

FARM LEGAL SERIES

Tax Considerations in Liquidations and Reorganizations

Phillip L. Kunkel, Jeffrey A. Peterson, Jessica A. Mitchell

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INTRODUCTION

Generally, when a person is experiencing extreme financial distress, income tax liability is not a major concern. After all, the lack of income is at least partially responsible for the person's financial difficulties. In the case of farming operations, however, income tax liabilities present real difficulties.

For farm debtors using the cash method of accounting, the income tax basis of raised animals or stored grain is zero. Machinery and equipment have often been depreciated rapidly, with a resulting low basis, and land that was purchased some time ago frequently has a low basis derived from the original purchase price and adjusted for improvements made in depreciation claimed. Thus, there is a potential income tax liability created when assets are sold or turned over to creditors. In addition, income taxes may be generated when debt is forgiven.

There are several options available to the farmer in dealing with these income tax problems.

Liquidation Liabilities — If farm assets are liquidated outside of bankruptcy, any resulting tax liability is solely the responsibility of the debtor as the taxpayer. In the event of a liquidation, tax liabilities may take several forms:

1. Ordinary income will result from the sale of assets—such as grain or livestock—held for resale.
2. Ordinary income will result from the recapture of certain previously claimed tax benefits such as depreciation, soil and water conservation expenses, land clearing expenses, and government cost sharing payments excluded from income.
3. If capital assets such as real estate are sold to pay debts, capital gains may result from the sale.
4. An alternative minimum tax may be imposed on preference income that includes the portion of capital gains that individuals do not include as income.
5. If a taxpayer negotiates an arrangement with his creditors to transfer property to the creditor in forgiveness of the debt, such debt forgiveness may generate ordinary income.

If, rather than selling assets, the taxpayer turns the assets over to a creditor in partial or total satisfaction of the debt or the creditor exercises the right to foreclose on the assets, the outcome is essentially the same. The transfer of property to a creditor and a foreclosure are both treated as a sale of the property for an amount equal to the

property fair market value. There is, of course, the possibility of further income tax liability if the indebtedness that is discharged by the transfer or foreclosure is greater than the value of the assets. When property is transferred or foreclosed upon in satisfaction of a debt the general rule is that the taxpayer realizes:

1. Gain on the property transferred (possibly capital gain) to the extent that the fair market value of the property exceeds the income tax basis in the property.
2. Debt discharge income to the extent the amount of debt discharged exceeds the fair market value of the property.

To illustrate, assume that Fred Farmer purchased his farm for \$100,000 several years ago. He recently borrowed \$650,000 to build and operate a hog feeding operation and used the appreciated value of the farm land collateral for the loan. Fred Farmer defaults on his loan, the bank accelerates the \$650,000 balance, and forecloses on the farm, now worth \$500,000. At the foreclosure sale, the bank acquired the farm by a credit bid for the \$650,000 owed to the bank. In this case, Fred has realized a capital gain of \$400,000, which, for most taxpayers, may be taxed at a federal rate of 15% (i.e., \$60,000). In addition, Fred has realized \$150,000 as debt discharge income because the discharged debt exceeded the value of the property received to discharge that debt by \$150,000. This income from discharge of indebtedness may or may not be recognized, depending on whether Fred was solvent, insolvent, or in bankruptcy. If he was in bankruptcy when the debt was forgiven, he does not have to report the forgiven debt as income. If he was not in bankruptcy when the debt was forgiven but

was insolvent, he is treated as though he were in bankruptcy. If, however, he was solvent, he may be able to exclude from income the forgiven debt if the debt was classified as “qualified farm debt” and Fred meets several other special rules.

Even if such debt discharge income is not recognized, the debtor's tax attributes will be reduced to the extent of such debt discharge income. The law sets forth a detailed order in which the tax attributes are reduced:

1. Net operating loss.
2. Certain credit carryovers, namely, investment tax credit and other credits not applying to farmers.
3. Capital loss carryovers.
4. Basis reduction by reducing basis of property of the taxpayer.

But Fred's problems are not confined merely to capital gains and debt discharge income. He also may be subject to the alternative minimum tax.

The alternative minimum tax was included in the tax code to prevent a taxpayer with substantial economic income (income without regard to special exclusions or deductions) from avoiding substantial tax liability by using tax exclusions, deductions, and credits to reduce their taxable income. The alternative minimum tax calculation starts with the taxpayer's regular taxable income for the tax year.

