

Chapter 11 *

INCOME TAX CONSEQUENCES OF FARM FINANCIAL DISTRESS

Introduction

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 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.

Example 11.1: Transfer of Assets

Danica Distress previously weathered financial setbacks by tapping her secured line of credit with her local bank. However, she has reached the limit of that credit and now wants to know the income tax consequences of selling her assets to pay her debts. She has \$500,000 of secured debt. Her assets are shown below.

Danica's Assets

Asset	Fair Market Value	Basis
Stored grain	\$20,000	\$0
Raised herd	90,000	0
Machinery	75,000	20,000
Land	<u>300,000</u>	<u>80,000</u>
Total	<u>\$485,000</u>	<u>\$100,000</u>

(continued)

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Example 11.1: Transfer of Assets (continued)

Danica is married and files a joint federal income tax return with her husband Dillon, who earns \$30,000 a year from an off-farm job. He has enough federal income tax withheld from his paycheck to pay the federal income tax on all of their income, the FICA taxes on his wages, and the self-employment tax on Danica's \$10,000 of farm income. They have two children.

If Danica sells all of her assets for their \$485,000 fair market value, she and Dillon will owe an additional \$75,174 of federal taxes on the \$385,000 (\$485,000 – \$100,000 basis) gain (tax calculations approximate). However, all \$485,000 of the sales proceeds will go to her secured creditors to reduce the debt owed to them from \$500,000 to \$15,000. After paying \$485,000 of debt with the sale proceeds, Danica will still owe \$90,174 (\$75,174 + \$15,000) in taxes and lender debt.

Tax Planning for Gain on Transfer of Assets

Tax planning for the gain on the sale of assets because of financial distress is the same as planning for the sale of assets outside of financial distress. Two particularly useful strategies are income averaging and timing of income.

Income Averaging

The income-averaging rules allow farmers to use tax brackets from the 3 prior years to compute taxes on some or all of the current-year electable farm income. Therefore, income in the high brackets of the current year can be taxed at lower rates.

Cross-Reference

See Chapter 7 of this book for an explanation of the income-averaging rules.

Timing of Income

If farmers can control the timing of asset sales, they may delay selling some assets until the following tax year to save both income taxes and self-employment (SE) taxes.

Bunching up SE income in one year can push some of that income above the social security wage base, which is \$160,200 for 2023. Earned income above the wage base is subject to a 2.9% SE tax rate instead of the 15.3% tax rate that applies to earned income up to \$160,200. The income-averaging rules can then be used to reduce the income tax rate on the income that is pushed into a higher tax bracket by the bunching of income.

Example 11.2: Bunching Self-Employment Income

Sven Olssen has potentially \$160,200 of net earnings from self-employment in Year 1, and \$100,000 of net earnings from self-employment in Year 2. He had no investment income. If the tax rate is 15.3% in both years, his SE tax would be \$24,511 ($\$160,200 \times 15.3\%$) in Year 1 and \$15,300 ($\$100,000 \times 15.3\%$) in Year 2, for a total of \$39,811.

If he can bunch the net earnings from self-employment into one tax year, his SE tax would be \$27,411 (\$24,511 on the first \$160,200, plus \$2,900 on the remaining \$100,000). That is a \$12,400 ($\$39,811 - \$27,411$) reduction in his SE tax.

Bunching up ordinary income has the added advantage of emptying the 12% regular income tax bracket for the following year so that long-term capital gains in the following year qualify for the lower tax rate for capital gains, which is 0% in 2022 and 2023.

The federal income tax rate on long-term capital gains and qualified dividends is the lesser of the ordinary income tax rate or the tax rate for long-term capital gain. For 2022, the tax rate for most long-term capital gains is 0% for eligible gains and dividends included in total taxable income that does not exceed the \$83,350 for Married Filing Jointly (MFJ) filed returns or \$41,675 for single individuals. It is 15% for eligible long-term capital gains and dividends included in income that would be above \$83,350 for MFJ filed returns or above \$41,675 for single filers.

Figure 11.1. 2022 Long Term Capital Gain Rates

2022 Long Term Capital Gains Rates						
	Single/Individual		Married Filing Jointly		Head of Household	
	Above	Top	Above	Top	Above	Top
0%	\$ -	\$ 41,675.00	\$ -	\$ 83,350.00	\$ -	\$ 55,800.00
15%	\$ 41,676.00	\$ 459,750.00	\$ 83,351.00	\$ 517,200.00	\$ 55,801.00	\$ 488,500.00
20%	\$ 459,751.00	And Up	\$ 517,201.00	And Up	\$ 488,501.00	And Up

*There are higher capital gain rates for collectibles. Long-term capital gains for C-corporations are treated at the same tax rate as ordinary income.

