corn, soybean and a farrow to finish swine operation. Bryan received a bachelor of science degree from Iowa State University in Agricultural Business and a master of science degree from University of Missouri-Columbia in Agricultural Economics. He has worked with 130 farm families in three south central counties on a one-on-one advising relationships providing farm specific production and financial management information that is used for when making farm business and family decisions. Through KFMA he provides profitability analysis as well as income tax planning, farm succession, entity and estate planning.

Mark Wood

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Mark Wood is an Extension Agricultural Economist with the Farm Management Association in Northwest Kansas. He has been assisting Association member families with record keeping, analysis, management and generational transfer opportunities in Northwest Kansas for over 29 years. He graduated from North Dakota State University with a Master's degree in Agriculture Economics in 1986 and Kansas State University with a Bachelor's degree in Agricultural Economics in 1982. Mark grew up on a farm near Wakefield, Kansas.

Abstract/Summary

With production agriculture in a lower net income cycle, many farm families are facing net cash flows that are not able to meet debt obligations. The income tax consequences of asset liquidation and the work-out of debt obligations are significant in most sections of the economy. For agriculture, with use made of the cash method accounting and various depreciation recapture possibilities for personal property and the appreciated values of real property (debt was borrowed against FMV collateral), resolution of problems of debtor distress, are even more significant. This presentation will focus on the income tax consequences of repossession (voluntary or involuntary) of personal and real property, the handling of discharge of indebtedness for solvent, insolvent and bankrupt farmers, and the income tax consequences of bankruptcy.

Income Tax Aspects and Consequences of Financial Distress Transactions

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Disclaimer:

- The law of rights between debtors and their creditors and taxation of transactions between them is highly complex and complicated. The tax laws and other legal matters by this presentation are complex. These materials are designed solely to raise issues and serve as a guideline for the reader's research. These materials were assembled solely for the purpose of education. Every taxpayer has a distinct set of facts and circumstances that makes it impossible to give solutions other than in a general guideline approach. If legal advice, tax advice, accounting assistance or other expert assistance is required, the services of a competent professional person should be sought.
- THE FOCUS OF THIS TOPIC IS TO CONDUCT A GENERAL REVIEW OF THE INCOME TAX ASPECTS AND CONSEQUENCES OF ASSET LIQUIDATION, DISCHARGE OF INDEBTEDNESS, AND BANKRUPTCY. IT IS ALWAYS ENCOURAGED THAT THE DEBTOR AND CREDITOR DISCUSS DETEORATING FINANCIAL CONDITIONS BEFORE THEY ARRIVE AT A POINT OF NO BILATERAL OPTIONS. DUE TO LIMITED TIME OF THIS CONCURRENT SESSION, IT IS NOT POSSIBLE TO COVER THESE TOPICS IN COMPLETE DETAIL.

Concept of Capital Use in Agriculture:

- Wise use of capital is central to short and long run financial performance
- Capital availability can affect productivity of farm operations
- "Boom" times: increased profit margins and cash flows can encourage growth of farm operation and expanded borrowing
- "Bust" times: negative profit margins and cash flows along with excess debt financing from expansion during "boom" years can financial distress.
- Financial distress can force scaling back farm operation (liquidation of assets) creating lender/creditor frustration, production efficiency challenges, and reduced likelihood of successful generation transfers
- Family relationships can be stressed to the breaking point

Loan Review and Liquidation Approach

- Debt Restructuring steps:
 - Re-amortization of loans over a longer period.
(moving LOC and Machinery Term Loans to Real Estate)
 - Interest Rates negotiated lower
 - Forgiveness of Principal
 - Some combination of all of the above

Loan Review and Liquidation Approach

Important Factors to Consider:

- Is loan secured by realistically valued collateral?
- Would restructure make borrower financially or economically healthy?
- Is there a conflict of interest in the borrower/lender relationship?
- How much will deferring principal payments (restructure) improve the borrower's ability to succeed/recover?

What factors should be considered before Asset Liquidations?

