Chapter 11

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I. Introduction

Experiencing a disaster and receiving insurance payments or any of the various forms of disaster assistance will most likely affect a farmer's federal income tax obligations. This chapter discusses briefly only four of the many ways that a disaster can affect tax obligations.

First, the farmer's income tax obligation may decrease if the disaster caused damages that are deductible as casualty losses. Second, the farmer's income tax obligation may increase if disaster relief, government payments, and insurance payments are counted as taxable income. Third, the disaster could lead to debt cancellation by a creditor. This cancellation of debt can then have income tax consequences, often increasing the farmer's tax obligation. And fourth, disaster losses could lead a farmer to file a bankruptcy petition, which can have income tax consequences.[1]

II. Find Expert Advice

The intent of this chapter is only to give general highlights. Many of the federal income tax issues that will be significant for a farmer facing the effects of a disaster are not mentioned in this chapter.[2] State income tax rules present an additional set of complications. Further, the issues that are addressed in this chapter are discussed only briefly. This short chapter should therefore not be used to answer specific questions about income tax problems. Instead, it is crucial for farmers to find expert advice when confronted with income tax issues.

III. Losses Due to Disaster

For federal income tax purposes, when property is damaged by an accident or some sudden, unexpected, or unusual event—such as fire, storm, or flood—the property damage is referred to as a casualty loss.[3]

A. Deducting Casualty Losses

Casualty losses often can be deducted from income when calculating federal income taxes. In general, this is true whether the damaged property is used in the farming business or held for personal purposes.[4] Insurance payments or other compensation received for the property damage will reduce the amount of the eligible casualty loss claim.[5]

B. Quick Tax Refunds From Casualty Losses

If the taxpayer lives in a presidentially declared disaster area, some casualty losses may be reported to the Internal Revenue Service (IRS) as if they happened in the prior year.[6] For a casualty loss that happened in 2008, for example, it may be possible to amend a 2007 income tax return to claim the loss for 2007. If this is done, a taxpayer could get relatively quick tax relief for the disaster losses.

If a taxpayer is claiming a casualty loss in order to receive an income tax refund, the IRS has suggested writing "Disaster Area Loss" at the top of the amended return or claim for refund. It is also advisable to include a statement of the dates of the disaster and the state and county or counties where the damaged property is located.

C. Complications in Claiming Casualty Losses

Claiming casualty losses can be complicated, especially for farmers. For example, the amount of the loss can be hard to measure.[7] The deduction will depend on a number of factors, such as whether the damaged property was raised or grown by the taxpayer or was purchased.[8] In addition, the amount of the casualty loss deduction may be different depending on whether the damaged property is farm business property or personal-use property.[9] To resolve these and other problems, farmers need to discuss casualty losses with a tax expert.

D. Some Noncasualty Losses Also Deductible

Farm business assets that are damaged by a disaster but do not qualify as a casualty loss may still provide a loss deduction.[10]

E. Sale of Livestock Due to Weather

Farmers who have to sell livestock, including poultry, earlier than planned because of drought, flood, or other weather-related conditions may be able to include the income from the sale of the livestock in the following year's income.[11] This allows the farmer to avoid the bunching of income in one tax year.

F. Carrying Disaster-Related Farm Operating Losses Backward and Forward

Federal tax law generally allows businesses to carry a net operating loss back two years and forward 20 years to offset taxable income in those years.[12] Taxpayers may be able to carry a net operating loss back three years if the loss is due to a presidentially declared disaster.[13] There is also a separate five-year carryback period for farm operating losses, whether or not the losses are due to a disaster.[14]

To maximize the value of a carryback election, a farmer must understand which of the different operating loss options will be the most beneficial for the circumstances. The election itself requires the taxpayer to file certain statements within specified time limits.[15] Farmers with disaster losses are therefore advised to seek expert assistance in calculating and claiming their net operating loss deductions.

IV. Insurance and Other Disaster Benefits Considered Income

Most government payments to farmers are considered taxable income.[16] Generally, this includes disaster relief benefits.[17] Insurance payments will often be considered income as well.[18] Under some circumstances, farmers may be able to put off for one year reporting crop insurance payments and disaster payments as income.[19]

One exception to the rule that payments received under government programs are taxable income is the Emergency Conservation Program discussed in Chapter 5 of this book.[20] Payments under this program are not taxable income.

V. Cancellation of Debt Can Create a Tax Liability

Whenever a debt is reduced or canceled, there is a potential for tax liability. For example, if a farmer works out an agreement with a lender to reduce his or her debt, this will often result in an income tax obligation for the farmer. Similarly, if a farmer voluntarily or involuntarily gives up property in order to pay debt, this almost always has tax consequences even if no cash actually changes hands.

