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A DEFINITION OF "LIABILITIES" IN INTERNAL REVENUE CODE SECTIONS 357 AND 358(d)

Douglas A. Kahn* and Dale A. Oesterle**

INTERNAL Revenue Code section 351(a) provides that no gain or loss shall be recognized¹ if property² is transferred to a corporation solely in exchange for its stock or securities³ and the transferors⁴ control the corporation immediately after the exchange.⁵ If, in addition to receiving stock or securities in an exchange that would otherwise qualify for section 351 treatment, a transferor receives other property or money—"boot"—any realized gain is recognized up to the amount of the money and the fair market value of

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1. The transfer of property to a corporation in exchange for stock or securities is a "sale or other disposition" of the property causing the transferor(s) to realize gain or loss equal to the difference between the adjusted basis of the property transferred and the value of the stock and securities received. INTERNAL REVENUE CODE OF 1954 [hereinafter IRC], § 1001(a). Absent the section 351 exemption or some other specific nonrecognition provision, the entire amount of the gain or loss so realized would be recognized. IRC § 1002. See *Estate of Kamborian v. Commissioner*, 469 F.2d 219 (1st Cir. 1972); *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965).

If a transaction meets the requirements of section 351, it is a tax-free exchange regardless of the intention of the transferor(s). *Pocatello Coca-Cola Bottling Co. v. United States*, 139 F. Supp. 912 (D. Idaho 1956) (dealing with Int. Rev. Code of 1939, ch. 1, § 112(b)(5), 53 Stat. 37 (now IRC § 351)); *Gus Russell Inc.*, 36 T.C. 965 (1961).

2. Although money is considered property for the purposes of section 351, see Rev. Rul. 69-357, 1969-1 CUM. BULL. 101, the contribution of services is not. Treas. Reg. §§ 1.351-1(a)(1)(i), (a)(2) (*Example (3)*) (1955). See generally D. KAHN, BASIC CORPORATE TAXATION 333 (2d ed. 1973).

3. Short-term notes typically have been held not to be "securities." See *Turner v. Commissioner*, 303 F.2d 94 (4th Cir.), *cert. denied*, 371 U.S. 922 (1962); *Robert W. Adams*, 58 T.C. 41 (1972). Stock rights and stock warrants are not considered "stock." See *LeVant v. Commissioner*, 376 F.2d 434 (7th Cir. 1967) (stock options); Treas. Reg. § 1.351-1(a)(1) (1955). For a general discussion of the definition given "stock or securities," see D. KAHN, *supra* note 2, at 343-45.

4. The transferors may be individuals, partnerships, trusts, estates, companies, associations, corporations, or any combination of these. Treas. Reg. § 1.351-1(a)(1) (1955).

5. Immediately after the exchange the transferor(s) must own stock possessing at least 80 per cent of the combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of each nonvoting class of stock of the corporation. IRC § 368(c); Treas. Reg. § 1.351-1(a)(1) (1955). For a discussion of the technicalities involved in defining control, see D. KAHN, *supra* note 2, at 329-35.

the other property received.⁶ The transferee corporation's assumption of the transferor's liabilities or its acquisition from the transferor of property subject to a liability is not treated as boot unless the principal purpose of the assumption or acquisition was to avoid federal income tax or was not a bona fide business purpose.⁷ Regardless of the transferor's purpose, however, he will recognize gain under section 357(c) to the extent that the sum of the liabilities transferred exceeds the aggregate adjusted basis of the assets transferred.⁸

Section 357(c) has caused significant problems for cash method taxpayers⁹ seeking to transfer the assets and liabilities of a going business in a section 351 exchange.¹⁰ In *Peter Raich*,¹¹ a cash method taxpayer transferred all of the assets and liabilities of his sole proprietorship to a controlled corporation. The proprietorship's chief asset consisted of more than \$77,000 in trade accounts receivable; its liabilities exceeded \$45,000 and included more than \$37,000 in trade accounts payable.¹² While the Commissioner of Internal Revenue

6. IRC § 351(b). The receipt of boot, however, will not permit the recognition of a loss realized on the exchange. IRC § 351(b)(2).

7. IRC § 357(b).

8. [I]f the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.
IRC § 357(c).

Section 357(c) "gain" is computed for each transferor separately, Rev. Rul. 66-142, 1966-1 Cum. BULL. 66, and allocated among the properties transferred according to their market value to determine the extent to which the transferor recognizes the gain as long-term or short-term capital gain or ordinary income. Treas. Reg. § 1.357-2(b) (1955).

The constitutionality of section 357(c) was sustained in *George W. Wicbusch*, 59 T.C. 777, *affd.*, 487 F.2d 515 (8th Cir. 1973).

9. Under the cash method, income is realized in the year that cash (or its equivalent) is received, and deductions are taken in the year that payment is made. IRC §§ 451, 461; Treas. Reg. § 1.446-1(c)(1)(i) (1957). The relative simplicity of the cash method makes it the choice of many salaried and professional individuals. G. BLATTMACHR & R. KNAPP, ACCOUNTING PERIODS AND ACCOUNTING METHODS 34 (1955).

10. See D. KAHN, *supra* note 2, at 345-48.

Sections 357 and 358(d), the provisions dealing with the treatment of liabilities in section 351 transactions, also apply to liabilities transferred in other tax-free exchanges (*e.g.*, corporate reorganizations under section 361). See IRC §§ 357(a), 358(a). The construction advocated in this article for sections 357 and 358 applies as well to such other transactions. Note, however, that section 357(c) applies only to section 351 transfers and to "D" reorganizations under section 368(a)(1)(D).

11. 46 T.C. 604 (1966).

12. The transferred assets and liabilities were listed as follows:

| Assets | |
|---------------------------|-------------|
| Cash | \$ 1,045.40 |
| Trade Accounts Receivable | 77,361.66 |
| Receivables | 1,833.97 |
| Prepaid Rent | 125.00 |

stipulated that the transaction qualified as a section 351 exchange,¹³ he successfully claimed in the Tax Court that the trade accounts payable were liabilities within the terms of section 357(c), and that the trade accounts receivable had a zero basis.¹⁴ Accordingly, although the book value of the transferred assets was almost twice the face amount of the transferor's liabilities, Raich recognized a taxable gain of \$34,741.08, the amount by which the liabilities assumed by the corporation exceeded his basis in the transferred assets.¹⁵ Two subsequent Tax Court cases, *Wilford E. Thatcher*¹⁶ and *David Rosen*,¹⁷ have followed *Raich*; the Second Circuit, in *Bongiovanni v. Commissioner*,¹⁸ has rejected it.

While *Raich* dealt only with the application of section 357(c), its principles would seem to require that accounts payable also constitute liabilities under section 358(d).¹⁹ Section 358(a) provides that the transferor's basis in the stock and securities received in a section 351 exchange shall be the same as the basis of the property transferred, decreased by the amount of any money and the fair market value of any other property received and increased by the amount of gain recognized on the exchange. Section 358(d), by treating assumed liabilities as "money received," reduces the basis of stock and securities received by the amount of liabilities assumed or accepted by the controlled corporation. If accounts payable are

| | | |
|--------------------------------|-------------|--------------------|
| Equipment | \$13,626.30 | |
| Less: Accumulated Depreciation | 5,378.94 | 8,247.36 |
| Total | | <u>\$88,613.39</u> |
| | Liabilities | |
| Trade Accounts Payable | | \$37,719.78 |
| Notes Payable | | 8,273.03 |
| Total | | <u>\$45,992.81</u> |

46 T.C. at 605. The Commissioner argued that only the *trade* accounts receivable had a zero basis; he gave a value basis of \$1,833.97 to the other receivables. 46 T.C. at 607 n.5. That distinction does not seem to have been maintained in *Wilford E. Thatcher*, 61 T.C. 28 (1973), *appeal docketed*, No. 74-2245, 9th Cir., July 1, 1974.

