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INCOME TAX CONSEQUENCES OF FARM DEBT CANCELLATION AND BANKRUPTCY

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This bulletin is a revision of one with the same title published in June 1989. It is not intended to be an exhaustive treatment of income taxes related to farm financial distress. The intent is to give farmers and their financial and tax advisors some basic information about the income tax consequences of cancellation of debt and bankruptcy. Those who need information beyond that included in this bulletin should seek sound advice from competent attorneys and tax practitioners.

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Beginning in the mid-1980s, a substantial number of farmers suffered financial difficulties which led to debt restructuring, bankruptcy and consideration of liquidation alternatives. The Farmers Home Administration debt restructuring program which includes debt cancellation for some farmers has added to the concern about the tax consequences of debt cancellation. The primary purpose of this bulletin is to consider some of the income tax consequences of debt cancellation. A section on some of the income tax aspects of bankruptcy also is included.

Gains and Losses from Sale of Property

Sale of assets used in the farm business (such as real estate, equipment and breeding animals) usually results in income tax obligations due to capital gain, ordinary gain and the recapture of investment credit. There may also be tax liability due to the alternative minimum tax and/or state minimum taxes. These topics are covered in many publications dealing with farm income taxes such as annual issues of the Farmer's Tax Guide and will not be dealt with in detail here. However, it is critical to point out that even though the debt on an item of property will consume all or most of the sale price, there still may be substantial capital gain or ordinary income which will create income tax liability for the seller. This is because the gain or loss from the sale of property is the difference between the sale price and the ***tax basis*** of the property (rather than the amount of debt on the property).

Income from Cancellation of Debt

The United States Tax Code (Secs. 108 and 1017) specifies that cancellation of debt by the lender (creditor) is ordinary income to the borrower, similar to salaries, wages, net farm income, etc. The tax code refers to such debt cancellation as "discharge of indebtedness." The difference between income from discharge of indebtedness and other forms of ordinary income is that in many situations the taxpayer does not have to report the income and pay tax on it. However, in return for not reporting the income, the taxpayer must reduce "tax attributes" such as investment credit and net operating loss carryovers. More detail on this will be presented in later sections.

An example will be used to illustrate the nature of the problem. Assume that Stressed Farmer owes his creditor $300,000 on farm real estate that has a fair market value of $275,000. Stressed is unable to make the payments on the mortgage. Rather than foreclose on the property, the creditor agrees to reduce the principal on the loan to $250,000 which will make the payments manageable by Stressed. In this example, there is $50,000 of cancelled debt (discharge of indebtedness). Whether the $50,000 will be included in taxable income will depend on a number of factors discussed in a later section, Tax Treatment of Discharge of Indebtedness Income.

In some transactions, the debtor will have a combination of "discharge of indebtedness income" (IRC Sec. 61(a)(12)), capital gain income and ordinary income due to recapture of depreciation. Suppose that Stressed Farmer, rather than obtaining a reduction in the debt, decided to transfer the property to the creditor in return for the discharge of the $300,000 mortgage. Whether there is discharge of indebtedness income (DII) depends on whether the debt is recourse or nonrecourse debt. Recourse debt means that the lender has the right to obtain a judgment against the debtor for the portion of the debt not covered by the value of the property, in this example $300,000 - $275,000 = $25,000. Most farm debt is recourse, and the debt in this example is recourse. However, the debt in some seller-financed installment sales is nonrecourse.

The adjusted basis of the property in this example is $200,000 and $40,000 of rapid depreciation under the Modified Accelerated Cost Recovery System (MACRS) had been taken on the dairy facilities which are single-purpose livestock structures and silos. With recourse debt, Stressed would have the following income:

Debt discharged	$300,000
Fair market value	275,000
Discharge of indebtedness income	$ 25,000

Fair market value	$275,000
Basis	200,000
Gain	$ 75,000
Ordinary gain (recapture of depreciation)	40,000
Capital gain	$ 35,000

In the recourse debt situation, an appraisal will be necessary to establish the fair market value (FMV) of the property.

If the creditor had foreclosed on the property and it had been sold for $275,000, the result would be exactly the same as in the example above. An appraisal would not be necessary because the sale established the FMV. The only difference (from a tax standpoint) between a foreclosure sale and a voluntary transfer is that the FMV may differ because the appraiser may put a different price on the property than the auctioneer is able to obtain. This would affect the allocation between discharge of indebtedness income and gain.

