A Tale of Two Liabilities

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A TALE OF TWO LIABILITIES

CARTER G. BISHOP†

We should be careful to get out of an experience only the wisdom that is in it—and stop there; lest we be like the cat that sits down on a hot stove lid. She will never sit down on a hot stove lid again—and that is well; but also she will never sit down on a cold one any more.

—Mark Twain.

In two recent cases, the Second and Ninth Circuit Courts of Appeal conflicted substantively over the impact of Internal Revenue Code section 357(c) on shareholder notes and continuing guarantees of liabilities “transferred” to a corporation where the liabilities exceed the basis of the assets transferred. This article reviews the judicial as well as the legislative history of section 357(c). It concludes that legislative action is necessary to allow the tax law to properly reflect the true economic reality of such transfers to shareholders as well as their corporations.

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1. Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989) and Owen v. Commissioner, 881 F.2d 832 (9th Cir. 1989), cert. denied, 58 U.S.L.W. 3526 (U.S. Feb. 20, 1990). The author accepted a pro bono referral of Owen through the William Mitchell College of Law legal tax clinic. On November 2, 1989, a Petition for a Writ of Certiorari to the United States Supreme Court was filed with regard to the section 357(c) issue in the Owen case.
2. I.R.C. § 357(c) (1986). Statutory references are to the Internal Revenue Code of 1986 unless otherwise indicated.
INTRODUCTION

It would be interesting to know whether Mr. Twain had a tax lawyer in mind. As tax practice becomes increasingly complex, practice errors become more commonplace. Some practice errors result in attorney discipline while still others result in malpractice claims.

3. In a lawyer's career in Minnesota, chances are about one in ten of having an ethical complaint filed against him with the Minnesota Board of Lawyer's Professional Responsibility and about one in three of being named in a malpractice action. J. Geis, Remarks at the Minnesota 49th Annual Tax Institute: Tax Practice Versus Malpractice (November 10, 1989).

4. The relationship between ethical standards of tax practice as expressed in ABA Comm. on Professional Ethics, Formal Op. 314 (1965); ABA Comm. on Ethics and Professional Responsibility, Formal Op. 335 (1974), 346 (1982), and 352 (1985), and as reflected in the MINNESOTA RULES OF PROFESSIONAL CONDUCT (1988), and the standards governing malpractice in providing tax advice is not clearly defined. The Preamble to the Minnesota Rules states that the rules are not intended to form the basis of legal malpractice claims but are rather designed to be prescriptive of lawyer
The body of tax law has become complex because of inherent statutory intricacies, frequency and volume of legislative enactments, and subsequent judicial and administrative interpretations. Yet despite the complexity of this area of practice, lawyer practice standards remain high. 5 This article tells the conduct in general. Nevertheless, it is difficult to imagine that a plaintiff's expert witness testimony would not include a reference to the Minnesota Rules (presuming a violation has been established) as evidence of a breach of a standard of care.

As with any tort claim, a malpractice violation is premised upon the existence of (i) a duty (inferred from the lawyer-client relationship), (ii) a breach of that duty (reasonable conduct standard increasingly interpreted as the standard of practice for national tax specialists), and (iii) damage causally connected to the lawyer's negligent advice or conduct.

The issue of damages in the field of tax practice is not always easy to establish. In many cases where the tax liability was under reported, the taxpayer will simply have to pay the tax liability that would have accrued from a properly reported transaction. If this is an increase over the amount originally paid, the taxpayer may not be able to establish damage since they are simply paying what the transaction correctly required in the first place. Interest on the deficiency may also not be an element of damage since the taxpayer has, in fact, had the use of the deficiency amount in the interim and will have a deduction for the interest expense paid to the government. See I.R.C. § 163(h) for the conditions of deductibility.

Incorrect advice may cause real damage to a taxpayer where a transaction which could have been more favorably reported results in a deficiency related to an overpayment. The damage results where the option for correction and refund has been precluded by either the time or manner of the original reporting. Yet even in these cases, the taxpayer's loss will be compensated by an increase in basis in some asset as a result of paying more tax than was necessary. Thus the damage may be nothing more than a measure of the time value of money determined by the estimated nature of the recovery of the increased basis.

There may, however, be some circumstances involving personal as opposed to business transactions where the additional basis may not compensate the taxpayer because it will never be recovered. See, e.g., Clark v. Commissioner, 40 B.T.A. 333 (1939) (the practitioner advised an election resulting in a less advantageous filing status which resulted in the taxpayer overpaying the tax liability). For a general discussion of the relationship between ethical standards and nontax malpractice claims see Hoover, The Model Rules of Professional Conduct and Lawyer Malpractice Actions: The Gap Between Code and Common Law Narrows, 22 NEW ENG. L. REV. 595 (1988).

On the other hand, violations and sanctions under the rules governing professional conduct and therefore licensing standards do not require damage to the client. The prescriptive nature of the rules are designed to influence prospective lawyer conduct regardless of monetary client damage. See Ohralik v. Ohio State Bar Ass'n., 436 U.S. 447, 466 (1978).

story of a common business transaction in which the potential for tax practice error lurks; not because of the complexity of the statute, but because of the counter-intuitive tax result. When tax results do not follow economic patterns, intuition misleads the practitioner and a classic trap for the unwary is created. Unfortunately, the unwary increasingly includes experienced tax practitioners.