- Probable net recovery on collateral in event of liquidation?
(Will proceeds pay off loan, other loans too?)
- What is the probability of unsecured lender of recovering loan after income taxes and selling costs?
- What is the economic cost to the lender of interruption of interest payments?
- Can the borrower service remaining debt after restructure and Asset liquidation?
- The decision to restructure is up to the *lender*
- Legal and accounting fees could be significant if resolution between lender and borrower can not be resolved.

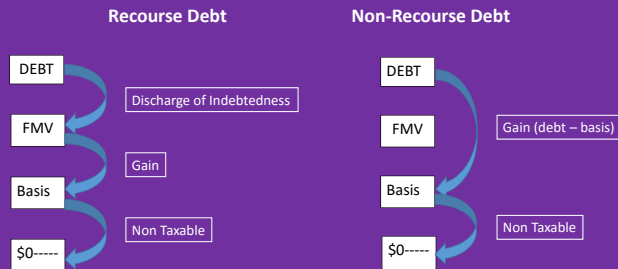
Planning Information needed:

- Cost of Assets: purchased, gifted, inherited
- Depreciation allowed or allowable
- Fair Market Value (FMV)
- Special use valuation on real estate (2032A elections)
- Depreciation recapture
- Determination of tax treatment of asset liquidation proceeds: ordinary income/loss, section 1231 gain/loss or capital gain/loss
- Tax Attributes: NOL, Business Tax Credits, Capital Loss Carryforwards, Asset Basis, Passive Activity Loss and credit carryforwards, Foreign Tax Credits

Types of Debt:

- **Recourse Debt:**
 - Lender has the ability to pursue borrower for additional funds to pay off loan if the assets securing the loan have been disposed and there remains a balance due. (Surety)
- **Non-Resource Debt:**
 - Asset is full satisfaction for loan used to secure the asset. If the asset is sold and there is a remaining balance on the loan, the lender takes a loss on the loan.

Tax Consequence of Debt Type:



Discharge of Indebtedness: Exception of Tax?

- Debtor is in Bankruptcy
- Non-bankrupt debtor is insolvent *before and after* Discharge of Debt
- Non-bankrupt debtor is able to avoid tax on the portion of Discharge of Indebtedness that returned the tax payer to zero solvency. Excess of Discharged Debt moving the tax payer into solvency would be considered taxable.
- Non-bankrupt debtor is solvent qualified farmer
- Tax attributes: NOL, Tax Credits, Asset Basis could be consumed to offset Discharge of Indebtedness not recognized as taxable in above situations.
- ****Basis reduction is \$0 when the aggregate of the basis of the property held by the taxpayer immediately after the discharge did not exceed the aggregate of the liabilities of the taxpayer immediately after the discharge**

Form 982 (Rev. January 2016)
Department of the Treasury
Internal Revenue Service

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

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

▶ Attach this form to your income tax return.
▶ Information about Form 982 and its instructions is at www.irs.gov/form982.

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	<input type="checkbox"/>
b Discharge of indebtedness to the extent insolvent (not in a title 11 case)	<input type="checkbox"/>
c Discharge of qualified farm indebtedness	<input type="checkbox"/>
d Discharge of qualified real property business indebtedness	<input type="checkbox"/>
e Discharge of qualified principal residence indebtedness	<input type="checkbox"/>

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. (For additional information, see the instructions for Part II.)

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
10a Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. <i>DO NOT use in the case of discharge of qualified farm indebtedness.</i>	10a
b Applied to reduce the basis of your principal residence. Enter amount here <i>ONLY</i> if line 1e is checked!	10b
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

Transactions that Create Tax Challenges:

Bunching of Income:

Betty Beans carries forward grain from 2015 to be sold in 2016. Betty cannot get credit to put in 2016 crop, her operation is shut down. She has no production expenses to offset carryover income. Betty will be subject to Federal, Self Employment, and possible State Taxes

Transactions that Create Tax Challenges:

Rapid Depreciation:

Fred Farmer bought a grain drill in 2014 for \$50,000. His KFMA Economist recommended regular depreciation, but Fred refused to pay anymore taxes than necessary, so section 179 was utilized and \$50,000 was depreciated in 2014.

