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Indebtedness in Excess of Basis:
A Problem Even for Gifts

-by Neil E. Harl

It is widely understood that indebtedness in excess of income tax basis is a problem in sales or exchanges of property. For example, taxable gain is recognized to the extent the sum of liabilities assumed or taken subject to by a corporation exceeds the aggregate basis of assets transferred in a tax-free exchange on formation of the corporation. That result can arise in connection with an installment sale, or about any other “sale or exchange” in addition to an otherwise tax-free exchange to a corporation, as noted. Transfers involving partnerships are subject to a somewhat different set of rules.

What is less widely known is that the same result can occur with a gift.

Consequences of a gift with indebtedness in excess of basis

A disposition of property resulting in debt relief results in gain to be reported to the extent of the excess of the debt relief over the adjusted income tax basis of the property. The regulations go on to state that if the disposition involves property subject to a recourse debt, the transferor is considered to be discharged from liability if another person agrees to pay the liability whether or not the transferor is, in fact, released from the liability. Stated differently, if the obligor continues to be liable on the indebtedness, and no one else becomes liable for the amount owed, the regulations effectively shield the amount of excess indebtedness over basis from income tax. However, if the transferee becomes liable on the obligation, the transferor is considered to be discharged from liability and the amount of indebtedness in excess of income tax basis is subject to tax.

For non-recourse liability, where the only recourse open to the creditor is to look to the property for payment, a disposition is considered to be a discharge of the transferor from the liability. A disposition specifically includes a gift of the property. The depreciation recapture rules apply to gains realized from debt relief involving gifts with part of the gain taxed as recapture income which is ordinary income.

Special rules for partnerships

Somewhat surprisingly, the regulations chart a somewhat different course for partnerships. Contributions and distributions of property between a partner and a partnership are not considered sales or other dispositions of property. The liabilities from which a transferor is discharged as a result of a sale or other disposition of a partnership

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interest include the transferor’s share of the liabilities of the partnership. 16

So if a general partnership, for example, has indebtedness in excess of basis, and the partners for business reasons want to shift to a limited liability company (LLC), a conventional transfer of the partnership assets to the newly formed LLC would not seem to come within the regulatory provision. 17 The transfer would not be a transfer “between a partner and a partnership.” 18

However, if the general partnership were to be dissolved, that would involve a “distribution” which would be within the language of the regulations, 19 and a subsequent transfer of assets to the LLC would seem to involve a “contribution” between partners and a partnership. Thus, the indebtedness in excess of basis would appear not to result in taxable income, at least not at that time. 20 Remember, LLCs are considered to be partnerships for federal income tax purposes under the default provisions. 21 However, a cautious practitioner could seek a private ruling inasmuch as guidance is sparse for such a sequenced transfer. In a 2004 private letter ruling, 22 no gain or loss was triggered on conversion of a general partnership to an LLC. Even the partners’ capital accounts in LLC would be the same as capital accounts in the partnership. 23

ENDNOTES

1 E.g., I.R.C. § 357(c).

2 See, e.g. Seggerman Farms, Inc. v. Comm’r, T.C. Memo. 2001-99, aff’d, 308 F.3d 803 (7th Cir. 2002). But see Peracchi v. Comm’r, T.C. Memo. 1996-191, rev’d, 143 F.3d 487 (9th Cir. 1998) (unsecured promissory note prevented recognition of gain); Lessenger v. Comm’r, 85 T.C. 824 (1985), rev’d, 872 F.2d 519 (2d Cir. 1989) (no gain recognized on transfer of taxpayer’s sole proprietorship assets and liabilities to taxpayer’s wholly-owned corporation even though liabilities exceeded basis).

3 See Burnet v. S & L Bldg. Corp., 288 U.S. 406 (1933) (excess of mortgage over adjusted basis considered as payment in year of sale and as part of “total contract price”).

4 See generally, 6 Harl, Agricultural Law § 48.03[5][b] (2013) (if the seller’s mortgage assumed by the buyer or taken subject to by the buyer is in excess of the adjusted basis for the property, the excess is considered a payment in the year of sale and as part of the total contract price).


9 Id.

10 Id.

11 Id.


15 Id.


18 Id.


20 However, in Rev. Rul. 84-15, 84-1 C.B. 158, the portion of a mortgage in excess of basis assumed by the other partners was treated as a distribution).


23 Id.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr

ANIMALS

COWS. The plaintiff, a resident of Colorado, was injured when the plaintiff’s vehicle struck the defendant’s cow on a public highway in Kansas near where the defendant’s dairy was located. The plaintiff sued in negligence, claiming that the cow escaped after one of the defendant’s employees failed to properly shut a gate. The defendant filed a motion to dismiss for lack of personal jurisdiction of a Colorado court over the defendant, a Kansas company. The defendant claimed, and the court found, no contact with Colorado except for sending motors to a company in Colorado for repairs. The court held that it had no personal jurisdiction over the defendant dairy because the dairy did not have sufficient contacts with Colorado. The court granted the plaintiff’s motion to transfer the case to a Kansas District Court. Sage v. Bird City Dairy, LLC, 2013 U.S. Dist. LEXIS 51056 (D. Colo. 2013).