Indebtedness in Excess of Basis

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The financial trauma of the 1980s has left a legacy rarely seen in the years since the Great Depression of the 1930s — indebtedness in excess of basis on farm property. While this state may be of only modest concern so long as the property is not sold or exchanged, any event requiring a realization of the gain, poses potentially serious additional income tax liability for the taxpayer.

**Installment sales.** In the event of an installment sale of property, if the seller's indebtedness taken over by the buyer is in excess of the adjusted basis for the property, the excess of the indebtedness over the adjusted basis is considered a payment in the year of sale and as part of the "total contract price." For many years, the standard solution to the problem, if observed in time, was to delay the take over of the indebtedness until a later year. In the event the buyer is not required by the terms of the contract to take over the indebtedness until some future year, the excess of the indebtedness over basis is not treated as a payment in the year of sale. Any excess of indebtedness over basis would, of course, be reportable in the later year of actual take over of indebtedness by the buyer.

In a series of developments in the late 1970s, it became apparent that an obligation by the purchaser to make payments to the holder of the indebtedness, the mortgagee in the usual case, could be treated as an assumption for income tax purposes despite state law that such was not an assumption. The same result obtained where the buyer made payments to the seller who was obligated to make payments to the holder of the indebtedness. These developments narrowed the scope of the standard solution and suggested even more careful attention to drafting the documents governing the transaction.

As a relatively minor footnote to the matter, if indebtedness assumed or taken subject to exceeds the income tax basis, selling expenses are added to basis rather than being applied as an offset against the selling price.

With respect to "wrap around" indebtedness, for transfers after March 3, 1981, IRS in temporary regulations took the position that the wrapped debt is deemed to have been taken subject to even though title to the property has not passed and even though the seller remains liable for payments on the wrapped indebtedness. However, the temporary regulations have been held invalid in two Tax Court cases with the IRS now acquiescing in one of the decisions. With wrap around indebtedness, as part of the sales agreement the buyer issues the seller a note in which the principal amount reflects the existing mortgage.

**Tax-free incorporation.** A similar problem to that with an installment sale arises in a tax-free exchange to a corporation if the sum of the liabilities assumed or taken subject to by the corporation exceeds the aggregate basis of assets transferred. In one case, the entering of loans on the corporate books and use of corporate funds to repay the indebtedness were sufficient for an assumption to have occurred for income tax purposes.

In a decision viewed as questionable, the Second Circuit Court of Appeals in Lessinger v. Commissioner no gain was recognized on the transfer of the taxpayer's sole proprietorship assets and liabilities to the taxpayer's wholly-owned corporation even though liabilities exceeded the basis. Although the rule has been clear that taxable gain cannot be avoided by giving the corporation a personal promissory note for the difference, on the grounds that the note had a zero basis, the Lessinger case held that gain was eliminated by the shareholder's contribution of such a note.

If the problem of indebtedness in excess of basis is spotted in time, several solutions may be possible —

- Simply halt the transfer if the resulting income tax liability is unacceptable.
- Make contribution of cash to the corporation, sufficient to elevate the aggregate basis to the level of the indebtedness.
- Leave assets with a low basis and high indebtedness in the hands of the transferors.
- Arrange refinancing of some of the indebtedness such that the stock and other securities serve as collateral (after issuance) rather than the transferred assets.

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FOOTNOTES
9 Professional Equities, Inc., supra note 8.
10 I.R.C. § 357(c). See Owen v. Comm'r, 881 F.2d 832 (9th Cir. 1989)

EXEMPTIONS. The debtor's homestead was sold to satisfy a federal tax lien. The court held that the debtor was entitled to claim an exemption for the amount of the proceeds left after satisfaction of the tax lien. Matter of Clark, 116 B.R. 672 (Bankr. W.D. Wis. 1989).

Prior to filing for bankruptcy, the debtor had received a lump sum disability check which was deposited in a new bank account. The debtor's income consisted of social security payments, pension payments and AFDC payments for a minor ward. All income was used for expenses, with withdrawals from the bank account required to meet these expenses. The court held that the debtor was entitled to exempt the bank account funds under Section 522(d)(10) as disability benefits. In re Frazier, 116 B.R. 675 (Bankr. W.D. Wis. 1990).

A Chapter 7 debtor claimed an interest in a homestead as exempt. The debtor's spouse was not a debtor in the case. At the time the house was purchased, the debtor had several debts outstanding and used money borrowed from a cousin who was an unsecured creditor in the case. The court held that because the trustee could not reach the nondebtor spouse's interest, the trustee could not reach the debtor's interest in the homestead because under Iowa law, the homestead was not divisible by creditors, even where the debtor spouse had antecedent debts at the time the homestead was purchased. Matter of Tyree, 116 B.R. 682 (Bankr. S.D. Iowa 1990).

Three months prior to filing bankruptcy, the debtors used $5,000 from a savings account to purchase two IRA accounts which are exempt under Fla. Stat. § 222.21. The trustee objected to the exemption arguing that the purchase of the IRA's was an attempt to defraud creditors. The court held that the debtors had a right to convert non-exempt property to exempt property prior to filing for bankruptcy. In re Horath, 116 B.R. 835 (Bankr. M.D. Fla. 1990).

The debtors' interests in ERISA qualified pension plans were excluded from bankruptcy estate property under Section