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DEBT IN EXCESS OF BASIS
— by Neil E. Harl*

One of the important objectives in the incorporation of a farm or ranch business is to accomplish a tax-free exchange of assets to the new entity.¹ With a low income tax basis for many of the assets in most farm and ranch businesses, the consequences of a taxable exchange can be very serious in terms of income tax liability on the gain involved.²

A recent Tax Court case, Seggerman Farms, Inc. v. Commissioner³ has focused attention once again on the need for careful planning.

Facts in Seggerman

In the facts of Seggerman Farms, Inc.⁴ a father and two sons formed a farm corporation with a transfer of individually owned assets to the corporation. The father, Ronald Seggerman, conveyed assets with a fair market value of $445,820 and basis of $66,201 to the corporation with the corporation assuming debt totaling $402,903. One son, Craig Seggerman, transferred assets with a fair market value of $156,340 and basis of $30,517 to the corporation with the corporation assuming debt totaling $121,911. The other son, Michael, conveyed assets totaling $156,340 in value with a basis of $30,517 to the corporation with the corporation assuming debt totaling $113,111. The transferors remained personally liable on the debts accompanying the assets to the new corporation.

Whether gain was triggered

Ordinarily a transfer of assets to a newly formed corporation, where the debt involved exceeds the basis, triggers gain to the extent the indebtedness exceeds the basis.⁵ The basis of stock received by the transferors is the basis of property transferred, less “boot” received and plus gain recognized, if any.⁶ If a corporation assumes a liability of the transferor or takes property subject to a liability, as for example a mortgage, the amount of the liability is treated as “money received” and reduces the basis of stock received.⁷ Therefore, since negative basis figures are not possible, the excess of indebtedness over basis is gain.⁸

In determining the amount of gain recognized when several assets are transferred to a corporation, each asset is considered separately in exchange for a portion of each category of consideration received.⁹

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The taxpayer argued that the excess of liabilities over basis (which totaled $510,690) should not be subject to income tax because the transferors remained personally liable on the debt obligations. The Tax Court pointed out that it has consistently held that debt in excess of basis was subject to tax on the gain involved even if the transferors remained personally liable on the debt obligations. The taxpayers relied on Lessinger v. Commissioner (where the difference between the basis of property and debt was recorded as a loan receivable from the taxpayer to the corporation) and Peracchi v. Commissioner (the difference between the basis of assets and the liabilities transferred was recorded as a personal note from the taxpayers to the corporation). IRS, in response, took the position that the structure of the transactions in Lessinger and Peracchi was different from the way the transfer was handled in Seggerman Farms, Inc. in that the taxpayers in Seggerman did not contribute loan receivables or personal notes to the corporation to cover the difference between the transferred liabilities and the basis of the transferred property. The Tax Court agreed with the distinction urged by the Service. The court cited a Seventh Circuit Court of Appeals case, Testor v. Commissioner, which denied relief to a taxpayer with a gain on incorporation where the property is subject to liabilities (or portion thereof) shall be treated as having been assumed if the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor is relieved of such liability. It is clear that great care is needed in handling exchanges of property any time the indebtedness exceeds the basis. The stakes can be high.

Recent legislation

In 1999, Congress enacted changes to I.R.C. § 357(c), effective for transactions after October 18, 1998. The amendment struck the words “plus the amount of liabilities to which the property is subject” from the statute and provided relief for taxpayers transferring assets subject to liabilities where the transferee remains personally liable on the debt but for which the corporation did not assume liability. The 1999 amendment also added I.R.C. § 357(d)(1)(A) which provides guidance in determining the amount of liabilities assumed and states that “a recourse liability (or portion thereof) shall be treated as having been assumed if...the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor is relieved of such liability.”

The Tax Court pointed out that the 1999 amendment did not apply in the Seggerman case because the transaction was in 1993. In dictum, the court stated that even after the 1999 amendments, “...Congress has refrained from providing relief to taxpayers in petitioners’ situation.”}

FOOTNOTES

4. Id.
7. I.R.C. § 358(d).
8. Id. See Owen v. Comm’r, 881 F.2d 832 (9th Cir. 1989).
14. 143 F.3d 487 (9th Cir. 1998), rev’g, T.C. Memo. 1996-191.
16. Id.
17. 327 F.2d 788 (7th Cir. 1964), aff’g, 40 T.C. 273 (1963).
20. Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

ADDITIONAL CHILD TAX CREDIT. The debtor claimed an exemption for a portion of an income tax refund. The exemption was claimed under Idaho Code § 11-60394) for benefits received under federal, state or local public assistance legislation. The debtor claimed that a portion of the refund resulted from the additional child income tax credit allowed under I.R.C. § 24(d). The court applied a three part inquiry as to whether the tax credit was in the nature of public assistance: whether the credit had a public assistance purpose, whether the credit was refundable, and at what income level did the