13. 46 T.C. at 606.

14. 46 T.C. at 610.

15. The gain recognized under section 357(c) represented the difference between \$45,992.81 in liabilities assumed and an adjusted basis in the assets transferred of \$11,251.73. See note 12 *supra*.

16. 61 T.C. 28 (1973), *appeal docketed*, No. 74-2245, 9th Cir., July 1, 1974 (transfer by a partnership).

17. 62 T.C. 11 (1974) (transfer by a sole proprietorship).

18. 470 F.2d 921 (2d Cir. 1972).

19. "Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange."

treated as section 358(d) liabilities, and if accounts receivable have a zero basis for the purposes of section 358(a), the cash method taxpayer with a balance sheet similar to that of the taxpayer in *Raich* will not only recognize a gain on the section 351 exchange, but also will have a zero basis in the stock and securities received.²⁰ When the taxpayer subsequently sells the stock or securities, he will realize and recognize the entire sale price as taxable gain.²¹ In net effect, he will recognize two taxable gains as the result of his single transfer of liabilities.

The following example illustrates the arbitrariness of the *Raich* rule. Jones, a sole proprietor and cash method taxpayer, has tangible assets in his business with a value of \$25,000 and an adjusted basis of \$15,000. He also has trade accounts receivable worth \$20,000. His only liability consists of \$20,000 in trade accounts payable, all of which represent salary owed to employees and all of which will qualify for a business deduction when paid.²² Assume Jones wishes to transfer the sole proprietorship to a controlled corporation for stock having a value of \$25,000 (the net value of the proprietorship). Under *Raich*, Jones will recognize \$5,000 of gross income²³ and have a zero basis in the stock he receives in the exchange.²⁴ The acquiring corporation, on the other hand, will recognize \$17,777.78 of income when it collects the receivables, but it will receive a deduction of \$20,000 for satisfying the payables. (The acquiring corporation will not recognize the full amount of \$20,000 as gross income when it collects the receivables because the corporation's basis in the transferred assets (including the re-

20. Assume Smith incorporates his sole proprietorship by transferring the following assets and liabilities to corporation X in exchange for all of the stock of X:

| Assets | | Liabilities | |
|---------------------|---------|------------------|---------|
| Office Equipment | \$1,000 | Accounts Payable | \$2,000 |
| (basis: \$1,000) | | | |
| Accounts Receivable | | | |
| (basis: \$ 0) | 3,000 | | \$2,000 |
| Total | \$4,000 | Net Worth = | \$2,000 |

Under *Raich*, Smith would recognize \$1,000 of gain under section 357(c) (the amount by which his payables exceed the combined basis in the receivables and equipment). Smith's basis in the X stock received in the exchange is computed as follows:

| | |
|-------------|---|
| \$1,000 | (basis in property transferred) |
| - \$2,000 | (liabilities accepted (sections 358(a)(1)(A)(ii), (d))) |
| + \$1,000 | (gain recognized (sections 357(c), 358(a)(1)(B)(ii))) |
| <u> </u> | |
| \$ 0 | |

21. IRC § 1001.

22. IRC § 162(a)(1).

23. Liabilities assumed (\$20,000) minus aggregate adjusted basis in assets transferred (\$15,000). See note 20 *supra*.

24. See note 20 *supra*.

ceivables) is increased by the \$5,000 gain recognized by Jones, and the receivables' share of that basis allocation is \$2,222.22.) If instead the acquiring corporation were to pay Jones \$20,000 in cash for his receivables, Jones would recognize a \$20,000 gain. He could then use the \$20,000 to pay his salary obligations and obtain an offsetting \$20,000 deduction. Jones would then transfer the tangible assets (and no liabilities) to the corporation; he would recognize *no* income on the transaction and would have a \$15,000 basis in the stock received. Alternatively, Jones could retain the receivables and payables and transfer the tangible assets to the corporation in exchange for its stock. Again, although Jones would recognize \$20,000 of income when he collects the receivables, this gain would be offset by a \$20,000 deduction when he satisfies the payables. He still would recognize no gain on the exchange with the corporation and be left with a \$15,000 basis in the corporation's stock. While the net transactional effects of these three alternatives are identical, their tax consequences are vastly different.

The argument might be advanced that, in situations in which receivables transferred by a cash method taxpayer exceed payables transferred (by far the usual case), the *Raich* application of section 357(c) is justifiable under assignment of income principles as an attempt to adjust for the tax benefits granted to a transferor by refraining from taxing him on the income from the collection of the assigned receivables.²⁵ For instance, suppose Jones, in the previous example, had trade accounts receivable of \$30,000 rather than \$20,000. If the marginal rate on Jones's personal income were higher than the marginal rate on the corporation's income, the tax burden on the excess receivables would be less if they were transferred to and collected by the corporation. Arguably, the *Raich* rule may be justified because it counterbalances the inequity of allowing the cash method transferor to escape taxation on assigned receivables, by imposing the double burden of requiring the taxpayer to recognize gain upon a transfer of accounts payable and to take back stock with a reduced basis.

This argument has several serious weaknesses. First, as explained later,²⁶ assignment of income principles should not be applied to a transfer of receivables in a section 351 transaction, and apparently the Service has not sought to apply them. The identical considerations that render inappropriate the application of the assign-

25. Cf. Brief for Appellee at 21-22, *Thatcher v. Commissioner*, No. 74-2245 (9th Cir. July 1, 1974) (awaiting argument).

26. See text at notes 73-79 *infra*.

ment of income doctrine to a section 351 transfer of receivables would also render inappropriate any indirect means of taxing the transferor on such transactions. Second, even if it were appropriate to apply assignment of income principles to such transfers, those principles should be applied directly by allocating the income from the subsequent collection of the receivables to the transferor, rather than indirectly by imposing income tax consequences on the transferor according to the amount of payables transferred. The amount taxable to a transferor under the *Raich* rule does not correlate in any way with the amount of tax benefit inuring to the transferor from his transfer of the receivables, and, as previously noted, the *Raich* rule operates capriciously in practice.

Thus, returning to the immediately preceding example, if Jones had had \$30,000 of receivables and had transferred the receivables and payables to a controlled corporation for its stock, he would have had a \$5,000 gain on the exchange and a zero basis in the \$35,000 worth of stock received.²⁷ By restructuring his transactions as in the previous example, however, Jones could have avoided the *Raich* rule, recognizing no gain on the transfer to the corporation and acquiring a \$15,000 basis in the stock he received;²⁸ and he still would have gained the benefit of having the \$10,000 excess of receivables over payables taxed to the corporation at the lower, corporate rate.²⁹

The above discussion illustrates the inequity of the *Raich* rule. Section 351 transactions that are virtually identical in economic consequences receive radically different tax treatment. In effect, *Raich* taxes the transferor on nonexistent income: The amount

27. \$35,000 represents the net worth of the proprietorship, which has \$30,000 in receivables, \$25,000 in other assets, and \$20,000 in payables.