Rapid change, however, creates an unpredictable future in our tax system, particularly where the change challenges time-honored concepts. In a tax system dominated by unpredictability, new ideas tend to give rise to creative litigation to attempt to remedy poor planning, intolerable facts, or simply a significant change in the social and economic context of the marketplace where the original idea developed.6

When the occasion does arise to make new and creative arguments, an intellectual paradigm is necessary to test the weight and force of the idea. A preeminent paradigm is the macro-systemic view that taxation of gains and losses is predicated upon the realization of a related economic benefit or loss. Since many economic gains and losses are reflected in property transactions, as opposed to cash transactions, the system’s decision to tax a property transaction at the time of receipt or to postpone taxation until the disposition of the property is reflected in the basis of the property. This view of income taxation suggests that most such decisions are qualitatively timing decisions which manifest themselves in the tax system’s basis provisions.

Although a matter of timing and possibly gain characterization,7 the question raised is whether a presumed economic benefit is sufficiently realized to currently impose a tax. Two

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7. Contrast the discussion in footnotes 9 and 10 below.
recent cases 8 involving section 357(c) transfers provide an excellent opportunity for reconsideration of the propriety of judicial, legislative, and executive treatment of this issue. The Ninth Circuit would tax the shareholder on the liability excess at the time of the transfer 9 while the Second Circuit would not tax the shareholder at the time of the transfer or at anytime in the future unless the corporation pays the liabilities subsequent to the transfer. 10


9. Owen v. Commissioner, 881 F.2d 832 (9th Cir. 1989), cert. denied, 58 U.S.L.W. 3526 (U.S. Feb. 20, 1990). This decision presumes that the corporation will pay the transferred liabilities in the future and thus grants the shareholder a current basis increase for the recognized section 357(c) gain. If the corporation does not pay the liabilities, the shareholder's basis in the stock would increase a second time at the moment of the shareholder's payment of the liability and would either increase the shareholder's loss or decrease the shareholder's gain on the disposition of the stock.

An exception occurs if the shareholder holds the stock until death where the basis in the stock is changed to fair market value at the date of death under section 1014. Any unrealized gain or loss is thereby eliminated at the date of death.

10. Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989). Under this decision, the shareholder is either (i) not given a basis increase in the stock at the time of the transfer because the excess liabilities were not considered "transferred" to the corporation and therefore did not enter the stock basis equation under sections 357 and 358; or (ii) the shareholder is given a stock basis increase for the liabilities transferred to the corporation under Crane v. Commissioner, 331 U.S. 1 (1947) and Tufts v. Commissioner, 461 U.S. 300 (1983) because it is assumed at the time of the transfer that the shareholder and not the corporation will pay the liabilities. Id. at 525-28. This latter interpretation avoids problems accruing from the shareholder's negative basis. Several of such problems are discussed below.

If the shareholder does not in fact pay the liabilities in the future because the corporation pays the liabilities, the shareholder would have income from the discharge of indebtedness at that time. There would be no correlative stock basis increase since the basis increase occurred at the time of the transfer to the corporation.

The recognition timing and income characterization contrast of Owen and Lessinger and their interpretations of section 357(c) where the shareholder pays ("Assumption I"), or does not pay ("Assumption II") the liabilities "transferred" to the corporation after the transfer is illustrated below. For both examples assume that depreciable equipment is transferred to the corporation with a basis of $0, subject to a mortgage of $200, and that prior depreciation deductions equalled $500 since the original equipment basis was $500. The current fair market value is $100.

I. Assumption I: Shareholder Pays the Liabilities.

Under Owen, the shareholder would recognize a $200 section 357(c) gain at the time of the incorporation transfer which would be ordinary income under section 1245. The stock basis would be zero. When the shareholder subsequently pays the "corporate" liabilities of $200, her stock basis would increase to $200. The corporation now has an asset with a $0 basis and a fair market value of $100. When it is sold it will realize a $100 gain and have $100 to distribute in liquidation (ignoring the
I. CONTEXTUAL BACKGROUND ANALYSIS

The business world is rife with potential liability. Accordingly, there are numerous considerations that encourage the operation of a business as a corporation notwithstanding the attendant "tax costs." These costs include a maximum corporate tax rate in excess of the maximum individual tax rate\textsuperscript{11} as

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
 & Section 357(c) & Stock Basis & Liquidation \\
 & Gain & Incorp. & Debt Pay. & \\
\hline
Owen & $200 O.I. & $0 & $200 & ($200) C.L. \\
Lessinger & 0 & 0 & 0 & 0 \\
\hline
\end{tabular}
\end{table}

Under Lessinger, the shareholder does not recognize a gain under section 357(c) at the time of the incorporation. The stock basis is zero based upon the liability doctrine of Crane and Tufts. The subsequent shareholder payment of "corporate" debt does not increase stock basis since it was increased at the time of the incorporation based on the shareholder’s future liability payment responsibility. When the corporation sells the assets for $100 with a zero basis it recognizes a $100 gain and distributes $100 (ignoring the corporate tax liability) which causes the shareholder to recognize a $100 capital gain under section 331(a). Thus, the shareholder is not required to artificially recognize a $200 "gain" under section 357(c) because no gain existed at the time of the incorporation or later because the shareholder paid the liabilities with after-tax dollars. This "validates" the economic effect of the prior depreciation deductions by occasioning the prior depreciation deductions with a subsequent actual economic loss through the payment of liabilities.