Example 11.3: Tax Rate on Capital Gain

In 2022, Carlos and Virginia Little Otter have \$25,000 of long-term capital gains, in addition to \$80,000 of ordinary income. The top of the 0% tax rate for long-term capital gain is \$83,350 (total of ordinary income and capital gain income) for married filing jointly; any gain that falls above that amount will be treated at a 15% tax rate until \$517,200 of total income, where a 20% tax rate will be applied.

The Little Otters' have \$80,000 of ordinary income and \$25,000 of long-term capital gain income. Since the \$80,000 of ordinary income is below the \$83,350 (see below) there is \$3,350 of the long-term capital gain income that will be taxed at a 0% tax rate and the remaining long-term capital gain income will be taxed at a 15% tax rate since it is below the \$517,200.

Ordinary Income (\$80,000)			
<u>Tax on Ordinary Income</u>			
	\$20,550 at 10% (of the \$80,000)	\$2,055.00	
	\$59,450 at 12% (\$80,000 - \$20,550)	\$7,134.00	
	Total Tax Owed on Ordinary Income	\$9,189.00	\$9,189.00
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Long-Term Capital Gain (LTCG) (\$25,000)			
	\$3,350 of capital gain (\$83,350 – \$80,000) = (\$3,350 * 0%)	\$0.00	
	\$21,650 (\$25,000 - \$3,350) * 15%	\$3,247.50	
	Total Tax Owed on Long-Term Capital Gain	\$3,247.50	\$3,247.50
	Total of all Taxes Owed (\$3,247.50 LTCG + \$9,189 Ordinary Inc):		\$12,436.50

Bunching up ordinary income may create a situation where you owe additional taxes. If you have net investment income you may owe the 3.8% Net Investment Income Tax (NIIT) on the lesser of your net investment income or the amount your Modified Adjusted Gross Income (MAGI) exceeds the annual threshold. The 2022 threshold is \$250,000 for married filing jointly and \$200,000 for single.

Net investment income includes gross income from interest, dividends, capital gains, rental and royalty income, nonqualified annuities, and income from passive activities minus allowable expenses.

Discharge of Indebtedness Income

Creditors sometimes forgive or discharge some or all of a financially distressed 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 a creditor forgives debt for any reason other than for the purpose of making a gift to the debtor, the discharged debt is potentially included in taxable income as cancellation of debt income (CODI). Cancellation of debt may also occur because of foreclosure, repossession, abandonment, or voluntary transfer of the property to the lender.

When debt is canceled the creditor may send you a Form 1099-C, Cancellation of Debt, showing the amount and date of debt cancelled. Whether or not you receive a correct Form 1099-C, you are responsible for reporting the taxable amount of canceled debt as income on your tax return for the year

the cancellation occurs.

If your debt was secured by property, and the creditor takes that property in full or partial satisfaction of your debt, you are treated as having sold that property to the creditor. The tax treatment depends on whether you were personally liable for the debt (recourse debt) or not personally liable for the debt (nonrecourse debt).

For a recourse debt, the amount realized is the fair market value (FMV) of the property. You must include this cancellation of debt in your income unless an exception or exclusion applies (see below). Ordinary income from the cancellation of the debt is the amount of the debt in excess of the FMV of the property the lender repossessed. Gain or loss on the disposition of the property is the difference between the FMV and adjusted basis (usually your cost).

Example 11.4: Repossession of Assets

Paige Turner borrowed \$100,000 from her bank to buy a \$120,000 tractor in 2017. In 2021, she was unable to make the payments on the loan and the bank repossessed the tractor. At the time of repossession, the remaining debt was \$75,000 and the tractor's fair market value (FMV) was \$50,000. The bank decided to not pursue a claim for payment of the rest of the debt because Paige was insolvent.

For income tax purposes, Paige is treated as selling the tractor to the bank for its \$50,000 FMV and then using the \$50,000 to pay that much of her \$75,000 debt. The remaining \$25,000 of debt is potentially CODI.