Fred decided to sell the drill in 2016 to pay some debt. He received \$30,000 for the drill and his tax depreciation basis was \$0. Taxable gain on the drill sale was \$30,000 (\$30,000 sale – basis \$0). Fred will be liable for Federal and possible State Taxes.

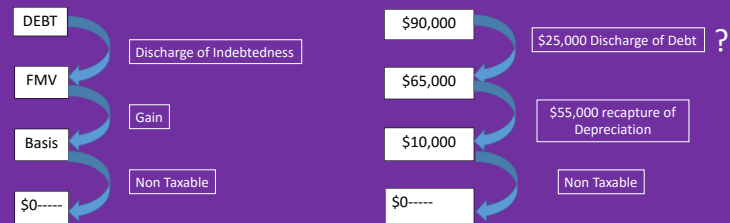
Transactions that Create Tax Challenges:

Property turned over to lender (same as sold outright):

Jim decides to turn his planter back to CNH Capital since he can't make the payments. He has a basis in his planter of \$10,000. The FMV of the planter is \$65,000 and he owes CNH Capital \$90,000. CNH Capital is willing to take back the planter to satisfy the loan.

Jim's Planter Turn back?

Recourse Debt



Transactions that Create Tax Challenges:

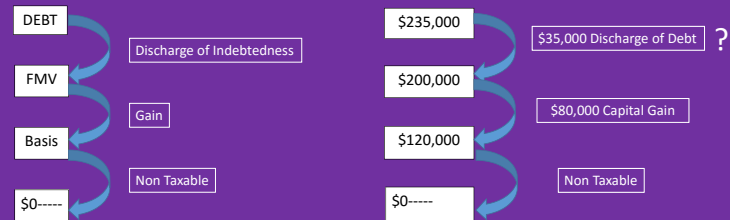
Land turned back to Lender: (same as sold outright)

Frank purchased 240 acres in 1990 for \$120,000. In 2010 he decided to add on to his house and borrowed \$300,000 (giving his bank first mortgage) when the FMV was \$480,000. In 2016, when the land had a FMV of only \$200,000 he turned back the land to the bank to offset the remaining loan balance of \$235,000.

Frank will have capital gain from FMV – Basis of \$80,000 and Discharge of Indebtedness income of \$35,000. He will pay federal capital gains rate on the \$80,000 and ordinary tax rates on the \$35,000 along with state income taxes.

Frank's Land turn back:

Recourse Debt



Transactions that Create Tax Challenges:

Insolvent Tax Payer not in Bankruptcy:

Henry Insolvent has the following fact pattern:

Asset	Tax Basis	FMV	Liability (before)	Liability (after)	Creditor
Cash	\$ 3,000	\$ 3,000	\$ -		
Unimproved Farmland	\$ 200,000	\$ 200,000	\$ 300,000	\$ 200,000	A
Depreciable Business Assets	\$ 100,000	\$ 100,000	\$ 123,000	\$ 100,000	B
Grain Inventory	\$ -	\$ 25,000	\$ 25,000	\$ 25,000	C
Total	\$ 303,000	\$ 328,000	\$ 448,000	\$ 325,000	
Net Worth			\$ (120,000)	\$ 3,000	

As part of the reorganization, Creditor A reduces mortgage debt by \$100,000 and Creditor B reduces secured debt by \$23,000.

Henry is insolvent \$120,000 (\$328,000 - \$448,000) before debt discharged and \$3000 solvent after (\$328,000 - \$325,000). He has \$15,000 NOL carried forward from 2015.

Transactions that Create Tax Challenges:

Insolvent Tax Payer not in Bankruptcy: Tax Consequences:

Henry has total debt discharged of \$123,000, but \$120,000 is while he is insolvent, making it non-taxable. Henry will report the \$3,000 of debt discharged that made him solvent as a discharge of indebtedness income, unless the solvent qualified farmer exception applies. He will also be required to use up his NOL of \$15,000 (tax attributes) and to offset the discharged debt of \$120,000, leaving \$105,000 of debt discharged that would not be included as income since Henry was insolvent for that adjustment.