The taxpayer must then make adjustments and add back certain tax preferences to arrive at the taxpayer's alternative minimum taxable income. Some common examples of tax preferences and adjustments that affect farmers include the excess of accelerated

depreciation over straight-line depreciation on real property, accelerated depreciation on leased personal property and an increase to gain on the sale of property sold or foreclosed on. Certain itemized deductions must be added back for alternative minimum taxable income calculations. State and local taxes are not allowed.

The taxpayer's alternative minimum taxable income is then reduced by the allowed exemption to arrive at the taxpayer's taxable excess income. The allowed exemption amount for calculating alternative minimum tax depends on the filing status of the taxpayer. For a taxpayer who is married and files jointly, the allowed exemption is \$70,950 for 2009. For a single person or head of household, it is \$46,700 for 2009. For a married taxpayer filing separately or for estates, it is \$35,475 for 2009. The allowed exemptions begin to phase out when the taxpayer's alternative minimum taxable income exceeds certain thresholds. For example, the allowed exemption is reduced by 25% of the amount by which alternative minimum taxable income exceeds \$112,500.

This calculation is illustrated using the following formula:

$$\begin{array}{r}
 \text{Regular taxable income} \\
 + \text{Tax preferences (and adjustments)} \\
 \hline
 \text{Alternative minimum taxable income} \\
 - \text{Allowed exemption amount} \\
 \hline
 \text{Taxable excess}
 \end{array}$$

The taxable excess is then taxed at 26% up to \$175,000 (\$87,500 for married filing separately,) with the remainder taxed at 28% to arrive at the taxpayer's tentative minimum tax. The taxpayer's alternative minimum tax liability equals the taxpayer's tentative minimum tax minus the taxpayer's regular taxable income.

$$\begin{array}{r}
 \text{Taxable excess} \\
 \times 26\% \text{ (or } 28\%) \\
 \hline
 \text{Tentative minimum tax} \\
 - \text{Regular tax liability} \\
 \hline
 \text{Alternative Minimum Tax}
 \end{array}$$

Thus, the alternative minimum tax can result in significant additional income tax liability for Fred.

Chapter 7 and 11 — In the event that the debtor seeks protection of the Bankruptcy Code, additional results and planning opportunities follow. If an individual debtor files bankruptcy under either Chapter 7 or 11, a new taxable entity is created. The bankruptcy estate is a taxable entity that is separate and distinct from the debtor. All property owned by the debtor at the time the bankruptcy case is initiated passes by operation of the Bankruptcy Code to the bankruptcy estate. The transfer of assets by the debtor to the bankruptcy estate is not treated as a taxable disposition. Thus, the transfer does not require income tax to be paid on the gain in the assets involved. Nor does the transfer trigger income tax liability from the recapture of depreciation, recapture of soil and water conservation or land clearing expense, recapture of government cost sharing payments excluded from income, or recapture of investment tax credit. The estate is treated as the debtor would have been treated had he not filed for bankruptcy.

After the bankruptcy case has been initiated, income generated from assets included in a bankruptcy estate is included in the bankruptcy estate's income. Thus, if the bankruptcy estate disposes of assets or suffers a foreclosure and triggers income tax liability in the process, the income tax liability is a priority claim in the estate as an administrative expense. As a result, the tax

due is paid ahead of general unsecured creditors. Any income tax liability remaining does not pass back to the debtor, however.

Besides automatically transferring all the debtor's property to the estate, the initiation of a bankruptcy case gives an individual debtor one significant choice. He may elect a short tax year, ending the day before the bankruptcy filing. He thus creates two short tax years for himself. His income tax liability in the first short year becomes a priority claim against assets in the bankruptcy estate. That is because the bankruptcy estate is responsible for all the debtor's liabilities at the time of bankruptcy, including income taxes that accrue before the date of bankruptcy. As a result, electing to end a tax year before the day of bankruptcy causes the taxes on the income earned to that date to become a debt of the bankruptcy estate. If there are insufficient assets to pay the income tax, the remaining liability is nondischargeable. Any remaining income tax liability for the first short year returns to the debtor and can be collected from him later.

In the event the debtor does not elect a short year, the tax on the income earned during the tax year in which his bankruptcy occurs will accrue after the date of bankruptcy and will therefore not become a debt of the estate. As a result, none of the debtor's income tax liability can be collected for the year of bankruptcy filing for the bankruptcy estate. To illustrate, assume that a farmer who is a calendar year taxpayer is in financial difficulty and sells some assets in January to pay debts. On the 1st of May, she decides to file for bankruptcy. If she does not elect two short tax years', the gain she realizes on the sale of the assets will be included on the return she files for the full year. Those taxes will not be a debt of the

bankruptcy estate. If she elects two short years, the income taxes on the gain from the sale of the assets will accrue before the bankruptcy was filed. Therefore, the taxes on the gain will become a debt of the bankruptcy estate and will be properly payable out of the estate assets.