If the debt had been nonrecourse, which is unlikely, the fair market value would be ignored. Essentially, for tax calculation purposes, Stressed sold the property to the creditor for the loan balance of $300,000.

Loan balance (sale price)	$300,000
Basis	200,000
Gain	$100,000
Ordinary gain (recapture of depreciation)	40,000
Capital gain	$ 60,000

Tax Treatment of Discharge of Indebtedness Income

While discharge of indebtedness income (DII) initially is included in the taxpayer's gross income, it is ***excluded*** from income if any one of the following three exceptions applies.

Exception 1: The discharge of indebtedness occurs in either a Chapter 7, Chapter 11, or Chapter 12 bankruptcy case.

Exception 2: The discharge occurs when the taxpayer is insolvent, but only to the extent of insolvency. If the taxpayer becomes solvent during the debt discharge process, the DII that occurred while the taxpayer was solvent is excluded from income only if exception 3 applies.

Exception 3: The discharge is of "qualified farm indebtedness" of solvent farmers after April 9, 1986. (Prior to 1987, there was an exception for "qualified business indebtedness" of solvent taxpayers.)

Each of these exceptions will be discussed in later sections.

In addition, income is not recognized from discharge of indebtedness if payment of the debt would have resulted in a deduction that could have been claimed by the taxpayer. For example, suppose Stressed Farmer (a cash basis taxpayer) owed $10,000 for fertilizer and was unable to pay it. The dealer cancelled the debt. Stressed would have been able to claim the $10,000 as an expense if he had paid it. Therefore, the $10,000 cancelled fertilizer debt does not produce discharge of indebtedness income (DII).

If a cancelled debt includes interest, the interest should not become DII because it would have been deductible had it been paid. If the unpaid interest had been added to the principal, it still should not be DII assuming a cash basis taxpayer who did not deduct the interest in the year that it was added to the principal. However, it may be difficult to separate the interest from cancelled principal unless the debtor and creditor have good records.

Debts Discharged in Bankruptcy

If the debt is discharged in either a Chapter 7, 11 or 12 proceeding, the discharge of indebtedness income (DII) is not included in the taxpayer's gross income. However, the DII must be used to reduce tax attributes of the debtor. This is done by using Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness. A ***tax attribute*** is something that will decrease the tax bill of a taxpayer at sometime in the future. These tax attributes, listed in the order in which the reductions are taken, are:

1. Net operating losses (NOL) for the taxable year of the discharge and any NOL carryover to that taxable year.

2. General business credit carryovers to or from the taxable year of the discharge. For farmers, the most likely credit carryover is investment credit. Unlike all the other reductions which are dollar for dollar, these credits are reduced $.33 1/3 ($.50 before 1987) for each dollar of DII excluded from income, i.e., one dollar of credit offsets three dollars of DII.

3. The minimum tax credit determined as of the beginning of the tax year following the tax 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 section 1212. (Such capital loss carryovers are unusual for farmers.)

5. Basis reduction. The basis of property owned by the taxpayer must be reduced if the reduction of the tax attributes listed above does not offset all the DII excluded from income. The basis is reduced only to the aggregate amount of debt remaining on the taxpayer's property.

6. Passive activity loss and credit carryovers from the tax year of the discharge.

7. Foreign tax credit carryovers.

Items 3 and 6 apply only to discharge of indebtedness in tax years beginning after December 31, 1993.

In a bankruptcy situation, the debtor can elect to use all or part of the excluded DII to reduce the basis in ***depreciable*** property first, before reducing the other tax attributes. The election to reduce basis does not apply to nondepreciable assets such as farmland or a personal residence. Also, the limitation on not reducing the basis below the debt on the property does not apply if the election is made to reduce the basis in depreciable property before using the other tax attributes.

Why would a taxpayer elect to reduce the basis in depreciable property before reducing other tax attributes such as NOLs and investment credit? Basis in depreciable property is something that a taxpayer will (or may) use to reduce taxes over a period of years in the future as depreciation is claimed. In contrast, investment credit or NOLs can be used immediately to offset income that would lead to tax liability. Therefore, if the taxpayer expected relatively large tax liabilities in the near future, he would be better off retaining tax attributes such as NOLs and investment credit which could be used in large amounts to reduce taxable income.