Transactions that Create Tax Challenges:

Insolvent Tax Payer not in Bankruptcy: Tax Consequences:

Asset	Tax Basis	FMV	Liability (before)	Liability (after)	Creditor
Cash	\$ 3,000	\$ 3,000	\$ -		
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Depreciable Business Assets	\$ 100,000	\$ 100,000	\$ 123,000	\$ 100,000	B
Grain Inventory	\$ -	\$ 25,000	\$ 25,000	\$ 25,000	C
Total	\$ 303,000	\$ 328,000	\$ 448,000	\$ 325,000	
Net Worth			\$ (120,000)	\$ 3,000	

**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)

Transactions that Create Tax Challenges:

Insolvent Tax Payer not in Bankruptcy: Tax Consequences:

Same fact patten except Henry elected to reduce basis first:

Henry has total debt discharged of \$123,000, but \$120,000 is while he is insolvent, making it non-taxable. Henry elects to reduce his depreciable asset basis by \$100,000 leaving them \$0 basis. He will also be required to use up his NOL of \$15,000 to offset the remaining discharged debt of \$20,000. The remaining \$3,000 of debt discharged that made Henry solvent would not be recognized as debt discharged income because he uses the qualified farmer exception.

Transactions that Create Tax Challenges:

Tax Consequences on the Repossession of Real Property:

On repossession, the amount of gain recognized is the lesser of:

1) The amount of cash and the fair market value (FMV) of other property received prior to the reacquisition (but only to the extent such money and other property exceeds the amount of gain reported prior to reacquisition).

OR

2) The amount of gain realized on the sale (adjusted sales price less adjusted income tax basis) in excess of the gain previously recognized before the reacquisition and the money or other property transferred by the seller in connection with the reacquisition.

Transactions that Create Tax Challenges:

Tax Consequences on the Repossession of Real Property:

Farmland acquired in 1970 was sold by Fred under installment contract on January 2, 2015 to Jim for \$150,000 calling for \$15,000 down and payments of \$15,000 per year for nine years. The land had an adjusted income tax basis at the time of sale of \$30,000. The seller received the down payment and the first regular payment for the following year, with all payments income tax reported, where upon Jim proceeded to forfeit his interest in the property back to Fred.

Transactions that Create Tax Challenges:

Tax Consequences on the Repossession of *Real Property*:

Step 1: Calculate the amount of cash and the fair market value of the property received prior to reacquisition:

Year of Sale	\$15,000
Following year	\$15,000

Step 2: Subtract the gain returned as income for the period prior to acquisition:

Determine gross profit:	\$120,000 = \$150,000 - \$30,000
Determine total Contract Price:	\$150,000
Fraction reported as gain: Gross profit/Total contract price:	
	80% = \$120,000/\$150,000

Gain Reported: \$24,000 = \$30,000 x 80%

Gain before application of second application:

Money and other property received	\$30,000
Less: gain reported	<u>-\$24,000</u>
Basis utilized prior to acquisition	\$ 6,000

Transactions that Create Tax Challenges:

Tax Consequences on the Repossession of *Real Property*:

Step 3: Determine the second limitation on amount of gain:

Sales price of property		\$150,000
Less: adjusted basis at time of sale	\$30,000	
<i>plus:</i> gain returned as income before acquisition	<u>\$24,000</u>	
	\$54,000	\$ -54,000
Limitation on amount of gain		\$ 96,000

Step 4: Determine the *lesser* figure from Step 2 or Step 3

as the amount of gain resulting from reacquisition: \$ 6,000 < \$96,000

Transactions that Create Tax Challenges:

Tax Consequences on the Repossession of *Real Property*:

The character of the gain from reacquisition is determined by the character of the gain from the original sale. The adjusted income tax basis for the property is the sum of three amounts:

- 1) The adjusted income tax basis to the seller of the indebtedness, determined as of the date of repossession.
- 2) The taxable gain resulting from reacquisition
- 3) The money and other property (at fair market value) paid by the seller as reacquisition costs.