28. Under the first alternative, Jones would sell \$20,000 of receivables to the corporation for \$20,000 in cash and use the proceeds to satisfy the payables. He would then assign the assets of the business (including the remaining \$10,000 of receivables, but excluding all obligations) to the corporation for stock. Alternatively, he could retain \$20,000 of the receivables and the \$20,000 of payables and assign the remaining assets of the business (including \$10,000 of the receivables) to the corporation. In both alternatives, the corporation would pay tax on the collection of the \$10,000 of receivables assigned to it in exchange for stock. Under the first alternative, the transferor would recognize \$20,000 of income on the sale of that amount of receivables to the corporation for cash, but he would receive a deduction of like amount when he satisfies the payables. Similarly, under the second alternative, the transferor's recognition of \$20,000 on collection of the receivables would be offset by a \$20,000 deduction on satisfaction of the payables. Under either alternative, irrespective of *Raich*, Jones would recognize no income on the transfers to the corporation because no liabilities would be transferred.

29. See note 28 *supra*.

taxed to the transferor in *Raich* did not represent any accretion to his net worth.

While one canon of statutory construction urges that statutes be construed on the assumption that Congress did not intend to draw arbitrary distinctions³⁰—such as the distinction in tax treatment of the three alternative plans described above—Congress nevertheless has the power to adopt arbitrary measures (within constitutional limitations), and courts must respect congressional directives. *Raich* deserves doctrinal criticism, but many of the alternative approaches that have been advanced lack both historical and statutory support,³¹ and accordingly are easy prey to the Tax Court's retort in *Raich*:

We must assume that if Congress had . . . intended to limit this section, it would have employed the necessary language. Finding nothing in the language of section 357(c) or in the legislative history of the 1954 Code to indicate any congressional intent to . . . limit the application of this provision, we must reject petitioners' argument and hold that a computation under section 357(c) is required by the facts in this case.

. . . .

. . . [I]n the absence of a clearly expressed congressional intent, we decline to adopt a construction of section 357(c) which is supported neither by its language nor its legislative history.³²

There are, however, compelling historical reasons for rejecting the *Raich* approach. *Raich* rests on too broad an interpretation of the term "liability" as that term is used in sections 357(c) and 358(d). As we shall show, the legislative and judicial history of section 357 indicate that an obligation should not be treated as a liability for the purposes of either section 357(c) or 358(d) to the extent that its payment would have been deductible if made by the transferor.

The origin of the term "liability" in sections 357(a), 357(c), and 358(d) is found in what is now commonly referred to as the "*Crane* doctrine." Although the basic principles announced by the Supreme Court in *Crane v. Commissioner*³³ had been recognized and accepted in administrative practice and judicial decisions³⁴ for some years,

30. See, e.g., *United States v. American Trucking Assns.*, 310 U.S. 534, 543 (1940); *Bongiovanni v. Commissioner*, 470 F.2d 921, 924 (2d Cir. 1972).

31. See text at notes 82-102 *infra*.

32. Peter Raich, 46 T.C. 604, 609, 611 (1966).

33. 331 U.S. 1 (1947).

34. See notes 36-37 *infra*.

Crane provided the most complete and authoritative expression of those principles. The case involved a transfer of real property subject to a mortgage debt on which interest was overdue.³⁵ Specifically, the Court held that the established practice of treating a transferee's assumption of a transferor's personal liability as an amount realized³⁶ was equally applicable to the transferee's acceptance of property subject to a liability: "If [the transferor] transfers [property] subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another."³⁷ The Court noted with approval, however, that the Commissioner had alleged that only the principal amount of the mortgage debt was an amount realized by the transferor, and that the Commissioner had not treated the overdue interest as an amount realized *because interest is "a deductible item."*³⁸

The wisdom of excluding deductible items under the *Crane* doctrine is demonstrated by the "wash-out" of gain and loss on deductible expense items from an economic perspective. For example, if the overdue interest in *Crane* had been treated as an amount realized by the transferor, subsequent payment of the interest by the transferee should have provided the transferor with a deduction for interest paid. The *Crane* doctrine treats assumed liabilities as if the transferee had given the transferor money equal to the debt and the transferor had himself paid the debt. The entire transaction balances at zero, making it sound simply to ignore the transfer of debts on deductible items.³⁹ Moreover, *Crane's* exclusion

35. 331 U.S. at 3.

36. The Supreme Court ruled in 1929 that one person's payment of another's obligation represents taxable income to the latter. *United States v. Boston & M. R.R.*, 279 U.S. 732 (1929) (lessee paid lessor's income tax); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (employer paid employee's federal income tax). *Cf. Houston Belt & Terminal Ry. v. Commissioner*, 6 B.T.A. 1364 (1927); *Providence & Worcester R.R.*, 5 B.T.A. 1186 (1927), *nonacquiescence*, VII-1 CUM. BULL. 39. A vendee's assumption of the vendor's debt has long been taken into account in measuring the consideration received by the vendor. *See, e.g., United States v. Hendler*, 303 U.S. 564 (1938); *Stevenson Consol. Oil Co.*, 23 B.T.A. 610 (1931), *acquiescence*, XII-1 CUM. BULL. 12; S.R. 1226, IV-1 CUM. BULL. 130 (1925). *Treas. Reg. 103, § 19.112(a)-2* (1940), issued under the 1939 Code, stated that the transferor of property subject to a liability would not recognize gain in an otherwise tax-free exchange, whether or not he was personally liable. One implication of that regulation was that the transferor would *realize* income on the exchange.

37. 331 U.S. at 14. Other courts had previously reached the same result. *See, e.g., United States v. Hendler*, 17 F. Supp. 558, 563 (D. Md. 1936), *affd.*, 91 F.2d 680 (4th Cir. 1937), *revid. on other grounds*, 303 U.S. 564 (1938), *discussed* in note 44 *infra*; *Brons Hotels, Inc. v. Commissioner*, 34 B.T.A. 376 (1936).

38. 331 U.S. at 4 n.6 (emphasis added).

39. This was essentially the approach adopted by the Tax Court in *J. Simpson*

from amount realized of the assumption of debts for deductible items is convenient in several respects. Unnecessary calculations on the tax form are avoided, as are the potential administrative and practical problems caused by income recognition in one year and deduction in another. For example, if deductible items were not excluded, a cash method taxpayer would recognize income from the assumption of deductible liabilities on a sale of his property on the date of the transfer. Unless the creditor relieved the transferor of further liability on the debt (an atypical case), the transferor would not receive an offsetting deduction until the transferee ultimately satisfied the liability—possibly not until a subsequent taxable year.⁴⁰ The administrative difficulty involved in tracing the transferee's payment, which would be necessary to determine the date of the transferor's deduction, and the tax-burden difference where the transferor's effective tax rate for the year of transfer is different from his rate for the year (or years) of payment make this an awkward approach.

It is also significant that, while in some respects (apart from differences in timing and tax rates) excluding the transferee's assumption of a deductible obligation from the transferor's amount realized is similar to the net effect of including the assumption as an amount realized and allowing a tax deduction for the payment of the obligation, in practice the effects are often quite dissimilar. For example, the amount realized as a result of the assumption of

Dean, 35 T.C. 1083 (1961) (en banc), *non-acquiescence*, 1973-2 CUM. BULL. 4 (interest-free loan does not cause borrower to recognize gain). See also Rev. Rule 55-713, 1955-2 CUM. BULL. 23. But see *General Aggregates Corp. v. Commissioner*, 313 F.2d 25, 28 (1st Cir. 1963) (dictum).