If there is discharge of indebtedness remaining after all the taxpayer's tax attributes are used, the remaining DII is not included in income. Basically, DII in a bankruptcy case is not included in income, but any tax attributes that are available must be used up to the extent of the DII.

The reductions in tax attributes are made ***after*** the income tax for the year of the discharge has been calculated. Return to the earlier example of Stressed Farmer and suppose that Stressed has the $50,000 of DII in 1994. He also has $40,000 of taxable income in 1994 and an NOL carryover to 1994 of $60,000. The NOL would first be used to reduce 1994 taxable income. Any remaining NOL would be applied to the $50,000 DII at the end of 1994 by filing Form 982. Neither the DII nor the NOL given up to offset the DII appears on Stressed Farmer's Form 1040 for 1994.

The provisions that allow the DII to be excluded from income in a bankruptcy situation mean that the taxpayer does not have to pay tax on the DII. However, the fact that any tax attributes available must be reduced means that the taxpayer loses the ability to use these tax attributes to reduce taxes in the future. Therefore, the taxpayer who has tax attributes that must be reduced eventually will pay tax on the DII to the extent that he or she has taxable income in the future.

Debts Discharged for Insolvent Debtors Outside Bankruptcy

Discharge of indebtedness income is excluded from the taxpayer's gross income if he is insolvent immediately before the discharge (because of Exception 2 listed earlier). However, ***the amount of DII excluded from income is limited to the amount of insolvency.***

If enough debt is discharged to make the taxpayer solvent, the remainder of the DII is treated under the solvent taxpayer rules.

Insolvency is defined in balance sheet terms: the excess of liabilities over the fair market value of assets. To the extent of insolvency, the DII and reduction of the tax attributes are treated exactly the same as for bankruptcy situations described in the previous section. The taxpayer has the same election to reduce the basis of depreciable assets before reducing the other tax attributes.

Insolvent Farmer has the following balance sheet:

	Assets	Liabilities
Real estate	$300,000	$350,000
All other assets	200,000	200,000
Total	$500,000	$550,000
Net worth		$-50,000

The real estate creditor cancels $50,000 of the real estate debt which becomes DII to the taxpayer. The $50,000 is excluded from income, but the taxpayer must reduce his tax attributes by $50,000 or by the entire value of the tax attributes if they total less than $50,000.

If the lender had cancelled more than $50,000 of debt, say $75,000, the first $50,000 of DII would be excluded from income (limited by the amount of insolvency) but the remainder of the DII would be treated under the rules applying to solvent debtors. As explained in the next section, the rules for solvent farmers were changed by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988 (TAMRA88).

Debt Discharged for the Solvent Farmer[1,2]

After the Tax Reform Act of 1986 and TAMRA88, some of the insolvent debtor rules (see page 5) are applied to solvent farmers for debt discharged after April 9, 1986. The discharged debt must be "qualified farm indebtedness". To meet the qualified farm

[1] Before 1987, a solvent debtor who had debts cancelled had a possibility of avoiding the recognition of DII as income under Exception 3 which applied to "qualified business indebtedness" (QBI) which is debt incurred by an individual in connection with property used in his trade or business. Most farm debt probably is QBI, but there are exceptions. Under the pre-1987 QBI rules, the only way for a solvent debtor to exclude DII from income was to reduce the basis of depreciable assets. Any excess of DII over the basis of depreciable assets was included in the taxpayer's income. However, any NOL or investment credit carryover could be used to help offset the DII that must be included in income. The qualified business indebtedness rules are repealed by the Tax Reform Act of 1986 for discharges after 1986. Therefore, this exception no longer applies unless one is dealing with a pre-1987 case.

[2] Solvent debtors other than farmers must include the DII in income except for some special provisions for discharge of real property business indebtedness that were added by the Revenue Reconciliation Act of 1993. Those provisions are beyond the scope of this publication.

indebtedness definition, (1) the debt must have been incurred directly in connection with the operation of the farm business, (2) 50 percent or more of the aggregate gross receipts of the farmer for the three previous years must have been attributable to farming, and (3) the discharging creditor must be (a) in the business of lending money and (b) not related to the farmer, did not sell the property to the farmer and did not receive a fee for the farmer's investment in the property.