In general, cancellation of a debt results in taxable income to the debtor in the amount of debt canceled.[21] Understanding how to put this general rule into practice, however, can be quite complicated. For example, a debtor is not required to declare the income until the debt is actually canceled, but the timing of the debt cancellation can be difficult to pinpoint.[22] Other aspects of the debt cancellation can be equally complicated.

Despite the general rule that debt cancellation is considered income, there are several circumstances in which the cancellation of debt does not create taxable income.[23] First, no income is realized from the cancellation of a debt to the extent that payment of the debt would have made the taxpayer eligible for a deduction.[24]

The second common exception involves a debtor who is technically "insolvent." A debtor is insolvent if his or her debts exceed the fair market value of his or her assets.[25] An insolvent debtor can generally exclude debt-cancellation income from gross income—up to the amount of his or her excess debts—when filing an income tax return.[26] Determining whether insolvency exists, however, can be more difficult than it first appears.[27]

Third, some non-bankruptcy debt cancellation might not be taxable as income if the debt is "qualified farm indebtedness."[28] This debt must have come directly from the farming operation, and at least 50 percent of the taxpayer's total gross income for the previous three years must have come from farming.[29]

Fourth, discharge of debt in a Chapter 11 bankruptcy is not taxable as income.[30]

Fifth, taxpayers who are not corporations might not be taxed on the cancellation of "qualified real property business indebtedness."[31] Qualified real property business indebtedness is debt acquired in connection with real property used in a trade or business and secured by that property.[32] Debts taken on after January 1, 1993, are only considered qualified real property business indebtedness if they were taken on for the purpose of acquiring, constructing, or substantially improving real property.[33]

There are other exceptions to the general rule regarding income from debt cancellation, and the use of any of the exceptions can be very complicated. Farmers are urged to consult a tax expert regarding their specific circumstances.

VI. Taxes and Bankruptcy

A. Relieving Tax Debts in Bankruptcy

In some cases, taxes owed to a government entity can be discharged in bankruptcy as if they were a debt owed to any other creditor.[34] The extent to which this is possible depends on a number of factors including, in some cases, how long the taxes have been owed.

B. Tax Obligations in Bankruptcy

The tax consequences of filing a bankruptcy petition can vary greatly depending on a number of factors, beginning with the type of bankruptcy filed. In general, the act of voluntarily filing for bankruptcy creates a separate entity—called an "estate"—that takes ownership of the debtor's assets.[35] When the estate sells property or when debt is canceled, it may be that the estate and not the debtor will owe taxes on the income.[36] However, sometimes income from the transfer or sale of property or cancellation of debt in bankruptcy may still be taxable to the debtor.

A debtor using either Chapter 7 or Chapter 11 bankruptcy has the option of stopping the tax year on the day the bankruptcy petition is filed and dividing the normal tax year into two separate parts.[37] This can be an extremely important—and complicated—decision for debtors and should only be made with advice from a tax expert. Large tax liabilities can hang in the balance.

VII. More Information

For more information about federal income tax obligations after a disaster, contact the IRS at 800-829-1040.

IRS forms and publications are also available on the IRS website at www.irs.gov.

IRS publications that might be helpful include:

- Pub. 225 Farmer's Tax Guide
- Pub. 536 Net Operating (NOLs) Losses for Individuals, Estates, and Trusts
- Pub. 544 Sales and Other Dispositions of Assets
- Pub. 547 Casualties, Disaster, and Thefts (Business and Nonbusiness)

- Pub. 584 Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
- Pub. 584B Casualty, Disaster and Theft Loss Workbook
- Pub. 908 Bankruptcy Tax Guide
- Pub. 2194 Disaster Losses Kit for Individuals
- Pub. 2194B Disaster Losses Kit for Businesses

Chapter 11 Notes

[1] The following sources are helpful in the area of farm taxation: Neil E. Harl, FARM INCOME TAX MANUAL (Matthew Bender 2007) and AGRICULTURAL LAW (Matthew Bender 2007); Neil E. Harl and Roger A. McEowen, REPORTING FARM INCOME (BNA/Tax Management 2005); Gregory E. Stern, TAX ASPECTS OF RESTRUCTURING FINANCIALLY TROUBLED BUSINESSES (BNA/Tax Management 2002); and William Tatlock, DISCHARGE OF INDEBTEDNESS, BANKRUPTCY AND INSOLVENCY (BNA/Tax Management 2003).

