

Shared Appreciation Agreements

Abstract:

Certain farmers who had Farm Service Agency (FSA) loans were eligible for a write-down of the loan if they met certain criteria. As a condition of the write-down, the FSA is allowed to require the farmer to enter into a shared-appreciation agreement. This agreement obligates the farmer to repay part or all of the debt if the land appreciates in value from the time the debt is restructured until a trigger event occurs. This material discusses the tax consequences of the write-down and the recapture.

ISSUE 4: SHARED APPRECIATION AGREEMENTS

Farmers who have loans from the Farm Service Agency are eligible for a write -down of the loan if they meet certain criteria. As a condition for the write -down, the FSA is allowed to require the farmer to enter into a Shared Appreciation Agreement that obligates the farmer to repay part or all of the debt write-down if the land appreciates in value from the time of the restructuring to the occurrence of a recapture event. The recapture events are set out in 7 U.S.C. §2001(e)(4) as follows:

(4) Time of recapture

Recapture shall take place at the end of the term of the agreement, or sooner —

- (A) on the conveyance of the property;
- (B) on the repayment of the loans; or
- (C) if the borrower ceases farming operations.

A Shared Appreciation Agreement raises the income tax question of whether there is discharge of indebtedness income at the time the debt is restructured.

Example 1. In 1996, Sarah Songbird owed the FSA \$270,000 and was delinquent on her payments. The FSA offered to let her buy out the debt for the \$92,000 net recovery value of her farm if she agreed to a Shared Appreciation Agreement. Under the Shared Appreciation Agreement, the FSA can recapture 75% of the appreciation in value of Sarah's farm if a recapture event occurs within four years of the date of the write-down or 50% of the appreciation in value if the recapture event occurs more than four years after the date of the write-down. Sarah accepted the offer and borrowed \$92,000 from a local bank to pay the FSA. The FSA wrote off the remaining \$178,000 of debt.

The income tax question is whether the Shared Appreciation Agreement delays the discharge of indebtedness until the recapture event. If so, then Sarah has no discharge of indebtedness income in 1996. If not, \$178,000 debt write-down is discharge of indebtedness in 1996.

IRS Position

In a letter to Chet Bailey, Farmer Program Division, Farm Service Agency, dated May 22, 1989, Peter K. Scott, Acting Chief Counsel of the Internal Revenue Service, states that farmers must treat the debt write-down as discharge of indebtedness in the year of the write-down. That conclusion was based on the reasoning that the Shared Appreciation Agreement is so contingent that it is impossible to estimate whether and when any amount will be paid under the Shared Appreciation Agreement.

Example 2. Under the IRS interpretation, Sarah in Example 1 realized \$178,000 of discharge of indebtedness income in 1996.

Tax Court Position

In *Jelle v. Commissioner*, 116 T.C. 63 (2001), the Tax Court reached the same conclusion. However, that conclusion was based on a different interpretation of the Shared Appreciation Agreement. In *Jelle*, the Shared Appreciation Agreement had only one recapture event—the sale of any part or all of the real estate within 10 years of the agreement. If taxpayers chose not to dispose of their property, then no further payments would be due. Based on that agreement, the Tax Court concluded that “whether and when the [taxpayers] would ever be required to make any further payments to FmHA (the predecessor to the FSA) rested totally within their own control.” Consequently, the court found that the taxpayer’s obligation was “highly contingent” and followed prior case law in holding that the debt write-down was discharge of indebtedness income in the year of the write-down.

Alternative Position

Taxpayers could argue that the Shared Appreciation Agreement results in no discharge of indebtedness income in the year of the agreement since the agreement may require part or all of the write-down to be repaid to the FSA. The discharge, if any, occurs when there is no longer a potential recapture of the write-down.

Example 3. Under this argument, Sarah in Example 1 has no discharge of indebtedness income in 1996. She will have discharge of indebtedness only if the Shared Appreciation Agreement expires without triggering an obligation to repay all of the write-down. There could be several different scenarios resulting in part, with all or none of the write-down becoming discharge of indebtedness income.

Scenario 1. Sarah does not trigger a recapture event before the end of the 10-year agreement. At the end of the 10 years, her land has appreciated by \$400,000. Sarah is required to recapture \$178,000, which is the lesser of:

1. The \$178,000 debt write-down, or
2. 50% of the \$400,000 appreciation, which is \$200,000

Since Sarah is required to repay all of the write-down, she has no discharge of indebtedness income in 2006 or in any other year.