These rules are quite restrictive and may prevent some solvent farmers from using tax attributes to offset DII. For example, a farmer with DII who had purchased the real estate or other property from the lender who later cancelled part or all of the debt would not meet the QFI rules, at least for the DII related to this property.

Solvent farmers must reduce tax attributes in exchange for not reporting DII as income. Also, for solvent farmers, the basis reduction for property owned by the taxpayer must take place in the following order: (1) depreciable assets, (2) land held for use in the trade or business of farming, and (3) other property. The limit on reducing the basis below the remaining debt does not apply to solvent taxpayers.

Unlike the rules for insolvent debtors, any DII remaining after the tax attributes have been reduced must be included in taxable income. In other words, if the DII exceeds the total of the tax attributes, all the tax attributes will be given up and the excess of DII over the tax attributes will be included in income and therefore may cause a tax liability.

Example for an Insolvent then Solvent Debtor

An example will illustrate the situation where a debtor has debt cancelled while he initially is insolvent but becomes solvent during the process of debt forgiveness. The initial situation is:

	Assets	Liabilities
Land	$300,000	$600,000
Depreciable real estate	200,000	
Equipment	80,000	90,000
Cattle	100,000	90,000
All other	20,000	50,000
	$700,000	$830,000

Excess of liabilities over assets = $130,000 = amount of insolvency.

Debt is cancelled by lenders as follows:

	Debt cancelled	Remaining debt	Basis
Land & depreciable real estate	$150,000	$450,000	$300,000
Equipment	10,000	80,000	70,000
Cattle	0	90,000	0
Other	30,000	20,000	0
	$190,000	$640,000	$370,000

After the debt is cancelled, the Tax Payer (T.P.) is solvent to the extent of $60,000 (he still has $700,000 of assets and his debt has been reduced to $640,000). Therefore, $130,000 of the $190,000 debt cancellation (DII) took place while T.P. was insolvent and $60,000 while T.P. was solvent.

The first step is to consider the DII while T.P. was insolvent and the tax attributes that must be reduced to avoid reporting the DII as income.

Tax attribute	Amount	Amount of DII offset
Investment credit	$ 10,000	$ 30,000
Net operating losses	70,000	70,000
Basis of depreciable real estate	160,000	*
Basis of equipment	40,000	*
Basis of land	150,000	*
Total	$430,000	$100,000

*See explanation in following paragraph.

The $10,000 of investment credit offsets $30,000 of DII, and the $70,000 of NOLs offsets $70,000 of DII for a total of $100,000 out of the $130,000 of debt that was discharged while T.P. was insolvent. The basis of the land, the depreciable real estate, and the equipment does not have to be reduced because the aggregate remaining ***debt*** on these items ($530,000) is greater than the aggregate ***basis*** of these items ($370,000).

None of the $130,000 DII that took place while T.P. was insolvent has to be included in taxable income. In return, T.P. reduced his tax attributes by $80,000 ($10,000 of IC plus $70,000 of NOLs). These reductions are made after he files the tax return for the year in which the DII occurred. If the debt on the land and depreciable assets had been less than the basis, T.P. would also have been required to reduce the basis on these assets by the excess of the basis over the debt.

The next step is to consider the $60,000 of DII that took place while T.P. was solvent. Assume that T.P. meets the "qualified farm indebtedness" rules. The rule on not reducing the basis of property below the remaining debt does not apply, so T.P. must reduce the basis of the depreciable real estate or equipment to avoid including the $60,000 of DII in income. If T.P. reduces the basis of the depreciable real estate, $60,000 of that basis will be used to offset the DII and his remaining basis is $150,000 - 60,000 = $90,000.

In this example, T.P. does not have to include any DII in income, but he has lost $80,000 of tax attributes while insolvent and $60,000 of tax attributes while solvent.

If the amount of debt cancelled while T.P. was solvent was great enough to exceed the basis in depreciable assets, T.P. would be required to reduce the basis in land to avoid including the DII in income.

It is possible that a taxpayer like T.P. would be required to include in taxable income DII due to debt cancellation that occurred while he was solvent. This could occur if the amount of debt cancelled exceeded all of T.P.'s tax attributes, including the basis in land. In our example, it is unlikely (but possible) that the lender would cancel enough debt to put T.P. in such a position.