[2] Many additional federal income tax issues may be directly or indirectly triggered by a disaster. For example, a disaster often triggers what the tax code refers to as an "involuntary conversion" of property. 26 U.S.C. § 1033. Similarly, the sale or transfer of property after a disaster can create income or loss for the farmer. Such gains or losses on property used in a business are generally governed by 26 U.S.C. § 1231.

[3] 26 U.S.C. § 165(c), (h).

[4] No deduction may be taken on the first $100 of loss on personal property. 26 U.S.C. § 165(h)(1).

[5] 26 U.S.C. § 165(a).

[6] 26 U.S.C. § 165(i)(1). If the taxpayer does not choose to move the loss claim back to the preceding year, the loss is deductible on the disaster year tax return.

[7] See IRS Publication 225, FARMER'S TAX GUIDE (2007), at 64-71.

[8] FARMER'S TAX GUIDE, at 65.

[9] FARMER'S TAX GUIDE, at 65-67.

[10] See, for example, FARMER'S TAX GUIDE, at 64.

[11] 26 U.S.C. § 451(e); FARMER'S TAX GUIDE, at 8-9.

[12] 26 U.S.C. § 172(b)(1)(A).

[13] 26 U.S.C. § 172(b)(1)(F).

[14] 26 U.S.C. § 172(b)(1)(G), (i).

[15] See, IRS Publication 536, NET OPERATING LOSSES (NOLS) FOR INDIVIDUALS, ESTATES, AND TRUSTS (2007).

[16] See 26 U.S.C. § 61(a).

[17] 26 U.S.C. § 451(d); FARMER'S TAX GUIDE, at 10-11.

[18] Insurance proceeds that exceed the farmer's adjusted basis in the damaged property are considered income. See FARMER'S TAX GUIDE, at 66. However, the income will not be recognized for tax purposes if the taxpayer uses the excess amount to restore or replace the damaged property within a certain period, usually two years. 26 U.S.C. § 1033.

[19] 26 U.S.C. § 451(d).

[20] 26 U.S.C. § 126(a)(4).

[21] 26 U.S.C. § 61(a)(12).

[22] See, for example, *Milenbach v. Comm'r*, 318 F.3d 924 (9th Cir. 2003); *Friedman v. Comm'r*, 216 F.3d 537 (6th Cir. 2000); *Exchange Security Bank v. United States*, 492 F.2d 1096 (5th Cir. 1974). If there is more than one debtor, the tax implications can be even more complicated.

[23] 26 U.S.C. § 108.

[24] 26 U.S.C. § 108(e)(2).

[25] 26 U.S.C. § 108(d)(3). This calculation is made based on the taxpayer's assets and liabilities just before the debt cancellation.

[26] 26 U.S.C. § 108(a)(1)(B), (a)(3).

[27] The IRS has taken the position that all of a debtor's assets must be considered available when determining whether the debtor is able to exclude debt-cancellation income because of insolvency. Private Letter Ruling 99-32-019 (May 10, 1999). This position was adopted by the Tax Court in 2001. *Carlson v. Comm'r*, 116 T.C. 87 (2001). Assets that are exempt from creditor collection actions under state law are therefore not excluded when determining whether a debtor's assets exceed his or her liabilities for income tax purposes.

[28] 26 U.S.C. § 108(a)(1)(C). The amount of canceled debt excluded from income as qualified farm indebtedness cannot exceed the sum of what are known as the taxpayer's adjusted "tax attributes" and the adjusted basis of the qualified property. 26 U.S.C. § 108(g)(3).

[29] 26 U.S.C. § 108(g)(2).

[30] 26 U.S.C. § 108(a)(1)(A). See Chapter 10 of this book for brief descriptions of the different types of bankruptcy.

[31] 26 U.S.C. § 108(a)(1)(D), (c). Qualified real property business indebtedness does not include qualified farm indebtedness. 26 U.S.C. § 108(c)(3).

[32] 26 U.S.C. § 108(c)(3).

[33] 26 U.S.C. § 108(c)(3)(B), (c)(4). The amount excluded from the debtor's gross income is generally capped by the amount that the principal owing on the canceled debt exceeds the fair market value of the property securing the debt. 26 U.S.C. § 108(c)(2)(A).

[34] 11 U.S.C. § 523(a)(1).

[35] 11 U.S.C. § 541(a). The taxpayer's interest in certain "exempt" assets—such as a home, personal vehicle, furnishings, and tools of a trade—are generally not taken into the bankruptcy estate. 11 U.S.C. § 522(b), (d).

[36] 26 U.S.C. § 1398(c), (f)(1); 11 U.S.C. § 346(a).

[37] 26 U.S.C. § 1398(a), (d).