Transactions that Create Tax Challenges:

Tax Consequences on *purchased price adjusted property*:

John purchases farm land for \$120,000 a few years ago where he pays \$10,000 down and gives \$110,000 purchase-money mortgage for the balance. If, after \$75,000 has been paid on the mortgage, the seller agrees to reduce the balance of the debt by \$15,000, and if the purchaser is solvent at that time, there would be \$15,000 of discharge of indebtedness income absent IRS code section 108(e)(5).

**Under IRS code section 108(e)(5), instead of recognizing income, the purchaser would reduce his basis in the property to \$105,000 (\$120,000 - \$15,000). Assuming that the price of the property will increase in the future years, John would be required to recognize a larger gain upon a subsequent resale.

BANKRUPTCY: The Last Resort?

- Stall for time to pay off creditors
- Cooperate with lender(s) in the sale of some asset(s)
- Refinance, if possible
- Seek protection in Bankruptcy Court

BANKRUPTCY: What Can it do for me?

- Eliminate the legal obligation to pay most of your obligations
 - Discharge of Debts
- Stop foreclosure on your residence, and catch up on missed payments
- Prevent repossession of an automobile or other property, or force creditor to return property—even if repossessed
- Stop wage garnishment, debt collection harassment and similar credit actions

BANKRUPTCY: What Can it NOT do for me?

- Eliminate certain rights of “secured” creditors
- Discharge types of debts singled out by bankruptcy law for special treatment:
 - Child Support – alimony – most student loans – court restitutions – criminal fines – most taxes.....
- Protect cosigners on your debts
- Discharge debts that arise after bankruptcy has been filed

BANKRUPTCY: What types are there?

- Chapter 7: Liquidation
 - Relief from debt and taxes
- Chapter 12:
 - Added in 1986, amended in 2005 – designed for *active* farmer/fishermen
 - Allow for reorganization?
 - Disputed/unclear relief of income tax on liquidation?
- Chapter 11: Reorganization
 - Used for business and few individuals with large debts (larger than Chapter 12)
- Chapter 13: Reorganization
 - Individuals to pay off all or portion of debt over period of years

BANKRUPTCY: CREATING ESTATE

- Types of Bankruptcy (chapters): 7 – 11 – 12 – 13
- Taxed as separate estate (tax return) 7 – 11
 - Includes property that belonged to debtor before filing date
- Trustee is appointed to manage estate for benefit of **creditors**
- Allows the debtor **fresh start**
- If bankruptcy case is dismissed, treated as if never happened

BANKRUPTCY: Income, Deduction, and Transfers

- Gross Income: Debtors income to which the estate is entitled
- Deductions for paid or incurred normal business expenses **plus** attorney and trustee fees, and court cost
- Taxable income taxed as an individual, married filing separately on form 1041 filed under “Bankruptcy Estate”

1041 U.S. Income Tax Return for Estates and Trusts 2015

OMB No. 1545-0042

A Check all that apply:
 Decedent's estate
 Simple trust
 Complex trust
 Qualified disability trust
 SIFT (S-partner only)
 Chapter 13E trust
 Bankruptcy estate (2015)
 Bankruptcy estate (2014)

B For calendar year 2015 or fiscal year beginning 2015, and ending 20
Name of estate or trust (if a grantor type trust, see the instructions.)
Name and title of fiduciary
Number, street, and room or suite no. (if a P.O. box, see the instructions.)
City or town, state or province, country, and ZIP or foreign postal code

C Employer identification number 20
Date entity created
Nonexempt (checkable and split interest trusts, check applicable boxes, see instructions.)
 Described in sec. 6637(a)(1). Check here if not a private foundation.
 Described in sec. 6637(a)(2)

D Number of Schedules K-1 attached here
E Check applicable box:
 Initial return
 Amended return
 Change in trust's name
 Change in fiduciary
 Change in fiduciary's name
 Change in fiduciary's address

F Check here if the estate or trust made a section 640 election. Trust 1041

BANKRUPTCY: Income, Deduction, and Transfers

- Transfers in or out of bankruptcy estate are treated non-taxable
- Attribute Carryover: treated the same as an individual, determined on first day of bankruptcy case begins.

Questions?