II. Assumption II: Corporation Pays the Liabilities

Finally, if the shareholder does not pay the "transferred" liabilities, the choice presented by the cases is as follows: Owen would force the shareholder to recognize $200 in ordinary income at the time of the transfer under sections 357(c) and 1245. The assumption is that the corporation would pay the liabilities. Lessinger would postpone that decision until the corporation actually did pay the shareholder liabilities and at that time tax the shareholder with $200 ordinary income under a section 61 discharge of indebtedness theory.

III. Chart

The following chart illustrates these principles:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
 & Section 357(c) & Stock AB & Liquidation \\
 & Gain & Incorp. & Debt Pay. & \\
\hline
Owen & $200 O.I. & $0 & 0 & 0 \\
Lessinger & 0 & 0 & $200 O.I. & 0 \\
\hline
\end{tabular}
\end{table}

11. After the Tax Reform Act of 1986, the maximum effective section 11 corporate tax rate is 34% while the maximum effective section 1 individual tax rate is 28%. This is the first time since 1913 that both an individual and corporate tax have co-existed and the corporate rate has exceeded the individual rate. The corporate rate, of course, exceeded the individual rate from 1909 until 1913 prior to the enactment
well as a double tax on corporate earnings distributed as dividends.\textsuperscript{12} The most significant nontax corporate attribute is limited liability.\textsuperscript{13}


\textsuperscript{12} Since a shareholder's dividend investment return on a capital investment in the corporation is not deductible to the corporation, this aspect of corporate earnings is subject to a double tax. First, the earnings are taxed at the corporate level at a maximum rate of 34\% and the balance of the earnings distributed as a dividend are taxed at the individual shareholder's maximum 28\% rate (corporate shareholders are entitled to a section 243 deduction of either 70\% or 100\%). For example, a corporation with $1,000 of earnings will pay a tax of $340 and have $660 available for a dividend distribution which will be taxed to the shareholder at a 28\% rate or $184.80. Thus, the combined tax paid by the corporation and the individual will be $524.80 or a combined rate of 52.48\% compared to the individual rate of 28\%. This double taxation applies to both income from operations and to pre-contribution gain from the sale of assets contributed by shareholders. (The same idea would allow the corporation a double deduction of pre-contribution losses which has evoked a statutory limitation ("anti-stuffing rules" of section 336(d)) to avoid transfers of loss assets to a corporation principally for the purpose of a double loss recognition.)

To compensate for this double tax feature, techniques have evolved which include (i) eliminating the corporate level tax or (ii) accumulating earnings in corporate solution to be taxed upon the disposition of the corporate stock in the form of a higher sales price. This latter technique defers the second shareholder level tax at the expense of a higher current corporate tax (34\%) on a greater pre-tax amount (earnings on $660 taxed at 34\% at the corporate level versus earnings on $475.20 taxed at 28\% at the shareholder level). Until the elimination of the preference for the capital gains tax in the Tax Reform Act of 1986, this was a more attractive technique because the increased price for the stock was taxed at a lower tax rate (20\%) than the dividend distribution (50\%).

The first alternative contemplates efforts to transfer corporate earnings to shareholders without the earnings first being taxed at the corporate level by creating a deduction for the withdrawal and payment to the shareholder. This involves recharacterizing the dividend distribution as a deductible expense. The most common expense categories include salary withdrawals and interest expense. The former is limited by § 162(a)(1) which allows deductions only for reasonable compensation. The latter is limited by § 385 which attempts to govern the ratio of debt and equity in the capital structure of the corporation. Current legislative efforts are under way to alter the debt-equity balance by substantially restricting the use of debt in corporate formations. \textit{See infra} note 34.

Of course, many small properly structured corporations will be able to avoid the corporate level tax by electing to be treated as a small business corporation under §§ 1361-1378. There are, however, significant capital structure limitations expressed in § 1361(b) which may disqualify many organizations from utilizing these provisions. In essence, these provisions permit the corporate earnings to be taxed directly to the shareholders.

\textsuperscript{13} For a small corporation owned by one person with few if any employees the limited liability feature may be more illusory than real. Liability will generally arise in the context of a negotiated contract or the commission of tortious conduct.

With respect to contract liability, most creditors negotiating with the corporation will require the shareholders' personal guarantee of major contracts absent a significant corporate operating history or corporate balance sheet independently justifying
In a traditional section 351 incorporation, a shareholder transfers assets to a corporation in return for all of its stock. In many cases, these assets may be subject to purchase money security interests serving as collateral for loans incurred to acquire the assets. Where the assets were subject to depreciation prior to the transfer to the corporation or when the shareholder borrows against significant pre-contribution asset appreciation, the amount of the liabilities at the time of the credit extension. These creditors include banks, occupancy and equipment lessors, as well as significant vendor financed transactions. Ordinary trade creditors would normally be excluded from this category.

Similarly, if the sole owner-employee of a corporation commits a negligent act while on company business, the person will be personally liable for the resultant damage as the primary tortfeasor. In addition, the corporation may also be liable as the employer under the doctrine of respondeat superior. Where there are a number of shareholders, however, the corporate structure may shield the corporate owner's personal assets from liability for the acts of other negligent employees. The corporation may also be liable but the owner's liability will ordinarily be limited to the current investment in the corporation.

Finally, there is expanding liability for environmental waste problems prompting a significant consideration of the corporate structure as a method of alleviating personal liability. The liability extends not only to health hazards, and to those connected to or affected by "hazardous waste," but also to the clean up costs. For example, the elimination of asbestos in a fifteen year old apartment can be enormously expensive, yet the existence of the liability may not have been known by the current owner who acquired the building for cash five years ago. In many cases, where the building is subject to a nonrecourse mortgage, the owner's equity may not be sufficient to cover the costs of the clean-up. In such a case, the current owner may simply want to turn the building over to the lender. There may, however, be personal liability for all connected in the chain of title including lenders. This of course raises the question of liability allocation among those persons as well as the function of the nominal corporate owner.