40. Since a transferee's assumption of a debt does not satisfy the debt and typically does not relieve the transferor of his liability vis-à-vis the creditor, there is no apparent justification for granting the transferor a tax deduction until the debt is actually satisfied. However, if the creditor agrees to relieve the transferor of any further liability on the debt, then the creditor effectively accepts the transferee's obligation as full payment for the transferor's debt, and in such cases the transferor should be permitted a deduction immediately upon the cancellation of his liability. But cf. *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964), where a newspaper publishing corporation sold its assets pursuant to a section 337 plan of liquidation, and the purchaser paid cash and agreed to assume the liability of completing and redeeming outstanding subscriptions. Judge, later Justice, Blackmun interpreted the *Crane* rule to cause the inclusion of the subscription reserve in the purchase price and to allow the corporation an offsetting deduction in the same amount. Applying *Pierce* by analogy, one Tax Court judge would treat an assumption of liabilities by a transferee corporation in a section 351 transfer as equivalent to the payment of those liabilities, which provides the transferor with an immediate deduction on the date of their assumption. Wilford E. Thatcher, 61 T.C. 28, 42 (1973) (Hall, J., dissenting), *appeal docketed*, No. 74-2245, 9th Cir., July 1, 1974. Such a result, however, raises significant problems. See text at notes 102 *infra*. See also Wellen, *New Solutions to the Section 357(c) Problem*, 52 TAXES 361, 369-70 (1974).

the liability may be treated as a capital gain, while the offsetting deduction may be an ordinary deduction. In that event, the taxpayer normally would be better off if he were allowed a deduction and denied nonrecognition than he would be under *Crane's* exclusion approach.⁴¹ The Commissioner and the *Crane* Court, however, apparently found it convenient simply to ignore the difference between capital and ordinary income items and to exclude deductible obligations assumed from the amount realized.

Legislative history demonstrates that the exclusion of the assumption of deductible liabilities under the *Crane* doctrine was incorporated into sections 357 and 358: The term "liabilities" in those sections refers only to obligations the transfer of which would cause realization of income to the transferor under *Crane*.

Section 112(k) of the 1939 Code⁴²—the predecessor of section 357—was adopted to modify the effect of the Supreme Court's decision in *United States v. Hendler*,⁴³ in which the Court had held that secured mortgage bonds assumed by a transferee in a reorganization constituted boot ("money received"⁴⁴) to the transferor and caused it to recognize income. Although *Hendler* was decided nine years earlier than *Crane*, the principles expressly enunciated in *Crane* were implicit in *Hendler*.⁴⁵ The Court in *Hendler* must have contemplated that the assumption of the mortgage bonds caused income realization to have held that it also caused gain recognition. Congress, worried about the effect of the decision on tax-free reorganizations and transfers to controlled corporations,⁴⁶ promptly enacted

41. Assume Jones sells his home (with a basis of \$5,000) for \$10,000 cash plus the transferee's assumption of Jones's \$5,000 mortgage and \$1,000 overdue interest obligation. Under the exclusion approach Jones would recognize a \$10,000 capital gain. Under the alternative approach, he would recognize an \$11,000 capital gain and apply a \$1,000 deduction against his ordinary income.

42. 53 Stat. 37.

43. 303 U.S. 564 (1938). Both the House and Senate committee reports recommended passage of section 112(k) and stated: "This change was made in view of the *Hendler* case . . ." H.R. REP. No. 855, 76th Cong., 1st Sess. 6 (1939), reprinted in 1939-2 CUM. BULL. 504, 507, 518-20; S. REP. No. 648, 76th Cong., 1st Sess. 3 (1939), reprinted in 1939-2 CUM. BULL. 524-25. See also *Hearings Before Comm. on Ways and Means on Revenue Revision*, 76th Cong., 1st Sess. 44-52, 59-62, 91-93, 106, 260-61 (1939).

44. Although the lower courts in *Hendler* deferred recognition of the gain represented by the assumption of the mortgage bonds, they indicated in dicta that, under traditional principles, gain was realized by the transferor of the bonds. *United States v. Hendler*, 17 F. Supp. 558, 563 (D. Md. 1936), *affd.*, 91 F.2d 680, 682 (4th Cir. 1937).

45. The *Crane* Court in fact cited *Hendler* as support for its treatment of an assumed obligation. 331 U.S. at 13.

46. The predecessor of section 351, Int. Rev. Code of 1939, ch. 1, §§ 112(b)(5), (c), (e), 53 Stat. 37, 39, also caused gain to be recognized to the extent of money received in an exchange between a transferor and a controlled corporation.

section 112(k).⁴⁷ Congress did not reject *Hendler's* application of what was later called the *Crane* doctrine; it merely postponed recognition of the gain realized by reducing the transferor's basis in stocks and securities received in a section 351 exchange by the amount of liabilities transferred to the corporation.⁴⁸ In net effect, the amount realized through a transfer of a liability was treated as a return of capital. Section 357(a), therefore, was and is intended to affect only those liabilities that, if assumed by a transferee corporation in a tax-free exchange, would cause gain recognition.

Section 358(d), originally enacted to effect a basis adjustment for gain on which recognition was postponed under the predecessor of section 357(a),⁴⁹ also should be applied only to the assumption of obligations that would cause income recognition under the *Crane* doctrine. Congress intended sections 357(a) and 358(d) to be liberalizing provisions—they were enacted to defer recognition of income that otherwise would have been recognized at an earlier date.⁵⁰ Congress had no intention of penalizing transferors by reducing their stock's basis on a transfer of obligations that would not have caused some recognition under *Hendler*.

The same analysis applies to section 357(c), which was enacted in 1954 to correct a technical flaw in the post-*Hendler* deferral mechanism.⁵¹ When assumed liabilities on which gain was deferred exceeded the aggregate adjusted basis of the property transferred, the question arose as to how the excess should be treated. Rather than grant a total tax exemption for the amount realized on the excess, Congress could have either deferred recognition by giving the transferor a negative basis in the stock and securities received in the exchange⁵² or taxed the excess immediately. It adopted the

47. Revenue Act of 1939, §§ 213(a)-(c), 53 Stat. 870, amending Int. Rev. Code of 1939, § 112 [now IRC §§ 357(a), (b), 368(a)(1)].

48. Revenue Act of 1939, § 213(d), 53 Stat. 871, amending Int. Rev. Code of 1939, § 113(a)(6) [now IRC § 358(d)].

49. See text at note 48 *supra*.

50. See Surrey, *Assumption of Indebtedness in Tax-Free Exchanges*, 50 YALE L.J. 1, 10-14 (1940).

51. The congressional committee reports cast no light on the purpose for adopting section 357(c). Most commentators suggest that the purpose was to avoid the problems of a negative basis. Cooper, *Negative Basis*, 75 HARV. L. REV. 1352, 1359 (1962); Comment, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154 (1967). But see David Rosen, 62 T.C. 11, 19 n.3 (1974), suggesting that the provision was designed to preclude a taxpayer from depreciating an asset purchased with borrowed funds and then transferring the liability to a controlled corporation.