Scenario 2. Sarah sells the land for its \$292,000 fair market value in 2001. That triggering event requires her to recapture \$100,000, which is the lesser of:

1. The \$178,000 debt write-down, or
2. 50% of the \$200,000 appreciation (\$292,000 - \$92,000), which is \$100,000

Since Sarah will never have to repay \$78,000 (\$178,000 - \$100,000) of the write-down, she has \$78,000 of discharge of indebtedness income in 2001. She has no discharge of indebtedness income in any other year.

Scenario 3. Sarah quits farming in 1998, when her land is still valued at \$92,000. That triggering event requires her to recapture nothing since there is no appreciation. Her recapture amount is the lesser of:

1. The \$178,000 write-down, or
2. 75% of the zero appreciation (\$92,000 - \$92,000), which is zero

Since Sarah will never have to repay any of the debt write-down, she has \$178,000 of discharge of indebtedness income in 1998.

Which Position Is Best for the Taxpayer?

On its face, the alternative position discussed above appears to be the best for the taxpayer because it postpones the recognition of discharge of indebtedness income and may result in never recognizing discharge of indebtedness income. That will be true in some cases.

Example 4. Assume the same facts as in Example 3, Scenario 3, and in addition, assume that Sarah did not qualify for any of the I.R.C. §108 exceptions to recognizing discharge of indebtedness income in 1996 or in 1998.

Under the IRS position, Sarah is required to report \$178,000 of discharge of indebtedness income in 1996. Under the alternative position, she is required to report \$178,000 of discharge of indebtedness income in 1998.

However, some taxpayers may be better off under the IRS interpretation because they may qualify for an exception to recognizing the discharge of indebtedness income in the year of the agreement and not qualify for an exception in the year of recapture.

Example 5. Assume the same facts as Example 3, Scenario 2, and in addition, assume that Sarah was \$200,000 insolvent when she entered into the agreement in 1996, but was solvent when she triggered the \$100,000 recapture in 2001. Also assume that the FSA debt was her only debt and that her only tax attribute was \$100,000 of basis.

The IRS position would allow Sarah to realize the \$178,000 of discharge of indebtedness in 1996 when she is insolvent and not have to recognize any of it as income. She does have to reduce tax attributes as a consequence of not recognizing the income. That requires her to reduce her basis by \$8,000 down to the \$92,000 of debt

that remains after the discharge. After that reduction, there is no further reduction of tax attributes as a consequence of not recognizing the \$178,000 of discharge of indebtedness income.

The alternative position would require Sarah to recognize the \$78,000 discharge of indebtedness income in 2001.

Practitioner Note. In some cases, the IRS position will allow taxpayers to restore tax attributes that are reduced as a result of the discharge of indebtedness income when the taxpayer is required to repay the FSA. See the discussion of recapture below.

Which Position Is Likely to Prevail?

Based on current case law, it is difficult to predict which position will prevail. Although the Tax Court ruled in favor of the IRS in *Jelle, supra*, the facts in that case can be distinguished from most Shared Appreciation Agreements. The only recapture event in *Jelle* was sale of the property within 10 years of the agreement. As the *Jelle* court noted, the taxpayer had considerable control over that recapture event. By contrast, most Shared Appreciation Agreements will include three more recapture events over which the taxpayer has less control. The taxpayer has some control over two of them — cessation of farming and default on the loan. The taxpayer has no control at all over the third recapture event—expiration of the 10-year period. Consequently, *Jelle* is not a strong precedent for the IRS with respect to Shared Appreciation Agreements that include expiration of the 10-year period as a recapture event.

Whether the recapture is triggered by the expiration of the 10-year period is itself the subject of litigation. In *Israel v. USDA*, 135 F. Supp. 2d 945 (W.D. Wis.), the farmers who had entered into a Shared Appreciation Agreement argued they did not owe the recapture amount at the end of the 10-year period because the Shared Appreciation Agreement was ambiguous and they had relied on oral statements from FSA employees that they would not owe any recapture amount at the end of the agreement. The trial court held that the expiration of the 10-year period was a recapture event and required the farmers to pay the recapture amount. *Israel* has been appealed to the 7th Circuit Court of Appeals and other cases on this issue are pending in other courts. Therefore, the ultimate interpretation of the Shared Appreciation Agreements could go either way.