Consider the following situation where everything is the same except that T.P.'s basis values are as follows:

Basis of depreciable real estate	$10,000
Basis of equipment	10,000
Basis of land	30,000
Total	$50,000

The $60,000 of debt that was cancelled while T.P. was solvent exceeds the basis of the depreciable real estate, equipment, and land, and there would be $10,000 of DII that T.P. would be obligated to include in taxable income.

Situation if the Qualified Farm Indebtedness Rules Are Not Met

Now suppose that T.P. did not meet the "qualified farm indebtedness" (QFI) rules because less than 50 percent of his aggregate gross receipts in the three previous years were attributable to farming.[3] T.P. must include the $60,000 DII in income. However, T.P. still has all his tax attributes because the reduction of tax attributes to offset DII does not take place until after the tax return for the year of the debt cancellation has been filed.

When T.P. files his tax return for the year during which the debt was cancelled he may use the NOL carryforward of $70,000 to reduce his taxable income. If his taxable income had been zero before including the DII, the $70,000 NOL would more than offset the DII of $60,000 and he would have no taxable income for the year.

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[3] T.P. would be in the same situation if he failed any of the qualified farm indebtedness rules discussed on pages 6 and 7.

If there was any taxable income remaining after using the NOL, the $10,000 investment credit could be used to offset part or all of the tax on it.

Now T.P. is in a different situation with respect to the DII that occurred while he was insolvent. His NOL carryforward will be reduced by the amount used on his tax return for the year that the debt cancellation while he was solvent took place. He may or may not have some investment credit, depending on whether any of it was used to offset tax liability for the year. T.P. will not include the DII that occurred while he was insolvent in income. He will give up NOL and investment credit depending on whether he has any carryforward after filing his tax return for the year that the debt was discharged.

For the taxpayer who does not meet the QFI rules, the situation will differ depending on the amount of DII, NOL, and investment credit. In our example, the DII while solvent did not result in tax liability for T.P. because he had enough NOLs to offset the DII. Even if there wasn't enough NOL to offset the DII, the investment credit carryforward would have offset all or most of the tax liability. And using the NOLs and IC to offset the tax liability for the DII while solvent did not hurt T.P. because he was going to lose them in the process of offsetting the DII while insolvent anyway.

Discharge of Indebtedness Income vs. Gain from Sale of Property

The reader will recognize that the fair market value of the property will affect the allocation between DII and gain. Is the taxpayer better off with DII or gain? There is no general answer to this question because it depends on the specific situation. If the taxpayer is bankrupt or insolvent and has no tax attributes to be reduced, he is better off with DII because it will be excluded from income and he gives up nothing in return. (For the nonbankrupt insolvent debtor, this is true only to the extent of insolvency.)

If one is dealing with a 1987 or earlier case, on either an amended or original return, the preferential treatment of capital gain may have an impact on the taxpayer's desire to influence the fair market value. Before 1987, if there were tax attributes to be reduced, the taxpayer may have been better off with gain, to the extent that it was capital gain, because only 40 percent was included in income. But the capital gain exclusion may have triggered AMT. In 1987 the taxpayer may have been better off with gain, if it was capital gain, because the top Federal tax rate on capital gain was 28 percent compared with 38.5 percent on ordinary income. In 1988 through 1990, capital gain and ordinary income effectively were taxed at the same rates, so the FMV did not affect the tax bill of an insolvent taxpayer with tax attributes to be reduced which could have been used to reduce taxes in a future year.

Since 1991 the maximum rate on capital gain income has been 28 percent, while the rates on ordinary income can exceed 28 percent. Therefore, in some situations the taxpayer would pay less tax if the FMV were higher, which would shift ordinary income (from

DII) to capital gain. In summary, the taxpayer and his tax practitioner should carefully review the consequences before trying to influence the appraiser who is setting the FMV.

Bankruptcy

There are four types of bankruptcy: Chapter 7, Chapter 11, Chapter 12 and Chapter 13.

Chapter 7 bankruptcy, sometimes called real bankruptcy, usually means that the debtor disposes of all of his assets (except exempt assets) and discontinues the business.