52. See, e.g., Jack L. Easson, 33 T.C. 963 (1960), *rev'd.*, 294 F.2d 653 (9th Cir. 1961). See also *Parker v. Delaney*, 186 F.2d 455, 459 (1st Cir. 1950) (Magruder, J., concurring), *cert. denied*, 341 U.S. 926 (1951); Cooper, *supra* note 51.

latter alternative, declaring that "such excess shall be considered as a gain from the sale or exchange" of the asset involved.⁵³ The language of section 357 indicates that section 357(c) operates solely as an exception to section 357(a).⁵⁴ Where section 357(a) does not apply, section 357(c) should not apply. Incorporation of the *Crane* doctrine into section 357(a), therefore, should also limit the applicability of section 357(c). The term "liability" in both sections should be limited to those obligations that, if transferred, would constitute an amount realized by the transferor under the *Crane* doctrine.

The remaining question in so far as legislative history is concerned is whether *Hendler* incorporated *Crane's* treatment of assumptions of deductible obligations. While *Crane* was grounded in precedent established long before *Hendler*,⁵⁵ it is not clear whether *Crane* was the first instance in which the assumption of deductible obligations was excluded from amount realized or whether that aspect of *Crane* merely reflected an established administrative practice that accompanied the assumption of liability doctrines from their inception. Some early cancellation of indebtedness cases implicitly adopted the exclusion treatment noted in *Crane*,⁵⁶ but there is some contrary early precedent for the practice of including the assumed debt in amount realized and allowing a deduction for its payment.⁵⁷

Despite the ambiguity of the precedents prior to *Hendler*, several considerations support reading *Hendler* to include the *Crane* disposition of the assumption of deductible obligations. First, the paucity of exclusion cases does not indicate a contrary administrative practice: If exclusion were the existing administrative rule, the

53. IRC § 357(c).

54. This construction also conforms with the indicated purpose of section 357(c) to avoid a negative basis on the transfer of liabilities covered by sections 357(a) and 358(d).

55. See text at notes 33-36 *supra*.

56. See, e.g., *George Aftergood*, 21 T.C. 60 (1953), *acquiescence*, 1954-1 CUM. BULL. 3 (Taxpayer's debt of \$3,000 was forgiven in settlement. Since taxpayer's obligation arose out of his position as guarantor of a debt of the corporation in which taxpayer was a shareholder, taxpayer's payment of that obligation would have entitled him to a non-business bad debt deduction. See IRC § 166. Held: taxpayer did not recognize income when the obligation was forgiven); *Iceland, Inc.*, 23 B.T.A. 15 (1931), *acquiescence*, X-2 CUM. BULL. 34 (forgiven back rent had never been accrued or deducted by the taxpayer and therefore was not income).

57. See *Norman Cooledge*, 40 B.T.A. 1325 (1939), *acquiescence*, 1940-1 CUM. BULL. 2 (taxpayer sold real estate subject to taxes and interest that had accrued against the property and taxpayer prior to sale; transferee's payment of the taxes was included in the purchase price and deducted by taxpayer); S.M. 4122, V-1 CUM. BULL. 55. Cf. Rev. Rul. 75-68, 1975 INT. REV. BULL. NO. 9, at 7.

issue would not often reach the courts. The Commissioner would not seek to force income recognition since that would be contrary to the administrative practice, and in most cases the taxpayer would not wish to litigate the question.⁵⁸ In fact, in *Crane* itself the Commissioner did not seek to force income recognition on the assumption of the obligation to pay the defaulted interest on the assumed mortgage, and it is only through a chance footnote in the Court's opinion that we know of the Commissioner's position.⁵⁹ In addition, exclusion offers such substantial administrative convenience⁶⁰ as to suggest strongly that the Commissioner's position in *Crane* reflected longstanding pre-*Hendler* practice.

Even if *Hendler* did not incorporate the exclusion approach, *Crane*, as the most authoritative decision on the assumption of liability doctrine, should control the construction of the transfer of liability doctrine that was clearly adopted by *Hendler* and embodied in sections 357 and 358(d). Thus, when Congress adopted sections 357 and 358, it intended that they apply only to the transfer of obligations that would cause the transferor to recognize gain. Congress did not specify precisely which obligations would cause recognition of gain when transferred, but since *Crane* establishes that the transfer of deductible obligations does not cause gain realization (and thus does not cause gain recognition), such obligations are not covered by sections 357 and 358.

If this exclusion theory had been used in *Raich*, most (perhaps all) of Raich's trade accounts payable would not have constituted liabilities under section 357(c) and would not have reduced the basis of the stock he received under section 358(d), because had Raich satisfied those payables they would likely have been deductible.⁶¹ Any interest due on his notes payable⁶² also would have been excluded, because such interest also would have been deductible if paid by Raich.⁶³ Other obligations that should normally be excluded from section 357(c) treatment are rental obligations and salary obligations. The principal of a mortgage debt would not be excluded, however, for the transferor would not enjoy an additional tax benefit by paying the mortgage debt himself. Similarly, other

58. *But see* note 41 *supra* and accompanying text.

59. 331 U.S. at 4 n.6.

60. *See* text following note 38 *supra*.

61. IRC §§ 162, 212. Most trade accounts payables are deductible.

62. *See* note 12 *supra*.

63. IRC § 163. The Tax Court in *Raich* apparently did not include interest in its computation of liabilities.

capital expense obligations that would be reflected in the basis of the transferor's assets immediately upon his incurring the obligation should not be excluded.⁶⁴

There is one significant difference in the treatment of the transfer of assets subject to a liability in a *Crane*-type exchange and in the treatment of such transfers in a section 351 exchange. In an exchange of property not qualifying for section 351 treatment, the transferee cannot deduct payments subsequently made by him on the transferred liability, because the accepted debt is part of the transferee's purchase price.⁶⁵ Thus, the transferee in *Crane* would not have been entitled to a deduction when he paid the defaulted interest to the creditor. On the other hand, while the Code is silent about whether a section 351 transferee can deduct its subsequent payment of liabilities that were deductible in the hands of the transferor, the Internal Revenue Service has permitted such deductions in most cases.⁶⁶

If there is an inequity in both allowing the transferee corporation to take a deduction and allowing the transferor to exclude the transfer of the deductible debts from a determination of his gain, the proper cure would be to deny a deduction to the transferee corporation rather than to tax the transferor on a nonexistent gain through an overextension of section 357. In fact, however, such a "double" tax benefit may be an appropriate means of implementing the recognized congressional policy of removing tax deterrents to the incorporation or reorganization of businesses. Congress has expressly granted one type of "double" tax benefit where depreciated property (that is, property whose basis is greater than its value) is transferred to a controlled corporation in exchange for its stock: The transferor's basis in the stock received in exchange equals his basis in the transferred property, yet the transferee corporation also

64. *E.g.*, legal fees incurred in the defense of title to property. *See* *Woodward v. Commissioner*, 397 U.S. 572 (1970).

65. *Crane v. Commissioner*, 331 U.S. 1 (1947) (assumption of mortgage obligation); *Commissioner v. Oxford Paper Co.*, 194 F.2d 190 (2d Cir. 1952) (assumption of lessee's obligations); *Consolidated Coke Co. v. Commissioner*, 70 F.2d 446 (3d Cir. 1934) (assumption of mortgage obligation and promissory notes).