If the Shared Appreciation Agreements are ultimately held to **not** require recapture at the end of the 10-year period, then the IRS position is more likely to prevail on the tax issue. If the Shared Appreciation Agreement is ultimately held to require recapture at the end of the 10-year period (as the FSA argues) then the IRS could still prevail on the tax issue, but it is less likely to prevail.

In order to prevail on the tax issue, the IRS must convince the court that the recapture provision in the Shared Appreciation Agreement is “highly contingent.” The application of the test was described as follows in *Zappo v. Commissioner*, 81 T.C. 77 (1983), at page 90:

When an obligation is highly contingent and has no presently ascertainable value, it cannot refinance or substitute for the discharge of a true debt. The very uncertainty of the highly contingent replacement obligation prevents it from reencumbering assets freed by discharge of the true debt until some

indeterminable date when the contingencies are removed. In a word, there is no real continuation of indebtedness when a highly contingent obligation is substituted for a true debt. Consequently, the rule in *Kirby Lumber* applies, and gain is realized to the extent the taxpayer is discharged from the initial indebtedness.

Taxpayers can argue that the date the contingency is removed is determinable in a Shared Appreciation Agreement for which expiration is a re capture event since it can be no later than the expiration date. They can also argue that the asset was never free of the encumbrance and the true debt continues until a recapture event occurs. Given that the value of land is very likely to increase in a 10-year period, in almost all cases, the taxpayer must repay part of the write-down and in many cases they will repay all of the write-down.

Practitioner Note. Shared Appreciation Agreements entered into after August 18, 2000 have a five year period. The end of the five-year period is a recapture event.

To illustrate the income tax consequences of the recapture payment under the Shared Appreciation Agreement, we begin with an example of the income tax consequences of the debt reduction.

Example 6. On May 1, 1991, Matthew Horton owed FmHA \$150,000 of principal plus \$15,000 accrued interest. At that time, he entered into a buy-out agreement with FmHA under which he paid \$125,000 (the fair market value of the farm at the time of the workout) and the FmHA terminated his obligation to pay \$15,000 of accrued interest and \$150,000 of principal on his farm loan. Under the terms of the loan, payments are first applied to accrued interest and then to principal. Therefore, the workout agreement resulted in a discharge of \$15,000 of interest and \$25,000 of principal.

The workout included a Shared Appreciation Agreement that requires Matthew to pay the FSA 50% of the appreciation in value of the collateral on the earlier of:

1. The end of the agreement, which is May 1, 2001
2. The date the borrower transfers the property, defaults on the debt, or ceases farming

The total amount recoverable under the Shared Appreciation Agreement is limited to the \$40,000 of debt written down.

Before the workout, Matthew's total debt was \$338,000, his assets were worth \$300,000, and his adjusted basis in assets was \$302,000. After the workout, his debt was \$298,000 and his assets were still worth \$300,000. The debt was not qualified farm indebtedness because Matthew did not meet the requirement that 50% or more of his gross receipts were from farming for the three preceding tax years [I.R.C. §108(g)(2)(B)].

On his 1991 income tax return, Matthew followed the IRS position and reported the following on Form 982:

1. The \$15,000 of interest was not reported as income. It is excluded from income under I.R.C. §108(e)(2) because Matthew could have claimed a deduction if he had paid that interest.
2. After the \$15,000 of interest was discharged, Matthew had \$323,000 of debts and \$300,000 FMV of assets. Therefore, the first \$23,000 of the \$25,000 discharged principal was excluded from income under the insolvency exception [I.R.C. §108(a)(1)(B)]. Matthew reduced tax attributes as follows:
 - a. NOLs were reduced by \$16,000. That paid the price for \$16,000 of the \$23,000 that was excluded under the insolvency exception leaving, \$7,000 to be accounted for.
 - b. Bases of assets were reduced by \$4,000. Bases were not reduced any further because the \$4,000 reduction brought Matthew's aggregate bases in assets down to an amount that is equal to his remaining debt after the discharge (\$298,000). That paid the price for another \$4,000 of the \$23,000 that was excluded under the insolvency exception, leaving \$3,000 to be accounted for.
 - c. No attributes were reduced for the remaining \$3,000 of discharged debt that was not recognized under the insolvency rules because Matthew exhausted all available attributes.
3. The remaining \$2,000 of discharged debt was recognized as income (since Matthew was solvent to the extent of \$2,000 after the discharge).

See the 1999 *Farm Income Tax School Book*, Chapter 16, pages 557–563 for a detailed discussion of reduction of tax attributes as a result of discharge of indebtedness.

