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AVOIDING GAIN WHEN INDEBTEDNESS EXCEEDS BASIS

— by Neil E. Harl*

One of the most painful outcomes on the formation of a corporation in a tax-free exchange¹ is to discover, too late, that indebtedness taken over by the corporation exceeded the income tax basis of the property transferred to the corporation.² It is a fundamental requirement of a transfer to a corporation that if the 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 the stock received.³ If the sum of the liabilities assumed or taken subject to by the corporation exceeds the aggregate basis of assets transferred, a taxable gain is incurred as to the excess.⁴ The gain is allocated among all assets transferred on the basis of their respective fair market values with the gain characterized as capital gain or ordinary income depending on the nature of the asset to which allocated.⁵

A recent decision by the Ninth Circuit Court of Appeals, *Peracchi v. Commissioner*,⁶ raises once again⁷ the question of whether gain can be avoided (where indebtedness taken over exceeds the basis of property transferred) by issuing a personal promissory note for the difference.

Facts in *Peracchi*

In *Peracchi v. Commissioner*,⁸ the taxpayer and spouse owned 100 percent of a corporation with two wholly-owned subsidiaries, one of which was a property and casualty insurance company. Both subsidiaries required capital infusions and in 1989 the taxpayers transferred three parcels of improved real property with a combined adjusted income tax basis of \$981,400 and subject to liabilities of \$1.5 million to the parent corporation. In addition, to cover the difference, the taxpayers transferred an unsecured personal promissory note for \$1,060,000.⁹ The taxpayers remained personally liable on the real property encumbrances and the transferee corporation did not assume liability for payment.

The Internal Revenue Service determined that the taxpayers realized gain on the transfer of the properties and the Tax Court upheld the Service position.¹⁰ Under a 1968 revenue ruling, *Rev. Rul. 68-629*,¹¹ the Service had ruled that taxable gain could not be avoided by giving the corporation a personal promissory note for the difference; the note had a zero income tax basis.¹² Therefore, the promissory note contributed nothing in basis to the basis of the property transferred. Without additional basis, the gain (based on the difference between the basis of property transferred and the indebtedness taken over by the corporation) must be recognized.

On appeal, the Ninth Circuit, in a questionable decision, found the strategy employed was economically equivalent to borrowing the necessary funds from a lender and transferring the cash (which would be 100 percent basis) to the corporation.¹³ In effect, the Ninth Circuit allowed the taxpayer to issue a personal promissory note and to obtain an income tax basis equal to the face value of the note. The question is not so much the

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value of the note, as the court suggests, but its basis. The Ninth Circuit's position that a shareholder note given in a tax-free exchange to a controlled corporation should receive a basis seems wide of the mark in terms of well-established tax law.

The Second Circuit decision

The *Peracchi* court, while following somewhat different reasoning, reached the same essential conclusion as *Lessinger v. Commissioner*¹⁴ decided nearly a decade earlier. In *Lessinger*, 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 the liabilities exceeded the basis. The *Lessinger* court held that the gain was eliminated by the shareholder's contribution of a personal promissory note. The *Lessinger* decision was widely criticized at the time as an attempt to find a solution to a taxpayer's unfortunate plight.

Possible solutions to the problem

As a planning matter, if the problem of indebtedness in excess of basis is spotted in time, several solutions are possible.¹⁵

- Halt the transfer before conveyance of the assets and liabilities to the corporation.
- Contribute cash to the corporation sufficient to elevate the aggregate basis to the level of indebtedness.
- Leave assets with high indebtedness and low basis in the hands of the transferor.
- Arrange with the creditors for some of the indebtedness to remain with the transferor and be secured with stock received in the exchange rather than with the transferred assets.

Policy solutions

The case of *Lessinger v. Commissioner*¹⁶ could be dismissed as an aberrational result from a court displaying judicial sympathy for a taxpayer caught in a trap of tax liability from a seemingly innocent transfer. The decision in *Peracchi*¹⁷ makes it more difficult to ignore the problem.