66. *See Points To Remember*, 18 THE TAX LAWYER, April 1965, at 114; Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 32 J. TAX. 88, 90-91 (1970). *See also* *Bongiovanni v. Commissioner*, 470 F.2d 921, 925 (2d Cir. 1972). *But see* *Holdcraft Transp. Co. v. Commissioner*, 153 F.2d 323 (1st Cir. 1946); *Athol Mfg. Co. v. Commissioner*, 54 F.2d 230 (1st Cir. 1931); *M. Buten & Sons, Inc., P-H TAX CT. MEM.* ¶ 72,044 (1972) (transferee corporation denied a deduction for guaranteed payments to widow of a deceased partner of partnership whose assets and liabilities, including obligation to make guaranteed payment, had been transferred to the corporation).

assumes the transferor's basis in the property.⁶⁷ In addition, section 381, dealing with the carryover of tax attributes in reorganizations under sections 368(a)(1)(A), (C), (F), and in some cases (D), ensures the transferee in such reorganizations a deduction for an assumed liability of the transferor.⁶⁸ It would appear that the policy behind section 381, the encouragement of tax-free changes in corporate form, should also apply to section 351 transfers. Indeed, in some cases a transaction may qualify both as a tax-free exchange under section 351 and as a reorganization under sections 368(a)(1)(C), (D), or (F).⁶⁹ While the Senate Report on the 1954 Code states that section 381 was not intended to affect the carryover treatment of tax attributes in corporate transactions not described in section 381(a),⁷⁰ the same considerations that led to the adoption of section 381 could shed light on the proper treatment of section 351 exchanges.

In sum, Congress through section 351 sought to minimize tax deterrents to the incorporation of a business by precluding the imposition of any tax burdens on the formation of a corporation (other than tax consequences necessary to protect the integrity of the income tax system).⁷¹ In the *Raich* case, if Raich had not incorporated his proprietorship, he would have collected his trade accounts receivable and recognized that income. In addition, he would have received a deduction for the payment of his trade accounts payable. The net tax consequence from these two items would have been a taxable income of \$39,641.88.⁷² If, by our hypothesis, Raich's transfer of the payables in a section 351 exchange had not

67. IRC §§ 358, 362. The transferor can recognize a tax loss on his sale of the corporation's stock and the corporation can also recognize a tax loss on its sale of the property received from the transferor. Note, however, that if appreciated property (property whose value exceeds its basis) is transferred to the corporation, there is no special tax benefit to the parties and, indeed, the assignment of the same basis to both the corporation's stock and the transferred assets may result in a tax detriment to the parties. Just as the dual basis provision is advantageous only where depreciated property is transferred, so the granting of a deduction to the transferee corporation for the payment of transferred payables provides a double benefit only where the amount of the payables exceeds the amount of the transferred receivables; otherwise the deduction for the payables is fully offset by the income recognized on collecting the receivables.

68. IRC §§ 381(c)(4), (16); Treas. Reg. § 1.381(c)(4)-1 (1964).

69. Assume corporation *A* transfers all of its assets and liabilities to corporation *B*, a new corporation, solely in exchange for 40 per cent of *B*'s voting stock. As part of the same transaction, other persons also transfer property to *B* in exchange for 45 per cent of its voting stock. The exchange by corporation *A* qualifies both under section 351 and as a reorganization under section 368(a)(1)(C).

70. S. REP. NO. 1622, 83d Cong., 2d Sess. 277 (1954).

71. See note 76 *infra*.

72. See note 12 *supra*.

generated recognized gain, the transferee corporation then controlled by Raich would have had the same tax position as Raich would have had. The corporation would have recognized \$77,361.66 of income when it collected the receivables and would have received a \$37,719.78 deduction when it paid the debts represented by the payables. Thus, the business would have shown a taxable income of \$39,641.88 whether the business was in a corporate or proprietorship form—the desired result.

Because the corporation (rather than Raich) was taxed on the receivables, and because the corporation may have had a lower tax rate, the question arises whether “assignment of income” concepts⁷³ should be applied to such transferred receivables. While the assignment of income doctrine has been applied to section 351 exchanges in a few circumstances,⁷⁴ it appears inappropriate to apply it to the transfer of income-producing assets (including accounts receivable) of a going business, at least where the assets are such as are typically held by such businesses and where, therefore, no tax avoidance purpose appears to have motivated the transfer.⁷⁵ Application of the assignment of income doctrine to such assets in section 351 transfers would undermine Congress’ policy in adopting that section, namely, the removal of tax impediments to incorporation and some types of corporate reorganizations.⁷⁶ Just as it is inappro-

73. “The principle of *Lucas v. Earl* [281 U.S. 111, 114-15 (1930)], that he who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle, has been repeatedly invoked by this Court and stands today as a cornerstone of our graduated income tax system.” *United States v. Basye*, 410 U.S. 441, 450 (1973). See also *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972); *Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Eubank*, 311 U.S. 122 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940).

74. See, e.g., *Palmer v. Commissioner*, 267 F.2d 434 (9th Cir.), cert. denied, 361 U.S. 821 (1959) (assignment of construction contract earnings); *Brown v. Commissioner*, 115 F.2d 337 (2d Cir. 1940) (assignment of fees for legal services); *Adolph Weinberg*, 44 T.C. 233 (1965), affd. per curiam sub nom. *Commissioner v. Sugar Daddy, Inc.*, 386 F.2d 836 (9th Cir. 1967) (assignment of income from crops); *Clinton Davidson*, 43 B.T.A. 576 (1941), acquiescence, 1941-1 CUM. BULL. 3 (assignment of insurance commissions).

75. Several courts would apply the assignment of income doctrine to section 351 exchanges only where tax avoidance (rather than a legitimate business purpose) motivated the exchange. See, e.g., *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974).

76. Section 351 was intended to facilitate business reorganizations based on valid business reasons by affording them tax-free treatment. *Bongiovanni v. Commissioner*, 470 F.2d 921, 924 (2d Cir. 1972). In recommending enactment of section 351’s predecessor in 1921, the committee reports noted that the provision would “permit business to go forward with the readjustments required by existing conditions” H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921), reprinted in 1939-1 CUM. BULL. pt. II, at 168, 176; S. REP. NO. 275, 67th Cong., 1st Sess. 11 (1921), reprinted in 1939-1 CUM. BULL. pt. II, at 181, 189. *Nash v. United States*, 398 U.S. 1 (1970), is an example of

appropriate to apply assignment of income principles to the transfer of trade accounts receivable in a section 361 reorganization,⁷⁷ it is inappropriate to apply them to a transfer of receivables pursuant to a section 351 exchange.⁷⁸ In apparent recognition of these considerations, the Service (at least since 1965) has taxed the transferee corporation (rather than the transferor) on the collection of receivables assigned to it for good business reasons pursuant to a section 351 exchange.⁷⁹

The operation of the *Crane* principle as incorporated into sections 357 and 358 to transfers of accounts payable may be better understood by contrasting the treatment of transfers by a cash method transferor with that of transfers by an accrual method transferor who previously accrued and deducted his payables, but who (because of other losses) did not derive any tax benefit from those deductions. In one sense, it might appear that the status of the accrual method taxpayer is essentially the same as that of the cash method taxpayer, who also has not derived any tax benefit from his outstanding obligations because he has not yet deducted them. However, the

the Court's liberal attitude toward section 351 exchanges. In *Nash* the Court refused to apply the tax benefit rule to require a transferor of accounts receivable to recognize income in the amount of previously deducted bad-debt reserves that were reasonable in amount.