15. See Woodsam Associates, Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952) for an example of the latter circumstance. See also Owen v. Commissioner, 881 F.2d 832 (9th Cir. 1989), cert. denied, 58 U.S.L.W. 3526 (U.S. Feb. 20, 1990). Owen is an example of basis falling below the face amount of debt because of prior depreciation deductions.

Any attempt to distinguish between these two examples of liability in excess of basis appears to be fundamentally flawed because the connecting link to the transactions is the existence of a shareholder primary liability which survives the incorporation transfer. In other words, whether the taxpayer receives cash or a tax deduction, the fundamental nature of the transactions remains a loan. If the taxpayer consumes the cash from the loan or the cash is generated by the tax deductions, income does not exist at the moment of consumption because of the continuing obligation of the taxpayer to repay the loan. Income or economic benefit does not exist in a tax sense until the moment that the economic responsibility to repay the liability ceases. Unless the incorporation event, therefore, somehow operates to extinguish the taxpayer's liability (economic equivalent of corporate assumption), it simply is not an...
the incorporation may exceed the basis of the assets transferred to the corporation.

When the assets are subject to liabilities exceeding their aggregate basis, the unambiguous language of the applicable statutes makes the statutory result certain.\textsuperscript{16} To prevent the shareholder from escaping a tax on the economic benefit,\textsuperscript{17} the shareholder will be treated as if a gain was realized at the time of the incorporation transfer to the extent the liabilities exceed the aggregate basis of the assets transferred.\textsuperscript{18} The transfer is treated as if the shareholder retains the liabilities and the cor-

\textsuperscript{16} See I.R.C. §§ 351(a)-(b), 357(c)(1), and 358(a) and (d) (West Supp. 1989).
\textsuperscript{17} Presumably, such economic benefit is occasioned by the "corporation's payment" of the shareholder's former liabilities in excess of basis, or the creation of a "negative basis" in the shareholder's stock. For example, if the shareholder's aggregate bases in the assets transferred was $200, the fair market value (without debt), $500, and the property subject to a mortgage in the amount of $500, §§ 358(a)(1)(A)(ii) and(d)(1) would treat the corporation's liability assumption of $500 as money received and reduce the shareholder's carryover basis in the stock from the asset basis of $200 to a $300 negative basis. In order to prevent this result, § 357(c)(1) taxes the $300 liability excess as a gain from the disposition of the assets which brings the shareholder's basis to zero under the positive basis adjustment of § 358(a)(1)(B)(ii).

Where, however, the corporation has no current or anticipated ability to pay the "transferred" liabilities attached to assets "subject to" such liabilities, the presumption of this article is that the shareholder may not have realized an "economic benefit" as a result of the transfer.

Notwithstanding Rosen v. Commissioner, 62 T.C. 11, 19 n.3 (1973), aff'd, 515 F.2d 507 (3d Cir. 1975), in such an event § 357(c)(1) is not "analogous to other recapture provisions of the Code . . . ." Cash withdrawn in the form of loans or tax deductions do not present an economic benefit by reason of the incorporation transfer when such a transfer has an effect on the transferor's recourse obligations. See cases cited supra note 15. Moreover, the "recapture" analogy is incomplete and unsatisfactory. The function of the recapture provisions is to characterize a gain or a loss on a "sale;" not to create gain or loss where none exists in an economic sense in the first instance.

\textsuperscript{18} The "gain" recognized under § 357(c)(1) is based upon the economic release of liability benefit received by the shareholder on the transfer. See, e.g., Crane v. Commissioner, 331 U.S. 1 (1947); see also Tufts v. Commissioner, 461 U.S. 300 (1983). Thus, the statute establishes and recognizes the minimum gain that the shareholder would recognize if the assets were transferred for the amount of the liabilities only.

The concept of minimum gain from liabilities in excess of basis has other functions in the tax system as well. In the partnership tax area, special allocations are tested under § 704(b) for substantial economic effect. When the allocations are attributable to nonrecourse debt, the concept of a minimum gain chargeback to the person receiving the allocation validates, in part, the allocation.
poration transfers money to the shareholder. This enables the shareholder to pay the liabilities personally rather than transferring them to the corporation. Under section 351(b), the shareholder’s realized gain is recognized to the extent of the money received.

Provided there are valid reasons to support the assumption that the corporation will pay the liabilities in the future, treating liabilities in excess of basis the same as a receipt of money seems fair enough. But consider the result if the incorporation transfer assumption cannot fairly be made. What if it is unreasonable to assume that the corporation will or can independently pay the liabilities? If the shareholder must pay the liabilities either directly through a guarantee or indirectly through additional capital contributions, what is the implicit assumption of section 357(c) with regard to taxing transferred liabilities in excess of basis as if a “gain” had occurred? Is it relevant to ask what Congress had in mind in enacting section 357(c) in 1954? Finally, if it is determined that Congress never considered that the corporation may never pay the liabilities, what is the appropriate judicial response to the dilemma until and if Congress decides to respond with a clarifying amendment?

The answers to these questions depend in part upon the factual context in which the issue of probable corporate nonpayment arises. Whether the shareholder pays the liabilities directly because of a guarantee or indirectly through additional corporate capital contributions, enabling the corporation to pay the liabilities, the issue is the same: at the time of the incorporation transfer, is it reasonably clear that the corporation will be unable to independently make the liability payments in the future?