One possibility is for IRS to recognize a negative basis in such situations, with recognition of the gain postponed, a result which the Service has loathed in the past.¹⁸ Another is for Congress to amend I.R.C. § 357(c) to make it clear that the reading of the subsection by the Second and Ninth Circuits is incorrect. That policy solution seems to be a remote possibility, at best. The other policy solution is to concede that promissory notes, even to a controlled corporation, can be viewed as contributing basis to absorb liabilities taken over in the transfer.¹⁹

FOOTNOTES

- ¹ I.R.C. § 351. See generally 7 Harl, *Agricultural Law* §§ 53.02-53.05 (1998); Harl, *Agricultural Law Manual* § 7.02[2][c] (1998). See also Harl, "Indebtedness in Excess of Basis," 1 *Agric. L. Dig.* 185 (1990).
- ² See 7 Harl, *supra* n. 1, § 53.03[d]; Harl, *supra* n. 1, § 7.02[2][c][i].
- ³ I.R.C. § 358(d).
- ⁴ I.R.C. § 357(c). See, e.g., *Owen v. Comm'r*, 881 F.2d 832 (9th Cir. 1989) (liabilities secured by personal guarantee for which guarantors remained liable not excluded). Compare *Beaver v. Comm'r*, T.C. Memo. 1980-429 (entering of loans on corporate books and use of corporate funds to repay sufficient for assumption); Ltr. Rul. 8331035, April 28, 1983 (upon incorporation of farm partnership by two equal partners, each would recognize gain to extent their respective shares of partnership liabilities exceeded adjusted basis of their respective interests in partnership); Ltr. Rul. 8331036, April 28, 1983 (same); Ltr. Rul. 9640001, Nov. 29, 1994 (shareholder's basis in stock was zero; building subject to liabilities in excess of basis).
- ⁵ Rev. Rul. 68-55, 1968-1 C.B. 140.
- ⁶ 143 F.3d 487 (9th Cir. 1998).
- ⁷ See *Lessinger v. Comm'r*, 872 F.2d 519 (2^d Cir. 1989), *rev'g*, 85 T.C. 824 (1985).
- ⁸ 143 F.3d 487 (9th Cir. 1998).
- ⁹ *Id.*
- ¹⁰ *Peracchi v. Comm'r*, T.C. Memo. 1996-191.
- ¹¹ 1968-2 C.B. 154.
- ¹² *Id.*
- ¹³ See *Peracchi v. Comm'r*, 143 F.3d 487 (9th Cir. 1998).
- ¹⁴ 872 F.2d 519 (2^d Cir. 1989).
- ¹⁵ See Harl, "Indebtedness in Excess of Basis," 1 *Agric. L. Dig.* 185 (1990).
- ¹⁶ 872 F.2d 519 (2^d Cir. 1989).
- ¹⁷ 143 F.3d 487 (9th Cir. 1998).
- ¹⁸ See Shepherd, "Negative Basis, Economic Exposure and Runaway Metaphors," 80 *Tax Notes* 676 (1998).
- ¹⁹ See Bogdanski, "One Thumb Up for Peracchi," 79 *Tax Notes* 911 (1998). Compare Raby and Raby, "'Sorcery' Creates Tax Basis from 'Piece of Paper'," 79 *Tax Notes* 873 (1998).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

AVOIDABLE TRANSFERS. The debtor livestock corporation and a grain trading corporation were owned by the same person. The shareholder caused funds to be withdrawn from the grain trading corporation to meet margin calls for both corporations. The shareholder was not authorized to make this

withdrawal and the bank sought recovery of the funds. The shareholder then withdrew funds from the debtor's account and paid them to the commodity broker who transferred the funds to the grain trading corporation's account, restoring the improperly withdrawn funds. The bankruptcy trustee sought recovery of the funds, under Section 550(a)(1) from the bank as an "entity for whose benefit such transfer was made." The court held that the bank did not meet this requirement because the bank received the funds transferred. Because the funds were first transferred to the commodity broker, the bank was also not an initial transferee from whom recovery could have been made