77. See Treas. Reg. § 1.381(c)(4)-1 (1964). But see note 70 *supra* and accompanying text.

78. As the Third Circuit stated: "While we cannot fault the general principle 'that income be taxed to him who earns it,' to adopt taxpayer's argument would be to hamper the incorporation of ongoing businesses; additionally it would impose technical constructions which are economically and practically unsound." *Hempt Bros., Inc. v. United States*, 490 F.2d 1172, 1177 (3d Cir. 1974). See also *Thomas W. Briggs, P-H TAX CT. MEM.* ¶ 56,086 (1956) (uncollected service fees). Other cases have allowed the transferee corporation to collect and pay tax on the receivables assumed in a section 351 exchange without a discussion of the assignment of income problem. See, e.g., *Wilford E. Thatcher*, 61 T.C. 23 (1973), *appeal docketed*, No. 74-2245, 9th Cir., July 1, 1974; *Peter Raich*, 46 T.C. 604 (1966). Cases not dealing with accounts receivable have similarly limited the application of the assignment of income doctrine in section 351 exchanges. See, e.g., *Divine v. United States*, 10 Am. Fed. Tax. R.2d 5403 (W.D. Tenn. 1962) (earnings on construction contract); *Arthur L. Kniffen*, 39 T.C. 553 (1962), *acquiescence*, 1965-2 CUM. BULL. 5 (accrued interest). Note that when an installment obligation is transferred in a section 351 exchange, the transferor does not recognize income on the transfer and the transferee recognizes income when the debt is collected. Treas. Reg. § 1.453-9(c)(2) (1958).

79. *Points To Remember, supra* note 66. See *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974); *Worthy, supra* note 66. See also Rev. Proc. 68-23, 1968-1 CUM. BULL. 821, 823, stating that a favorable section 367 ruling will not be issued if accounts receivable are transferred to a foreign corporation "unless the income attributable to such property has been or will be included in the gross income of the transferor . . ." This condition would be unnecessary if accounts receivable were normally taxed to the transferor. Of course, the reason for imposing the condition on transfers to a foreign corporation is that the transferee will incur no United States tax liability on its collection of the receivables.

similarity is superficial. The assumption of a deductible obligation of a cash method taxpayer should enjoy nonrecognition under *Crane* not because the transferor derived no prior tax benefit from incurring the obligation,⁸⁰ but because the taxpayer would have been entitled to an additional benefit (a deduction) when he paid the obligation, and it would be inequitable simultaneously to treat the assumed liability as income to the taxpayer and to deny him the tax benefit for the satisfaction of that debt.⁸¹ Where the assumed obligation is previously accrued by an accrual method taxpayer, actual payment by the taxpayer would generate no additional tax benefit; the assumption of such a debt should constitute gross income whether or not the taxpayer previously benefited by the deduction. Similarly, a cash method taxpayer who transfers a liability that would not have been deductible to him should realize gain irrespective of whether he enjoyed a prior tax benefit, because his payment of that debt would not have entitled him to an additional tax benefit.

Several commentators⁸² and judges have perceived the inequity of the Tax Court's decision in *Raich* and have suggested routes for reaching a contrary result. One alternative is that adopted by the Second Circuit in *Bongiovanni v. Commissioner*.⁸³ Reversing the Tax Court, the court of appeals held that the term "liability" in section 357(c) does not include accounts payable: "Section 357(c) was meant to apply to what might be called 'tax liabilities,' i.e., liens in excess of tax costs, particularly mortgages encumbering property transferred in a Section 351 transaction The payables of a cash basis taxpayer are liabilities for *accounting* purposes but should not be considered liabilities for *tax* purposes under Section 357(c) until

80. *But see* text at notes 92-93 *supra*.

81. Although the taxpayer possibly would not be denied a subsequent deduction upon satisfaction of the debt in the non-section 351 context, *see* text preceding note 39 *supra*; cases cited note 57 *supra*, there is no statutory support for allowing the transferor a deduction in a section 351 exchange. *See* text at notes 97-102 *infra*.

82. *See* O'Connor, *Tax Problems on Transfers of Assets to Corporations*, 52 *TAXES* 756 (1974); Wellen, *supra* note 40; Note, *Payables of Cash Basis Taxpayers Under Section 357(c)*, 10 *HOUSTON L. REV.* 1170 (1973); Note, *Bongiovanni v. Commissioner*, 61 *ILL. B.J.* 557 (1973); Comment, *Section 357(c): The Quest for Equality Between Accrual and Cash Basis Taxpayers*, 52 *NEB. L. REV.* 527 (1973); Comment, *supra* note 51; Note, *Bongiovanni v. Commissioner: Tax-Free Transfer of Payables by Cash Method Taxpayer upon Incorporation*, 35 *U. PITT. L. REV.* 158 (1973); Comment, *Bongiovanni v. Commissioner: False Hopes for Cash Basis Taxpayers*, 10 *SAN DIEGO L. REV.* 857 (1973); Note, *Tax-Free Transfers to Controlled Corporations*, 76 *W. VA. L. REV.* 401 (1974); 7 *GA. L. REV.* 571 (1973); 1973 *U. ILL. L.F.* 402 (1973); 22 *VAND. L. REV.* 887 (1973).

83. 470 F.2d 921 (2d Cir. 1972).

they are paid."⁸⁴ While a literal reading of the court's emphasis on "liens" might suggest that all unsecured loans are exempt from section 357(c), it is doubtful that the court intended that meaning.⁸⁵ There is no reason why the absence of security for a debt should be relevant to the determination of whether section 357(c) will apply to the transfer of the debt: A sole proprietor who borrows \$10,000 on his unsecured note and later transfers the note to a controlled corporation in a section 351 exchange should treat the note as a liability for purposes of both sections 357(c) and 358(d). *Bongiovanni's* apparent exclusion of *all* accounts payable from the definition of "liabilities" is too broad; only those payables that would provide the transferor with a tax benefit (*e.g.*, a deduction) when paid by him should be excluded.⁸⁶

The major problem with *Bongiovanni* is the rationale offered by the court. Apparently, the court excluded accounts payable from section 357(c) to ensure that cash method taxpayers are not taxed more harshly on incorporating their businesses than are accrual method taxpayers.⁸⁷ It is highly doubtful that such equality is required: Cash and accrual method taxpayers often incur unequal tax treatment even in the context of section 351. Since cash method accounting is a form of deferral, taxpayers who elect to use the cash method frequently enjoy great advantages as against accrual method taxpayers. For example, where his accounts receivable greatly exceed his payables, the cash method transferor in a section 351 exchange effectively assigns his potential tax liability on the receivables to the corporation, there to be taxed at a possibly lower rate.⁸⁸ An accrual basis transferor will not have that opportunity. It would seem reasonable that just as in certain circumstances a cash method taxpayer can enjoy a tax advantage *vis-à-vis* an accrual method taxpayer on incorporating a business, so in certain circumstances the cash method taxpayer can be disadvantaged. The evil in the *Raich* rule lies not in its disparate treatment of taxpayers who use different methods of accounting, but in the taxation of nonexistent

84. 470 F.2d at 924 (emphasis original).

85. Such an exclusion has been rejected by the Tax Court and the Seventh Circuit. *N.F. Testor*, 40 T.C. 273 (1963), *aff'd.*, 327 F.2d 788 (7th Cir. 1964).

86. Some transferred accounts payable may be related to capital expenditures and thus may have previously increased the basis of a capital asset when the obligation was incurred. For example, salary obligations to employees who construct a capital asset are not deductible obligations. *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 13 (1974). No further tax benefit would therefore be available upon payment of the debt.