Many factors may contribute to this problem. Yet these factors become significant only when it appears that at the time of the asset and liability transfers, the corporation has no reasonable expectation of independently accepting responsibility for payment of the liabilities. This is especially true where the corporation has a negative net worth at the time of the transfer and either no operating history or an operating history that suggests the corporation will not be able to pay the liabilities.

In this context, a range of judicial responses to the language of section 357(c) are possible. Courts might determine that
the liabilities were not in fact transferred to the corporation either through the “assumption” or “subject to” language of section 357(c). Alternatively, it could be determined that the shareholder has not received the kind of “economic benefit” imagined by the statute when it is likely that the corporation will not in fact pay the liabilities. Moreover, the response might be that the language of the statute is clear and it is the responsibility of Congress to change it, not the courts.

A. Indirect Shareholder Payment

What is the result if at the time of the incorporation transfer, the shareholder also transfers an agreement to make future cash capital contributions secured by a note with a fair market value equal to its face value?\(^\text{19}\) The shareholder will receive additional basis in her stock when the note is paid in due course. Moreover, the agreement to transfer money in the future under the terms of the note negates the presumed “economic benefit” occurring as a result of the corporation paying the liabilities in the future. In effect, the shareholder maintains economic responsibility for a portion of the liabilities “transferred” to the corporation.

Should such notes be disregarded at the time of transfer to the corporation or should they be treated as true acquisition debt paid as partial consideration for the stock of the corporation? If treated as true debt, should the liabilities not result in an increase in the stock’s basis at the time of the incorporation?

B. Direct Shareholder Payment

If economic rationality mandates treating the shareholder note as true debt, is there any meaningful distinction between these notes and a shareholder’s continuing primary liability for debt secured, in part, by assets transferred to the corporation where the corporation does not pay the debt? What if the shareholder must continue to provide payment guarantee to obtain lender approval because of a weak corporate financial condition? This may be particularly true where the corporation is new and the assets transferred to the corporation are

\(^{19}\) This would be the case where the note states a market interest rate for the associated credit rating of the shareholder and any collateral pledged to secure payment of the note.
not sufficient in value to cover the liabilities. What would be the impact, if any, of a shareholder pledging personal assets to the lender to secure the corporate debt? If shareholder notes are to be treated differently than shareholder guarantees, will not all properly advised shareholders execute notes to formalize their guarantees?

If section 357(c) is not invoked at the time of the transfer, what happens if the shareholder does not pay the note in due course and the corporation forgives payment? Alternatively, what happens if the shareholder is not required to make payments on the guarantee because the corporation makes the payments? Must not income be recognized at that time under a discharge of indebtedness theory? If a shareholder is given basis in the stock for the amount of the section 357(c)(1) liabilities in excess of basis as true acquisition indebtedness, why should basis not be increased if the note exceeds this amount? Finally, if the shareholder's economic responsibilities are disregarded, a section 357(c) gain recognized, and a denial of a basis allowed for these kinds of notes and guarantees, are not taxpayers without the benefit of sophisticated tax planning penalized? Are we simply not encouraging tax planners to "cover up" their mistakes by backdating or creating new post-incorporation documents?

These are not intended to be rhetorical questions. The answers, as provided by two recent federal appellate court opinions, may be surprising.

The courts and the Internal Revenue Service have traditionally interpreted section 357(c) without addressing the economic reality associated with such notes and guaranteed liabilities. Yet in other contexts, such as with the acquisition of property, the taxpayer is given basis credit for the fair market value of her own acquisition notes and other liabilities which are treated as true debt. If true debt is recognized and reflected in the basis of property because of the economic responsibility to repay debt in the future, why the disparate tax treatment of notes and guaranteed liabilities in the context of a section 357(c) transfer?

This result is particularly troubling when the economic substance of the transactions does not justify the distinction. The

taxpayer could presumably borrow the funds from another source, contribute the loan proceeds to the corporation, liquidate the loan in due course, achieve basis credit at the time of the contribution, and avoid the section 357(c) gain. The fact that the corporation is the creditor is economically irrelevant to the shareholder.

Of course, with proper tax planning, the taxpayer would never have transferred liabilities to the corporation in an amount in excess of the transferred asset basis. This is particularly true where the shareholder must remain liable on the debt anyway and the lending institution continues to look to the shareholder for repayment, ignoring the corporation. This is not an unusual circumstance with the incorporation of small, closely-held corporations. In such a case, the shareholder may have personal and even liquid assets pledged against the now guaranteed corporate loan. It only seems prudent in such cases to eliminate the debt in excess of basis problem by bifurcating the lender liability\textsuperscript{21} and not transferring the excess amount of the liability to the corporation.\textsuperscript{22} If this is not feasible, another planning solution is to transfer additional assets with basis in an amount sufficient to offset the excess of liabilities over basis. In any event, if there is no substantive economic difference in these forms, why overlay an interpretation on section 357(c) that places a premium on sophisticated tax advice and thereby creates a trap for the unwary?

When it must deal with contributions of personal notes and the guarantee of transferred liabilities, the Internal Revenue Service is placed in the position of policing such debt structures. Thus, the Service's role is to assure that the notes are in fact true debt whose commercially reasonable terms are subsequently observed by shareholder, rather than corporate payment. But this is not an unreasonable role and it is one in

\textsuperscript{21} The corporation would not assume the excess liabilities. In addition, it would seek the lender's approval of the transaction through a partial release of the security interest.