Chapter 11 bankruptcy is a reorganization in which the debtor at least hopes to continue in business. The debtor must prepare a plan for restructuring debt and have it approved by the court.

Chapter 12 bankruptcy is a reorganization that applies only to family farmers with debt not exceeding $1.5 million. This provision was effective beginning November 26, 1986 and originally was to have lasted for seven years but has been extended to October 1, 1998.

Chapter 13 bankruptcy is primarily a way for wage earners and small businesses to develop a plan to pay debts over a period of time. The proceedings are less expensive and complicated than for Chapters 11 or 12, but the limits on the total value of assets are low enough that only quite small farm businesses could use Chapter 13.

Realistically, most farmers in financial difficulty and considering bankruptcy would choose between Chapter 7 and Chapter 11 or 12. Experience has shown that a large proportion of farm Chapter 11 reorganizations are not successful. This is because either the creditors will not accept the plan, the bankruptcy judge will not approve a plan over the objections of creditors, or because the debtor is unable to carry out the plan even if the judge approves it. The underlying reason is that farmers who are so heavily in debt (perhaps with liabilities exceeding assets) that they petition for Chapter 11 already have restructured their debt one or more times, and therefore little room is left for a reorganization that will enable payments to be made.

Experience to date with Chapter 12 shows that reorganization plans have been put in place much faster than under Chapter 11. This is largely because the language of Chapter 12 requires that the plan be put in place within a relatively short time after the bankruptcy petition is filed. Whether these Chapter 12 plans have allowed most of those who filed and had plans confirmed to continue farming on a long-term basis is unknown.

Some Income Tax Aspects of Chapter 7 and 11 Bankruptcy

When an individual files for Chapter 7 or 11 bankruptcy, an entity called a "bankruptcy estate" is created. This is not true when a partnership or corporation files for bankruptcy nor is it true in a Chapter 12 bankruptcy. The individual will file a tax return (two if he elects two short tax years) for the year in which the bankruptcy occurred, and the bankruptcy estate will also file a tax return. If assets are to be sold, the decision of whether they are sold by the individual before declaring bankruptcy or by the bankruptcy estate can make a difference in the tax bill to be paid by the individual.

The normal tax year of an individual who enters bankruptcy does not change. For example, if the taxpayer is on a calendar year, he will continue on a calendar year. However, the individual who goes bankrupt has an election to split his own tax year into two short tax years. The first short year would end on the day before the bankruptcy is filed and the second short year would start the next day. Therefore, a total of three tax returns would be filed, two by the individual and one by the bankruptcy estate.

Any tax due on the first short tax year becomes an obligation of the bankruptcy estate rather than of the taxpayer. The tax on the second short year is an obligation of the taxpayer. If two short tax years are not elected, the entire tax bill of the individual remains the obligation of the individual.

For example, suppose that John, who is in financial difficulty, sells some assets early in the year in an attempt to lighten his debt load and payments. As a result of this sale, the income to be reported (a combination of ordinary gain and capital gain) is $60,000. Later in the year he files for Chapter 7 bankruptcy and assets are sold which produce $70,000 of reportable gain. He then quits farming and takes a nonfarm job which produces $12,000 of taxable income during the balance of the year.

If two short tax years are not elected, the $60,000 reportable gain and the $12,000 of taxable earnings will produce tax liability for the bankrupt individual. The $70,000 will produce tax liability which will be paid by the bankruptcy estate. In both cases, there may be tax attributes and other factors which will reduce the tax liability.

If two short years are elected by the individual, the tax liability on the $60,000 of pre-bankruptcy gain will be passed to the bankruptcy estate. Only the $12,000 of taxable income earned during the second short tax year will produce income tax liability for the individual. If the bankruptcy estate does not have enough assets to pay the tax liability on the first short year, the remaining tax liability is passed back to the individual. However, the tax bill is a priority claim on the bankruptcy estate, so it normally is paid before at least some of the other claims against the bankruptcy estate are paid.

This example is somewhat oversimplified. In some cases there would be profits or losses from this year's farm operations, NOL carryover, and investment credit carryovers which would affect the actual tax liability of both the debtor and the bankruptcy estate.

