Handling Debt Securities in Small Farm and Ranch Corporations

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-by Neil E. Harl

It may come as a shock to many, but capitalizing a small farm or ranch corporation with debt securities as well as stock was relatively common until 1989. In that year, the Omnibus Budget Reconciliation Act of 1989 decreed that debt securities issued in a tax-free exchange were to be treated as boot. Gain has long been recognized to the extent of “boot” received by the transferor.

Inasmuch as debt securities typically had the same relative income tax basis as the stock, and the amount of basis to be allocated among the stock and debt securities was usually modest relative to the fair market value of the property transferred to the newly formed farm or ranch corporation, the result was gain to be recognized, often substantial, if debt securities were issued as part of the tax-free exchange after October 2, 1989.

Handling redemption of pre-October 3, 1989 debt securities

Some of the debt securities issued in tax-free exchanges before October 3, 1989, the effective date of the 1989 enactment, have been redeemed or paid off, but others have been reissued or renewed and have survived to the present, although the authority for substitution of “old” debt for “new” debt without recognition of gain has been largely limited to debt that was publicly traded. The question is, for the “old” debt securities that are still in existence, how is the gain handled if the debt securities are paid off?

Rule governing the allocation of income tax basis

The rule was well-established well before the 1989 amendment on debt securities that the income tax basis of the property transferred was to be allocated among the various classes of stock and securities (including debt securities) in proportion to the fair market values of stock and securities issued.

EXAMPLE

Real estate, machinery, equipment, livestock and cash totalling $2,000,000 in fair market value was conveyed to a newly formed corporation in early 1989 in exchange for $400,000 in debentures (face value) and 16,000 shares of common stock issued at $100 per share.

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
The interest rate on the debt securities was set on the basis of prevailing interest rates at the time for comparable risk assumed so there was no reason to calculate either a discount or premium in the value of the debentures. The aggregate income tax basis for the assets conveyed was $800,000. The debentures comprised 20 percent of the stock and debt securities issued so 20 percent of the basis available for allocation between the stock and debt securities would be allocated to the $400,000 of debentures issued. That would result in an income tax basis for the debentures of $160,000 and an income tax basis for the stock of $640,000. The stock, with an initial fair market value of $100 per share would have an income tax basis of $40 per share. The debentures, issued in $100 denominations would also have an income basis of $40 per debenture with a face value of $100.

If, in 2011, the decision is made to retire all of the outstanding debentures (4,000 in total) at their face value of $100, the holders would have a gain of $240,000.

Effect of the death of holders of debt securities

In many instances, debt securities were issued to the parents (or grandparents) to provide a relatively low-risk supplement to their retirement income. To the extent that was the case, and deaths had occurred some time after corporate formation, the potential gain on the debt securities would have been eliminated with an adjustment in income tax basis of assets held until death except for deaths in 2010 where an election was made to use 2010 estate tax rules and a carryover basis.

Of course, if the debentures had been transferred by gift, the original income tax basis would, in most cases, carry over to the donee.

Disposition of the original stock

While the stock and debt securities started out with the same relative income tax basis and the same potential gain on sale or exchange, that is unlikely to be the case currently. The basis of the stock might well have remained at the initial level (except for S corporations) but the stock value would have changed as the value of the assets changed over time.

ENDNOTES

1 See generally 7 Harl, Agricultural Law §§ 52.02, 52.03 (2011); Harl, Agricultural Law Manual § 7.02[2][b][ii] (2011); 2 Harl, Farm Income Tax Manual § 7.02[1][b][vii] (2011 ed.). See also Harl, “Tax-Free Incorporation,” 1 Agric. L. Dig. 117 (1990).


3 Id.

4 I.R.C. § 351(b), 358(a)(1)(A).

5 For a discussion of how debt securities might have been exchanged after October 2, 1989 without creating “boot” see the authorities in note 1 supra.

6 See note 2 supra. For property transfers by C corporations, the effective date was July 11, 1989, unless the 80 percent test of I.R.C. § 1504(a)(2) was met.


8 Rev. Proc. 99-18, 1999-1 C.B. 736 (new debt and old debt must be publicly traded); Rev. Proc. 2001-1 C.B. 742 (new election to facilitate the substitution of new debt for old debt; must be publicly traded).

9 See note 2 supra.


11 I.R.C. § 1014(a)(1).


13 I.R.C. § 1015(a).