The debtor's selection of a single tax year or two short years also affects the amount of tax attributes that pass from the debtor to the bankruptcy estate. The bankruptcy estate receives the tax attributes of the debtor as of the beginning of the tax year in which the bankruptcy was initiated. Therefore, if the debtor chooses a single tax year, the attributes that he or she has at the beginning of that year will pass to the bankruptcy estate and cannot be used by the debtor on the tax return for that year. If the debtor chooses two short tax years, the attributes do not pass to the bankruptcy estate until the beginning of the second short year. Therefore, the debtor can apply the tax attributes on his or her return for the short year first.

In most cases, if the debtor has income before the date the bankruptcy was initiated, it is usually to his advantage to choose short tax years. By doing so, the debtor not only makes the taxes on that income a debt of the estate, but also reduces the amount of taxes owed on that income.

Chapter 12 — Unlike Chapter 7 and 11, the legislation creating Chapter 12 did not create a separate tax entity for a Chapter 12 debtor. Instead, a the debtor must propose a plan to pay his creditors over 3-5 years. Since a separate entity is not created, the debtor does not have the option of filing a short tax year federal return. Furthermore, in 2005, Congress amended Chapter 12 to provide debtors capital gain tax relief. Prior to 2005, a debtor in bankruptcy may sell real estate

and machinery while in bankruptcy; however, the resulting capital gains from the sale of the property would be a priority claim by the government. The debtor would pay this claim in full during the life of the plan. For a farming operation that had very low basis on its real estate (and in some cases, its machinery), this often prevented the debtor from obtaining a discharge (or closing his or her Chapter 12 plan). When Congress amended Chapter 12 in 2005, it appears Congress intended to write into the Bankruptcy Code that any “capital gains” of the debtor would be a general unsecured claim of the government—a claim that does not have to be paid in full to obtain a bankruptcy discharge.

To illustrate, assume that Fred Farmer purchased his farm in 1985 for \$100,000. A few years later Fred borrowed money to buy and operate a small hog feeding operation adjacent to his farm for \$200,000. The farm was used as collateral for the hog operation loan. The farmland drastically appreciated in value, and Fred Farmer leverage the appreciated value to increase the size of his hog operation. Fred now owes the bank \$650,000. Fred Farmer files a Chapter 12 bankruptcy and elects to keep the hog feeding operation, and sell the farmland. The farmland is sold for \$450,000. Fred Farmer would have a \$350,000 gain on the sale of the farmland, and when taxed at a federal capital gains rate of 15%, Fred Farmer would owe \$52,500 in capital gains taxes. Prior to 2005, Fred Farmer would have had to pay the \$52,500 in full over the 3 to 5 years life of his Chapter 12 plan.

Now, with the 2005 amendment to Chapter 12, Fred Farmer can treat the \$52,500 as a general unsecured claim, and in most circumstances, no payment would need to be made through his Chapter 12 plan. Upon completion of his plan Fred Farmer would discharge any capital gain liability on the sale of the farmland.

This remains an unsettled area of law. Producers have argued that the favorable tax provisions under Chapter 12 also apply to capital gains that have been realized before the bankruptcy was filed (so that the producer may sell the assets prior to the bankruptcy, and while in the bankruptcy, treat the capital gains tax as a general unsecured claim). The critical questions have been whether the farm assets were “used in” the farming operation and liquidated as part of his/her Chapter 12 plan.

Conclusion — Tax planning is as important for farmers in financial distress as for those who are making a profit. Income tax consequences are triggered by the sale of assets, the foreclosure of debts, and the forgiveness of debts. The difference in income tax treatment for the liquidation of assets provides a strong motivation to file for bankruptcy. The difference in income tax treatment also may be important to creditors. A secured creditor may obtain a larger payment in bankruptcy than if the debtor sells the property and remits the after-tax balance to the creditor. When contemplating bankruptcy or liquidation, farmers must consider carefully the effect of their decisions from a tax point of view.

Phillip L. Kunkel
Attorney
Gray Plant Mooty

Jeffrey A. Peterson
Attorney
Gray Plant Mooty

Jessica A. Mitchell
Attorney
Gray Plant Mooty

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