Paige had claimed \$68,544 of depreciation on the tractor before 2021, and she can claim \$7,350 of depreciation for 2021 (half-year convention and the fifth year of 7-year property). Her adjusted basis in the tractor then is \$44,106 (\$120,000 – \$68,544 – \$7,350), and she has a \$5,894 (\$50,000 – \$44,106) gain on the deemed sale. The depreciation recapture rules treat all of that gain as ordinary income.

For a nonrecourse debt, the amount realized is the entire amount of the nonrecourse debt plus the amount of cash and the FMV of any property you received. You will not have ordinary income resulting from debt cancellation.

Exceptions to Recognition of CODI

If any of the following exceptions apply, the debtor does not have to include CODI in income.

1. A deduction for the amount paid would be allowable if the taxpayer paid the debt that was discharged. Examples include feed or other farm inputs purchased on credit from the seller and interest on a loan.
2. The debt was discharged in bankruptcy.
3. The debtor was insolvent at the time the debt was discharged.
4. The seller of property under an installment contract discharged the debt, and the original purchaser under the contract owed the debt that was discharged.
5. The debt discharged is *qualified farm indebtedness*.
6. The debtor is not a C corporation, and the debt discharged is *qualified real property business indebtedness*.

If discharged debt qualifies for more than one of these exceptions, the first applicable exception in the list is applied to the discharged debt.

Example 11.5: Qualified Farm Debt

Because the \$25,000 of debt that was discharged in Example 11.4 was discharged while Paige was insolvent, Paige does not have to include the \$25,000 CODI in her gross income, although she must record it on her federal income tax return.

Paying the Price

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

1. Net operating loss (NOL): Any NOL for the tax year of the discharge, and any NOL carryover to such year.
2. General business credit: Any carryover to or from the tax year of debt discharge of an amount includable in determining the amount allowable as a general business credit.
3. Minimum tax credit: The amount of the minimum tax credit available at the beginning of the tax year immediately following the tax year of the discharge.
4. Capital loss carryovers: Any net capital loss for the tax year of the discharge, and any capital loss carryover to such year.
5. Basis reduction: The basis of the taxpayer's property.
6. Passive activity loss and credit carryovers: Any passive activity loss or credit carryover of the taxpayer from the tax year of the discharge.
7. Foreign tax credit carryovers: Any carryover to or from the tax year of the discharge for determining the amount allowable as a foreign tax credit.

Credits are reduced \$1 for every \$3 of CODI that is excluded from income. The other tax attributes are reduced \$1 for every \$1 of CODI that is excluded from income. The CODI exclusion and tax attribute reductions are reported on IRS Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness.

Order of Reduction

The general rule is that the tax attributes are reduced in the order listed. However, a taxpayer can elect to reduce the basis in depreciable property first.

Example 11.6: Attribute Reduction

Paige (from Example 11.4) must reduce her tax attributes to pay the price for not including the \$25,000 discharged debt in her gross income. If she has no NOL, general business credit, minimum tax credit, or capital loss carryovers, she must reduce the basis in her farm assets by \$25,000.

Limit on Basis Reduction

If the debt discharge is excluded from income under the bankruptcy or insolvency exceptions, a limit applies to the reduction of basis in assets. The aggregate basis in the taxpayer's assets is reduced only down to the remaining debt after the discharge, so that the taxpayer's assets may equal his or her remaining liabilities.

Timing

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

Example 11.7: Timing of Attribute Reduction

Paige (from Example 11.4) must reduce the basis in her assets after she has claimed depreciation for 2021 and calculated gain on sale of assets in 2021. Assume that she had only one asset after the tractor was repossessed: land with a \$60,000 basis and a \$100,000 FMV.

If Paige sells the land in 2021 (the same year the tractor was repossessed), she must recognize \$40,000 (\$100,000 – \$60,000) of gain on the land. She then has no basis in assets to reduce and therefore does not have to pay a price for not recognizing the \$25,000 of CODI.

If she waits until 2022 to sell the land, she must reduce its basis by \$25,000 at the end of 2021 (to pay the price of excluding the CODI from her taxable income). She will then have a \$65,000 (\$100,000 – \$35,000 reduced basis) gain to report on her 2022 income tax return.

Summary

Farmers in financial distress face income tax consequences from transferring their assets as well as from cancellation of debt. Those taxes can be minimized by planning the timing of the transfers and the cancellation of debt, as well as by electing income tax options that reduce taxes. To make the best use of the tax-planning opportunities, it is important for farmers to consult their tax advisers before they enter into transactions to restructure their debt.