\textsuperscript{22} Notwithstanding the favorable treatment given to this kind of transfer in Jackson v. Commissioner, 708 F.2d 1402 (9th Cir. 1983), it remains a questionable practice, particularly outside the Ninth Circuit. Section 357(c) continues to apply where the corporation takes the property "subject to" the debt. Thus, if the asset transferred to the corporation continues to act as collateral for the loan, this reasoning would appear to be in conflict with the plain language of the statute.
which the Service already finds itself with regard to other forms of related party debt transactions.

If the liabilities are deemed transferred to the corporation, even though the shareholder remains economically responsible, the incorporation and basis statutes may be interpreted as creating a negative basis in the shareholder's stock. Equitable solutions to the problem of negative basis, other than those found in section 357(c) exist. The most realistic and consistent with current tax policy include: 1) recognizing the true economic nature of the shareholder notes or guarantees at the moment of incorporation, thereby eliminating a current section 357(c) gain; and 2) taxing the shareholder when and if the corporation pays the liabilities. In this way, tax law reflects rather than dictates economic rationality, a more suitable policy where tax abuse and avoidance is not present. The shareholder is not taxed under section 357(c) on a "presumed economic benefit" and is instead taxed on future economic benefit only if it in fact arises.

Nevertheless, modern interpretations of section 357(c) have not paid attention to these solutions, but rather have focused on plain meaning. In part, this may be because the courts have asked the wrong questions. The statute simply may not contemplate the shareholder paying liabilities which appeared to have been transferred to the corporation. The relevant question seems to require a more fundamental examination. Such an approach examines when and under what circumstances a taxpayer should be entitled to treat its continuing debt responsibility as true debt for economic basis purposes under the related judicial doctrines of Commissioner v. Tufts, and Crane v. Commissioner.23 The problem described may be solved in the short run by judicial construction confining the statute to its intended purpose. In the long run, an amendment to section 357(c) may be necessary. This is not unlike the situation resulting from the 1978 amendment to section 357(c) regarding the tax treatment of accounts payable.

Prior to the amendment, incorporation of ongoing cash method businesses possessing accounts receivable and accounts payable faced a problem: the accounts receivable did not have an income tax basis but the related accounts payable

were included at their face amount. This resulted in a gain from liabilities (payables) in excess of basis (receivables). In order to avoid this harsh result, judicial decisions did not interpret the accounts payable as “liabilities” for purposes of section 357(c).24 Subsequently in 1978, section 357(c) was amended to provide in subdivision (3) that accounts payable were not liabilities under section 357.25

Consistent with the 1978 amendments, recent decisions recognize the compelling economic arguments of taxpayers in the context of incorporation transfers where liabilities exceed basis. This is particularly true where the assets transferred to the corporation merely act as security for the loans but the economic responsibility remains with the shareholder. In this instance, even though the corporation has not “assumed” the liabilities either formally or economically, the “subject to” language of section 357(c) appears to mandate taxation of a gain presuming an economic benefit to the shareholder.

This may be more appropriate with nonrecourse loans as the shareholder’s personal responsibility to pay the liabilities transfers with the asset. Recognizing a gain may therefore be necessary to avoid permanently escaping taxation on the gain or, alternatively, creating a negative basis in the stock received in the exchange.26

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24. Early decisions in the United States Tax Court gave § 357(c) liabilities a broad and inclusive meaning. See Thatcher v. Commissioner, 61 T.C. 28 (1973), rev’d in part and aff’d in part, 533 F.2d 1114 (9th Cir. 1976); Bongiovanni v. Commissioner, 30 T.C.M. (CCH) 1124 (1971), rev’d, 470 F.2d 921 (2d Cir. 1972); Raich v. Commissioner, 46 T.C. 604 (1966). The courts developed three approaches to alleviate this problem. First, the Second Circuit concluded that the term “liability” under § 357(c) did not include accounts payable. See Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972). Second, the Ninth Circuit permitted the shareholder an immediate deduction of the accounts payable to offset the § 357(c) gain. See Thatcher v. Commissioner, 533 F.2d 114 (9th Cir. 1976). The first two approaches developed from reversals of the tax court’s position that the language of § 357(c) was clear and unambiguous.

Third, after these reversals, the tax court reversed its long standing position and determined that the term “liability” under § 357(c) would be limited to those debts which, if transferred, would cause gain recognition under Crane. The tax court also determined that the term would not include liabilities which would have been deductible if paid by the transferor. See Focht v. Commissioner, 68 T.C. 223 (1977). See Kahn, A Definition of “Liabilities” In Internal Revenue Code Sections 357 and 358(d), 73 Mich. L. Rev. 461 (1975) (co-authored by Dale Oesterle), for an analysis of these three approaches.


26. See Woodsam Assocs., Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952).
When recourse liabilities are involved, a different economic picture emerges depending upon whether the corporation or the shareholder intends to and does pay the liabilities. When the corporation is incapable of payment because the fair market value of the assets is less than their adjusted basis, the shareholder does not realize the kind of economic benefit envisioned by section 357(c).

