DESCRIPTION OF S. 1041

RELATING TO

CAPITAL GAIN ON TRANSFER OF FARM PROPERTY

IN DISCHARGE OF CERTAIN FARM INDEBTEDNESS

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

of the

SENATE COMMITTEE ON FINANCE

on July 28, 1989

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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JCX-36-89

INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance has scheduled a public hearing on July 28, 1989, on S. 1041 (introduced by Senators Conrad, Daschle, Boren, and others). The bill would provide tax relief for certain farmers who realize gain on the transfer of farm property in satisfaction of farm indebtedness. In addition, the bill provides that farmers meeting certain requirements could exclude income from discharge of farm indebtedness, subject to a maximum dollar limit.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the provisions of the bill, including present law and effective dates.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of S. 1041, Relating to Capital Gain on Transfer of Farm Property in Discharge of Certain Farm Indebtedness (JCX-36-89), July 21, 1989.

DESCRIPTION OF S. 1041: CAPITAL GAIN ON TRANSFER OF FARM PROPERTY IN DISCHARGE OF CERTAIN FARM INDEBTEDNESS

Present Law and Background

Gain on transfer of property for cancellation of indebtedness

Gain from the sale or other disposition of property is determined by computing the excess of the amount realized therefrom over the adjusted basis of the property. The amount realized is the sum of any money received plus the fair market value of any property (other than money) received. In general, the entire amount of gain determined on the sale or exchange of property is recognized for Federal income tax purposes (sec. 1001).

If a taxpayer transfers property to a creditor in exchange for the cancellation of an indebtedness, the taxpayer may recognize both gain on the property and cancellation of indebtedness income. The transfer of property in consideration of the cancellation of indebtedness is equivalent to a sale for Federal income tax purposes. For example, if the debt that is cancelled is one for which the taxpayer is personally liable, gain will be recognized in the amount of the excess of the fair market value of the property over the basis of the property. In addition, the taxpayer will have discharge of indebtedness income in an amount equal to the excess of the amount of the debt discharged over the fair market value of the property.

Cancellation of indebtedness income

Gross income generally includes income from the discharge of indebtedness (sec. 61(a)(12)).

Treatment of insolvent taxpayer

If an insolvent taxpayer realizes income from discharge of indebtedness, the income is excluded and certain tax attributes of the taxpayer (including items such as net operating loss carryovers and basis in property) generally are reduced by the excluded amount. The exclusion is limited to the amount by which the taxpayer is insolvent. If the taxpayer's discharge of indebtedness income (not in excess of the amount by which the taxpayer is insolvent) exceeds these tax attributes, the excess is forgiven, i.e., is not includible in income (sec. 108).

Treatment of certain farm indebtedness

The Tax Reform Act of 1986 provided that, in the case of a solvent taxpayer who realizes income from the discharge by a "qualified person" of "qualified farm indebtedness," the discharge is treated in a manner similar to a discharge incurred by an insolvent taxpayer (sec. 108(g)). Qualified farm indebtedness is indebtedness incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a specified gross receipts test. The gross receipts test is satisfied if 50 percent or more of the taxpayer's average annual gross receipts for the three taxable years preceding the taxable year in which the discharged indebtedness occurs is attributable to the trade or business of farming. A qualified person is one regularly engaged in the business of lending money and meeting certain other requirements. The Technical and Miscellaneous Revenue Act of 1988 provided that the amount excluded under this provision generally may not exceed the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in property held for use in a trade or business or for the production of income. Thus, if there is any remaining discharge of indebtedness income after the taxpayer has reduced these tax attributes, income will be recognized.

Explanation of the Bill

In general

S. 1041 (introduced by Senators Conrad, Daschle, Boren, Harkin, Kerrey, Dixon and Burdick on May 18, 1989) would provide tax relief for certain farmers who realize gain on the transfer of farm property in satisfaction of farm indebtedness. In addition, the bill provides that farmers meeting certain requirements could exclude income from discharge of farm indebtedness, subject to a maximum dollar limit.

Exclusion of certain gains

The bill would exclude from the gross income of certain farmers that portion of the gain from the transfer of farm property in complete or partial satisfaction of qualified farm indebtedness (i.e., debt incurred directly in connection with the trade or business of farming) that does not exceed $350,000. This rule would apply to a taxpayer that meets all of the following requirements: (1) the taxpayer's adjusted gross income (with certain modifications) is less than the national median adjusted gross income; (2) more than 50 percent of the taxpayer's gross receipts for 6 of the 10 taxable years preceding the year of transfer is attributable to the farming business, the sale or lease of assets used in farming, or both; (3) the taxpayer materially participates in the farming business; and (4) the amount of equity in all property held by the taxpayer after the transfer is less than the greater of (a) $25,000 or (b) 150 percent of the excess of the tax that would be due if this provision and section 108 of the Internal Revenue Code (which relates to exclusions of certain discharge of indebtedness income) did not apply, over the tax that would be due if this provision and section 108 did apply.

The bill provides that the $350,000 limit on excludable gains would be reduced by prior year exclusions of gains under this provision, as well as by current year and certain prior year exclusions of discharge of indebtedness income under section 108. In addition, any amount that is excluded by reason of this provision would reduce certain tax attributes of the taxpayer.

Exclusion of discharge of indebtedness income

The bill provides that farmers meeting certain requirements could exclude income from discharge of qualified farm indebtedness, but not in excess of $350,000. This provision would apply to a taxpayer meeting the requirements described above if, in addition: (1) the taxpayer's indebtedness both before and after the discharge is equal to 70 percent or more of the equity in all property held by the taxpayer, and (2) the taxpayer transfers only farm property to discharge the qualified farm indebtedness.

The bill provides that the $350,000 limit would be reduced by prior year exclusions of gains from the transfer of farm property (under the provision described above) and prior year exclusions of discharge of qualified farm indebtedness income under this provision.

The present-law rule that generally limits the exclusion of income from the discharge of qualified farm indebtedness to the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in certain property, would not be changed by this provision of the bill.

Effective Dates

The gain exclusion provision of the bill would apply to transfers after December 31, 1986, in taxable years ending after such date. The provision of the bill relating to the exclusion of discharge of indebtedness income would apply to discharges of indebtedness occurring after December 31, 1986 in taxable years ending after such date.