A possible problem that can arise is ***abandonment*** of property by the trustee of the bankruptcy estate back to the bankrupt person. This could occur if the trustee finds that the value of one or more of the assets is less than the debt on that asset. The creditors other than the ones involved with this asset would be better off without the asset and the trustee, therefore, abandons it to the bankrupt person. Now the bankrupt person will be liable for any tax due to the sale of this asset and would not achieve his objective of transferring the tax liability to the bankruptcy estate.

If two short tax years are not elected, the "tax attributes" of the debtor at the beginning of the normal tax year such as NOLs and investment credit carryovers automatically pass to the bankruptcy estate. Therefore, the debtor loses the ability to use these tax attributes to reduce his tax bill. If two short years are elected, such carryovers stay with the taxpayer during the first short year and can be used in the first short year before being passed to the bankruptcy estate as of the first day of the second short year.

If the debtor has taxable income in the period of his tax year before declaring bankruptcy, it usually will be to his advantage to elect two short years. The tax attributes will reduce the debtor's taxable income and tax if two short years are elected but not if the election is not made. In addition, any tax on the remaining taxable income will become a liability of the bankruptcy estate rather than of the debtor. Tax attributes such as investment credit and NOLs left over in the bankruptcy estate are passed back to the individual once the bankruptcy estate is terminated.

The debtor and his/her accountant should carefully estimate the tax consequences to the debtor before the decision is made to elect two short tax years. The election must be made before the 15th day of the fourth month after the end of the month in which the bankruptcy petition is filed. Once it is made, the election is irrevocable.

The election of two short tax years will not necessarily reduce the total tax liability of the debtor plus the bankruptcy estate. However, because the debtor is not responsible for the tax on the bankruptcy estate, he should be interested in minimizing the tax that he will be obligated to pay. It should be noted that the tax paid by the bankruptcy estate will come out of the unsecured creditors in situations where there is not enough money in the bankruptcy estate to satisfy all the claims.

Timing of Sale of Assets

Timing of the sale of assets may be important in determining the tax liability of the debtor. This is particularly true in Chapter 7 cases. As noted earlier, the tax liability on the first short tax year becomes an obligation of the bankruptcy estate. However, if there are no assets in the bankruptcy estate to pay the tax due on the short year, the remaining tax liability is not discharged but goes back to the debtor and can be collected from him. If most or all of the assets are sold and the money is used to pay down debts ***before*** the bankruptcy petition is filed, the estate will be left with debts but little or no income.

Therefore, there will be little or no funds with which to pay the tax on the first short year, and it will become an obligation of the debtor.

The individual who is contemplating bankruptcy should, in consultation with his attorney and tax advisor, carefully consider whether assets should be sold before or after declaring bankruptcy. They should also keep in mind that the sale timing decision interacts with the election of two short tax years.

Additional Information

The following publications are among the sources of additional information on the subjects of this bulletin:

Bock, C. Allen and Philip E. Harris. *Tax Consequences of Financial Distress Transactions*. Publication Services, Champaign, Illinois. 1993.

Bock, C. Allen and Philip E. Harris. *Farm Income Tax Schools Workbook.* Cooperative Extension Service, University of Illinois. Published annually and available to tax practitioners who attend tax schools which use this workbook.

Brownbach, Sam, Douglas F. Beech, DeAnn E. Hupe, and David M. Saxowsky. *Foreclosure, Bankruptcy and the Tax Implications of Liquidating a Farm Operation.* Cooperative Extension Service, Kansas State University, Manhattan, Kansas.

Saxowsky, David M., David L. Watt, and W. Allan Tinsley. *Tax Implications of Liquidating a Farm Operation.* Published by the Federal Extension Service, Washington, DC. November 1986.

Saxowsky, David M., Philip E. Harris, and W. Allan Tinsley. *Tax Implications of Liquidating a Farm Operation After the Tax Reform Act of 1986.* Published by the Federal Extension Service, Washington, DC. 1987.

OTHER A.R.M.E. EXTENSION BULLETINS
(Formerly A.E. Extension Publications)

No. 94-13	Dairy Farm Business Summary Oneida-Mohawk Region 1993	Eddy L. LaDue Jacqueline M. Mierek Charles Z. Radick Linda D. Putnam
No. 94-14	Dairy Farm Business Summary Southeastern New York Region 1993	Stuart F. Smith Linda D. Putnam Alan S. White Stephen E. Hadcock Larry R. Hulle
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