Increasingly, the judiciary is becoming dissatisfied with the inadequate language and solutions provided by section 357(c). In Lessinger, the Second Circuit ("Lessinger II") reversed the tax court ("Lessinger I") by recognizing the economic equivalence of the taxpayer's note. The court gave Lessinger basis in the note and additional basis in the transaction such that the sum of the liabilities transferred to the corporation did not exceed the aggregate basis of the assets transferred.27

In Owen, the Ninth Circuit ("Owen II") affirmed the tax court's decision ("Owen I") that a taxpayer's personal guarantee did not increase the taxpayer's basis in assets transferred or decrease the amount of liabilities effectively "assumed" by the transferee corporation. The Ninth Circuit also sanctioned the tax court's summary decision in Owen I to reduce the amount of liabilities assumed by the corporation by $100,000, the amount of a certificate of deposit pledged to the bank. The certificate of deposit remained the "asset" of the taxpayer and not of the transferee corporation.28

This may be looking for a silver lining in the Ninth Circuit opinion since Owen II represents a restriction of the court's earlier holding in Jackson v. Commissioner.29 At the very least, Owen II represents a failure to expand the court's Jackson doctrine.30


28. See Owen v. Commissioner, 881 F.2d 832 (9th Cir. 1989), cert. denied, 58 U.S.L.W. 3526 (U.S. Feb. 20, 1990) and Owen v. Commissioner, 53 T.C.M. (CCH) 1480 (1987). This issue was not argued on appeal by the government which means that either the issue was missed, or that the government approves of the treatment. A discussion with the taxpayer's appellate counsel indicated that the government missed the appeal on the matter but does not approve of the treatment.

29. Jackson v. Commissioner, 708 F.2d 1402 (9th Cir. 1983).

30. The Owen II Ninth Circuit opinion does not refer to the Lessinger II Second Circuit opinion even though the latter was decided on March 29, 1989 and the former was decided on August 9, 1989. A conversation with the appellate counsel for the taxpayer in Owen I and Owen II showed that counsel was aware of the earlier Lessinger decision even though it was decided after the December 5, 1988 argument.
The tax court obviously does not consider its interpretation of section 357(c) on a slippery slope, but that view may not be universal. In Owen I it relied on its own Lessinger I decision as primary authority. Of course, Lessinger I was reversed by the Second Circuit. There is a substantive conflict between the Second Circuit in Lessinger II and the Ninth Circuit in Owen II. On November 2, 1989, the taxpayer in Owen II filed a Petition for Writ of Certiorari to the United States Supreme Court to review the conflict between the circuits.

II. STATUTORY ANALYSIS OF INCORPORATION TRANSFERS

A. In General

In general, neither a transferee corporation nor its shareholders recognize gain or loss on the transfer of assets to the corporation or the corporation’s issuance of stock or securities. Under section 1032, the corporation does not recognize gain or loss on the issuance of its own stock (including treasury stock) in exchange for money or other property. The corporation takes a carryover basis under section 362 in the contributed assets. If the corporation acquires the assets in a taxable transaction, its basis will be a section 1012 cost basis.

A shareholder’s acquisition of stock for cash is not a taxable event for the shareholder. Rather, it is an investment that will generate income or loss at the time of the disposition of the stock. Where, on the other hand, the shareholder’s invest-
ment in the corporate stock is made in exchange for appreciated or depreciated property, there is a current gain or loss realization. This event is taxable under section 1001(a) in an amount equal to the difference between the bases of the assets given up and the fair market value of the stock received. Under section 1001(c), the realized gain or loss must be recognized absent a controlling nonrecognition statute such as section 351.

Under section 351(a), a shareholder will not recognize gain or loss on a transfer of property to a corporation provided that (i) immediately after the transfer the shareholder and any other transferrers are (ii) in control of the transferee corporation (iii) and the property is transferred solely for stock or securities of the transferor corporation. If any shareholder receives other property in addition to such stock or securities, section 351(b) provides that gain (but not loss) will be recognized to the extent of the amount of money received and the fair market value of other property.

B. Liabilities in Excess of Basis

Any excess over the aggregate adjusted basis of the properties transferred to the corporation by the shareholder is treated as a minimum gain under section 357(c)(1). The excess is determined by adding the sum of the liabilities "assumed" by the corporation to the liabilities to which the transferred properties are "subject." The character of the gain

36. Under United States v. Davis, 370 U.S. 65 (1962) the fair market value of property received in an arm's length commercial transaction is presumed equal to the fair market value of the property transferred in the exchange. Thus, if the stock is difficult to value, it will be presumed to be equal in value to the assets transferred to the corporation.

37. Under § 351(d), transferee corporate stock or securities issued for shareholder services and certain specified transferee corporation debt and interest will not be treated as if issued for in return for property causing the transferrers of such assets to recognize income or gain under §§ 1001 and 83.

38. See I.R.C. § 368(c) (West Supp. 1989) (providing that "control" for this purpose means the ownership of stock with at least 80% of both (i) the total combined voting power of all classes of voting stock, and (ii) the total number of shares of all classes of nonvoting stock).

39. Compare this result with the result under § 357(c)(1). This section provides that "if 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... then such excess shall be considered as a gain..." Under § 351(b)(1), the receipt of boot forces recognition only to the extent of realized gain.
is determined by the character of the assets transferred.\textsuperscript{40} Where there are multiple asset transfers, the resulting section 357(c) gain is allocated among the assets for characterization purposes according to the relative fair market values of the assets.\textsuperscript{41}

1. Stock Basis

Under section 358(a), a shareholder’s basis in stock received is equal to the basis of the assets transferred to the corporation increased by any gain recognized on the transfer and decreased by the amount of loss recognized and the sum of the “boot” received. “Boot” is a technical synonym for the amount of money and the fair market value of other property received; in other words, nonqualified property which would cause recognition under section 351(b). Section 358(d) provides that any liabilities of the shareholder assumed by the corporation in the transfer, or to which the assets transferred were subject, are not treated as money received. Money is treated as boot and requires immediate recognition of gain. Liabilities transferred to the corporation first reduce the taxpayer’s basis in the stock. The stock basis in turn is a carryover basis from the taxpayer’s aggregate basis in the assets transferred.