TAX CONSEQUENCES OF THE RECAPTURE

The tax consequences of recapture depend on the position the taxpayer took in the year of the agreement.

IRS Position

Under the IRS position, taxpayers must reverse the income tax consequences of the debt discharge when the taxpayer is required to repay part or all of the discharge d debt. That means the taxpayer begins at the bottom of the list of tax consequences and reverses those consequences in the year of the repayment until the repayment amount is accounted for.

Example 7. Assume the same facts as in Example 6. When the workout agreement terminated in 2001, Matthew's farm was worth \$185,000, which was a \$60,000 increase over the value of the farm at the time of the workout. Consequently, Matthew was required to repay \$30,000 (50% \$60,000) of the \$40,000 debt reduction.

That repayment reverses the tax consequences that were reported on Matthew's 1990 income tax return. Therefore, Matthew starts at the bottom of the list of tax

consequences in Example 6 and reverses them until he has accounted for the \$30,000 of discharged debt that he repaid.

1. Since the last \$2,000 that was discharged was recognized as income in 1991, Matthew claims a \$2,000 deduction in 2001 when he repays the discharged debt. (That accounts for \$2,000 of the \$30,000 repaid, leaving \$28,000.)
2. Since the next to last \$3,000 that was discharged was not recognized as income and did not cause tax attributes to be reduced, Matthew has no deduction nor any attribute restoration for that \$3,000 that he repaid. (That accounts for another \$3,000 of the \$30,000 he repaid, leaving \$25,000.)
3. The next \$4,000 (in reverse order) of the \$40,000 discharge resulted in reduction in the bases of assets in 1991. Therefore, Matthew adds \$4,000 to the bases of his assets in 2001. (That accounts for another \$4,000 of the \$30,000 repaid, leaving \$21,000.)
4. The next \$16,000 (in reverse order) of the \$40,000 discharge resulted in reduction of NOLs in 1991. Therefore, Matthew increases his NOLs in 2001 by \$16,000. (That accounts for another \$16,000 of the \$30,000 repaid, leaving \$5,000.)
5. The remaining \$5,000 of the \$30,000 that was repaid was part of the \$15,000 on interest that was discharged in 1991. Since that interest was not claimed as a deduction in 1991, Matthew can claim an interest deduction when that discharged interest is repaid in 2001.

Alternative Position

Taxpayers who took the alternative position at the time of the FmHA debt reduction do not have any tax consequences to reverse when they make a recapture payment under the Shared Appreciation Agreement. However, they may have debt discharge income to be reported at the termination of the Shared Appreciation Agreement because there is no longer any obligation to repay any debt that was not repaid at the end of the agreement.

Example 8. Assume the same facts as in Example 6 except that Matthew Horton took the alternative position on his income tax return.

Matthew reported no attribute reduction and no discharge of indebtedness income in 1991 because the Shared Appreciation Agreement could require him to repay all of the debt reduction.

Example 9. Assume that Matthew followed the alternative method of reporting the debt reduction in 1991 as in Example 6 and paid the same \$30,000 recapture amount in 2001 as in Example 7.

Matthew has no tax consequences to reverse in 2001 because he reported no discharge of debt in 1991. However, he does have \$10,000 discharge of debt to account for in 2001 since his debt was written down by \$40,000 in 1991 and he has repaid only \$30,000 in 2001. Since that \$10,000 was accrued interest that could have been

deducted if it had been paid, Matthew has no income tax consequences for the discharge of that debt in 2001.

Practitioner Note. Some taxpayers who used the alternative method of reporting the debt reduction at the time of the FmHA workout agreement will have discharged debt that must be reported at the termination of the Shared Appreciation Agreement.

Example 10. Assume the same facts as in Example 9 except that Matthew Horton was required to repay \$18,000 (rather than \$30,000) of the debt reduction at the end of the Shared Appreciation Agreement. Since Matthew's obligation to repay the remaining \$22,000 of the \$40,000 debt reduction in 1991 is terminated when the Shared Appreciation Agreement terminates in 2001, he must account for that \$22,000 debt discharge in 2001.

As in the previous examples, the first \$15,000 of the debt discharge is accrued interest and does not have to be reported as income because Matthew could have claimed a deduction if he had paid that interest.

The remaining \$7,000 is discharge of indebtedness income to Matthew in 2001 unless it fits within one of the other exceptions under I.R.C. §108. In this example, Matthew does not qualify for any of the exceptions, so he must report \$7,000 of discharge of indebtedness income in 2001.