87. 470 F.2d at 924-25.

88. *See* text at note 25 *supra*.

income created artificially by an erroneous statutory construction. While the Second Circuit reached the correct result in *Bongiovanni*, the court failed to provide a logical standard for determining which obligations should constitute tax liabilities within the meaning of sections 357 and 358. Accordingly, the Tax Court⁸⁹ and several commentators⁹⁰ have repudiated *Bongiovanni* as contrary to clear statutory language.

Judge Quealy, dissenting in part in *Wilford E. Thatcher*,⁹¹ argues that in *Bongiovanni* "a distinction is made not on the basis of 'secured liabilities,' but on the basis whether the liability in question was reflected in determining the income and expense of the taxpayer on a cash basis."⁹² He would consider as section 357(c) liabilities only those obligations that can be linked to some ascertainable and previously accrued tax benefit. He explains the distinction as follows:

Where a taxpayer buys a depreciable asset with borrowed funds, the deduction for depreciation enters into the computation of the taxpayer's income on a cash basis of accounting regardless whether the borrowings constitute a lien on the asset or represent a general obligation of the taxpayer. The indebtedness is reflected in the taxpayer's accounting. On the other hand, where the liability represents an inventoriable or deductible expense it cannot be reflected in the computation of income on a cash basis until paid.⁹³

The result Judge Quealy recommends may be very close to the position we advocate. However, Judge Quealy failed to offer a rationale for construing section 357(c) as he does, and (except for those obligations he specifically mentioned) his apparent definition of the term "liability" as an indebtedness that is "reflected in the taxpayer's accounting" is not especially helpful in distinguishing "liability" obligations from "nonliability" obligations. We believe that it is more helpful in making that distinction to focus on whether the transferor would have derived a tax deduction from the payment of the obligation had he satisfied the debt himself.

In a recent article, Professor Del Cotto adopts a position similar to Judge Quealy's and argues that the term "liabilities" refers only

89. David Rosen, 62 T.C. 11, 19 (1974); Wilford E. Thatcher, 61 T.C. 28, 36-37 (1973), *appeal docketed*, No. 74-2245, 9th Cir., July 1, 1974.

90. See, e.g., Wellen, *supra* note 40, at 72-73, 77-78; 7 GA. L. REV. 571, 577 (1973).

91. 61 T.C. 28, 39 (1973), *appeal docketed*, No. 74-2245, 9th Cir., July 1, 1974.

92. 61 T.C. at 40.

93. 61 T.C. at 40-41.

to those "liabilities which have given rise to a 'tax benefit.'"⁹⁴ Professor Del Cotto apparently restricts the term "tax benefit" to "those liabilities which given rise to deductions by the transferor or have arisen from a tax-free borrowing by the transferor on the value of the transferred assets."⁹⁵ Although this test is close to the standard we have proposed, there are significant differences, as the following example illustrates: Suppose Smith, a cash method sole proprietor in the trucking business, is subjected to a \$5,000 fine by the state government for transporting goods in overloaded trucks. In addition, Smith incurs an obligation to pay wages of \$40,000 to his employees; because of a wage-price freeze then in effect, however, the salaries in excess of \$32,000 are determined to be illegal. Smith assigns his business to a controlled corporation, and for good business reasons the corporation assumes Smith's obligation to pay the fine and the salaries. Neither the payment of the fine nor the payment of the \$8,000 of excess salary is deductible.⁹⁶ Under our approach, those obligations should constitute liabilities for purposes of sections 357 and 358, and similarly would be treated as liabilities under the *Crane* doctrine, because their subsequent payment would not give rise to a deduction or comparable tax benefit. Under the test propounded by Judge Quealy and Professor Del Cotto, however, such items might well be excluded from section 357 because no deduction had been allowed on their account and they did not represent borrowings on transferred assets.

Judge Hall, also dissenting in *Thatcher*,⁹⁷ advanced an alternative theory. Although acknowledging that typically no deductions are available in section 351 exchanges,⁹⁸ she contends that section 357(c) turns the transaction into an ordinary exchange for the purpose of recognizing gain. Since Judge Hall maintained that a transferor receives an immediate deduction for the assumption of his deductible obligation in an ordinary sale,⁹⁹ she concluded that the transferor should receive a deduction for his trade accounts payable

94. Del Cotto, *Section 357(c): Some Observations on Tax Effects to the Cash Basis Taxpayer*, 24 BUFFALO L. REV. 1, 6 (1974).

95. *Id.* at 1.

96. IRC §§ 162(c)(2), (f). See Rev. Rul. 72-236, 1972-1 CUM. BULL. 41.

97. 61 T.C. at 42. Judges Forrester and Featherston joined in Judge Hall's dissent.

98. See, e.g., *Doggett v. Commissioner*, 275 F.2d 823 (4th Cir.), cert. denied, 364 U.S. 824 (1960) (tax-free incorporation of a going business); *Citizens Natl. Trust & Sav. Bank v. Welch*, 119 F.2d 717 (9th Cir. 1941) (corporate reorganization); *Arthur L. Kniffen*, 39 T.C. 553 (1962), acquiescence, 1965-2 CUM. BULL. 5 (tax-free incorporation of a going business).

99. For a contrary view, see note 40 *supra* and accompanying text.

to the extent of the accounts receivable or the gain recognized under section 357(c), whichever is less.¹⁰⁰ This approach raises at least two problems. First, cash method taxpayers would benefit only if they transfer a significant amount of accounts receivable. However, a transferor's deductible payables should be excluded and his non-deductible payables included in determining liabilities under sections 357 and 358 without regard to the amount of uncollected receivables. In addition, a particular section 357(c) gain may not be fully allocable to the accounts receivable;¹⁰¹ for example, part of such gain may be allocated to capital assets and so be characterized as long-term capital gain, which will be taxed at lower rates than ordinary income, and thus the ordinary deduction to which Judge Hall deems the transferor of accounts payable to be entitled will not constitute a "wash" with the section 357(c) gain to the extent that the latter constitutes capital gain.¹⁰²

The Tax Court's decision in *Raich* and the Second Circuit's decision in *Bongiovanni* have stimulated great interest and inquiry about the tax treatment of liabilities in a section 351 transfer. While a cynical observer might assert that there has been much grappling in the dark for a conceptual handle, the better view is that the variety of solutions proposed for the *Raich* problem indicates that its significance has not escaped notice. Hopefully, a reexamination of sections 357 and 358 in light of *Crane*, *Hendler*, and the administrative practices on which those cases were grounded will shed light on the scope of those provisions.

100. "As a matter of appropriate allocation, in the case of incorporation of a cash basis business, the trade accounts payable should, for this purpose, be netted against the trade accounts receivable, up to the lesser of the trade accounts payable or the amount of liabilities treated as paid under section 357(c)." 61 T.C. at 43.

101. Treas. Reg. § 1.357-2 (1955) provides that gain generated by section 357(c) is to be allocated among the transferred assets according to their respective fair market values and characterized accordingly.

102. The fact that the deduction of the payables under Judge Hall's approach may not constitute a "wash" of the gain recognized does not itself make that result undesirable. There is no reason why such an exchange could not create an ordinary deduction and a capital gain for the taxpayer, but that is a different result from the one described in Judge Hall's opinion. For a discussion of the reasons for rejecting an immediate deduction of the payables, see notes 39-41 *supra* and accompanying text.