Dealing With Matured Debentures

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DEALING WITH MATURED DEBENTURES

— by Neil E. Harl*

For those who formed farm or ranch corporations before October 3, 1989,¹ and issued debt securities such as debentures,² a major concern is how to handle the maturity of the notes, bonds or debentures. Although a few farm or ranch corporations have established reserves for redemption of debt securities at maturity, more commonly reserve funds have not been established and, in many instances, the corporation is not in a sufficiently strong cash position to redeem the debt securities as they mature.

Where the problem exists, it is not prudent for the situation to be ignored. That type of response could lend to insistence by the Internal Revenue Service or creditors in an inferior security position that debt securities continuing well beyond maturity without appropriate action become effectively part of the equity capital base of the corporation.

Income tax basis of debt securities (before October 3, 1989)

An important part of the problem with debt securities, issued before October 3, 1989, is that the income tax basis from assets transferred to a newly formed corporation was to be allocated among the various classes of stock and debt securities in proportion to the fair market values of stock and securities received in the tax-free exchange.³ Thus, it was not permissible to allocate the basis from assets transferred to the corporation to debt securities to the extent of the face value of the debt securities with the remainder allocated to the stock or other equity securities.

As a consequence, any debt securities issued contained the same proportion of potential gain initially as did the equity securities. As an example, if stock was issued at $100 per share and the income tax basis was $48.07 per share, a $100,000 debenture should have had an initial basis of $48,070. Of course, the potential gain for the debt securities in most instances remained unchanged after the initial issuance because of the fixed principal character of debt securities whereas the fluctuating value of common stock meant that the potential gain varied over time although the income tax basis of the corporate stock remained unchanged (except for S corporations).⁴

Income tax basis of debt securities (after October 2, 1989)

Effective for transfers after October 2, 1989, in taxable years ending after that date, debt securities issued in a tax-free exchange to a corporation are treated as “boot” to the extent of realized gain on the exchange.⁵ In the event debt securities are issued for cash well after the tax-free exchange (outside the range of what could be reached with a “step transaction” assertion), the debt securities would have a basis equal to the face value. For debt securities issued after October 2, 1989, as part of a tax-free exchange, the income tax basis should likewise be the face value (unless the gain on the transferred property limited the basis to some figure less than face value).

Handling debt securities with gain

If debt securities end up with an income tax basis less than face value, the question is whether the debt securities can be renewed or rolled forward without recognition of gain. In Rev. Rul. 77-415,⁶ the Internal Revenue Service ruled that there was no gain on the issuance of new debentures for matured debentures. The issuance was considered to be a “type E” reorganization or “recapitalization” of debt securities for debt securities.⁷ As noted in the 1977 ruling, “...since the principal amount of securities received does not exceed the principal amount of securities surrendered...no gain or loss is recognized ... on the exchange of the … debentures for new debentures...”⁸ The ruling also noted that “...the creation by the corporation of securities in the form of the debentures and its issuance of the debentures in exchange for outstanding debentures...is a reshuffling of the corporation’s capital structure and, therefore, a recapitalization.”⁹ The ruling concluding that the original issue discount rules¹⁰ (applicable to the difference between the issue price and the stated redemption price at maturity) did not apply to the recapitalization.¹¹

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In the event the amount of debt securities given up is less than the principal value of debt securities received, the excess amount is boot and is recognized as capital gain.\(^\text{12}\) Gain on the exchange is recognized but not in excess of the difference between the principal amount of debt securities surrendered and the principal amount of debt securities received.\(^\text{13}\)

Taxpayers participating in a “type E” reorganization must keep records and file specified information with the appropriate income tax returns.\(^\text{14}\)

**FOOTNOTES**

1 Omnibus Budget Reconciliation Act of 1989, Sec. 7203, amending I.R.C. § 351(a), (b), (d), (g).


3 Treas. Reg. § 1.358-2(b). See Rev. Rul. 85-164, 1985-2, C.B. 117 (aggregate basis of property transferred to corporation must be allocated between stock and securities received in proportion to relative fair market values of each class).

4 See I.R.C. § 1367(a).

5 OBRA 1989, Sec. 7203, amending I.R.C. § 351(a), (b), (d), (g).


9 Id.

10 See I.R.C. § 1232.


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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**ADVERSE POSSESSION**

POSSESSION. The dividing line between the parties’ properties was originally established in 1866; however, a survey in 1895 erroneously set a stake at a corner 200 feet onto the plaintiff’s property. The error was not discovered until a 1993 survey and the parties each sued for establishment of the true property line, based on adverse possession. The parties stipulated at trial that the 1866 survey was correct and the 1895 marker was misplaced. Within two years before the suit, the plaintiff purchased the property from a family member of the defendant who had farmed the land with the defendant for many years before the sale. The court held that the plaintiff failed to demonstrate adverse possession because the plaintiff had not owned the land for at least 10 years and the plaintiff’s predecessor in interest had used the land permissively with the defendant. Similarly, the defendant could not claim title by adverse possession because the defendant used the disputed land with permission of the rightful owner. The boundary was moved back to the original position under the stipulation of the parties. *Kraft v. Metternbrink*, 559 N.W.2d 503 (Neb. Ct. App. 1997).

**BANKRUPTCY**

**GENERAL-ALM § 13.03.*\(^\text{a}\)**

**EXEMPTIONS**

AVOIDABLE LIENS. The debtors, husband and wife, each claimed farm implements as exempt under the Wisconsin tools of the trade exemption, Wis. Stat. § 815.18(3)(b), which allowed up to $7,500 in value as exempt. The debtors then sought to avoid nonpossessory, nonpurchase money security interests in the implements. The secured lender, the FSA, objected to allowing any avoidance in excess of $10,000, arguing that Section 522(f)(3) limited the avoidance to the maximum exemption allowed by the federal exemptions. The court held Section 522(f)(3) to be ambiguous as to exemption statutes such as the one in Wisconsin and found that the limitation of Section 522(f)(3) did not apply where the state exemption was not unlimited but was higher than the federal exemption. The court held that the debtors were entitled to avoid the security interest to the full extent of the allowed state exemption amount. *In re Ehlen*, 207 B.R. 179 (W.D. Wis. 1997), aff’d, 202 B.R. 742 (Bankr. W.D. Wis. 1996).

**CHAPTER 12-ALM § 13.03[8].\(^\text{a}\)**

TRUSTEE. In order for the debtor to produce a postpetition cotton crop, the trustee obtained Bankruptcy Court authorization for purchase on credit of crop production supplies from a supplier. The supplier was granted a security interest in the cotton crop, but the security interest was made subordinate to other secured creditors. The trustee received payments for the cotton in four checks, with the amounts of the first three checks paid to the priority secured creditors. Upon receiving the fourth check, the trustee paid the supplier in full;

\(^\text{a}\)Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.