The distinction between the section 351 tax treatment accorded to boot and liabilities is important and is reflected in the principles supporting section 357. As a general rule, section 357(a) provides that the transferee corporation’s assumption of liabilities is not treated as a receipt of money or other property. In these circumstances, the taxpayer is entitled to the more preferential treatment of recovering its basis in the

\textsuperscript{40} Rev. Rul. 60-302, 1960-2 C.B. 223.

\textsuperscript{41} See Treas. Reg. §1.357-2(b) (Example 1). This situation often produces counter-intuitive results where one or more of the assets transferred is a loss asset. In such a case, the fair market value of the loss asset will determine the character of a portion of the gain even though the asset was not responsible for any of the gain. Moreover, the corporation’s basis in the loss asset received is presumably increased by the correlative amount of the gain under §362 which has the effect of increasing the loss to the asset.

Since the character allocation rule of Treas. Reg. §1.357-2(b) appears in Example 1, perhaps this methodology can be considered illustrative only where all the assets are gain assets. Where some of the assets are loss assets, a more realistic approach may be to allocate the gain to assets for characterization purposes in accordance with the ratio of the gain on each asset. Since consistency is the hallmark of success in these cases, it would then be appropriate to follow the same plan under §362 when determining the basis of the assets to the corporation.
assets transferred before any gain is recognized on the exchange.\(^\text{42}\) This is reflected by a correlative basis reduction in the shareholder's stock under sections 358(a) and (d). The result is that the shareholder will recognize any gain on the transfer when a disposition of the stock occurs. Sections 351(a), 357(a), and 358(a), therefore, only defer the recognition of gain until disposition of the stock. Thus, the shareholder's release of liabilities in the transfer is not a tax equivalent to a cash out or a receipt of boot.\(^\text{43}\)

2. **Negative Basis**

Another problem may arise where the sum of the liabilities transferred exceeds the shareholder's aggregate basis in the assets transferred. The liabilities are still preferentially treated as a return of the shareholder's basis in the assets transferred. But once the aggregate basis is recovered, either the shareholder must be permitted a "negative basis"\(^\text{44}\) in the stock, or, alternatively, the excess of liabilities over basis of the assets transferred must be treated as boot requiring the shareholder to recognize gain. Not surprisingly, the statute takes the approach of requiring gain recognition.

Section 357(c)(1) requires liabilities in excess of transferred-asset basis to be treated as gain from the sale of the assets transferred. Moreover, section 358(a) reflects this treatment and prevents the shareholder from acquiring a negative basis in the stock by giving the shareholder a zero basis. Thus, in all cases where the shareholder recognizes a section 357(c)(1) gain, the resultant section 358(a) basis in the corporate stock will be zero.\(^\text{45}\)

\(^{42}\) This preferential basis-first treatment is reminiscent of "open transaction" reporting of "sales" under Burnet v. Logan, 283 U.S. 404, 413 (1931) which was virtually eliminated with the 1980 amendments to section 453 installment sales. I.R.C. § 453 (West Supp. 1989). See S. Rep., No. 96-1000, 96th Cong., 2d Sess. 25, 26 (1980).

\(^{43}\) If the stock is considered a § 1221 capital asset, the shareholder may convert the character of the gain from ordinary to capital. Capital gains have the advantage of a full absorption of capital losses under § 1211(b) and the possible future advantage of a preferential tax rate if Congress restores the capital gain preference.

\(^{44}\) For a discussion of the historical roots of the negative basis concept see Cooper, *Negative Basis*, 75 Harv. L. Rev. 1352 (1962). See also Parker v. Delaney, 186 F.2d 455, 459–60 (1st Cir. 1950) (Magruder, J., concurring), cert. denied, 341 U.S. 926 (1951) (approving the concept of a negative basis in a pre-1954 and therefore pre-section 357(c) case).

\(^{45}\) Oddly enough, this process does not permit the taxpayer to recognize loss
a. **Historical Development of Negative Basis**

This was not always the result. Section 357(c) was not enacted until the 1954 Internal Revenue Code. In *Eason v. Commissioner*, the taxpayer owned a building valued at $300,000, possessing a basis of $87,000, and subject to a mortgage in the amount of $247,000. The taxpayer transferred the building, subject to the mortgage, to a newly formed corporation in exchange for all of the corporation's stock.

The applicable statutes then governing the transaction were sections 112(b)(5) and (c)(1) of the Internal Revenue Code of 1939. These sections provided that gain was to be recognized only to the extent of the fair market value of money and other property received. Section 112(k) provided that the corporation's assumption of the mortgage did not constitute the receipt of money or other property. The statutes, therefore, did not require the recognition of gain by the shareholder. Moreover, the shareholder's basis in the stock was determined under section 113(a)(6). This section provided for a carryover basis of $87,000, reduced by the fair market value of any money or other property received. For this purpose, the corporation's assumption of the $247,000 mortgage was to be treated as money. On the basis of the statutory language,

under § 351(b) where the fair market value of the property has fallen below its adjusted basis and is subject to a liability equal to its adjusted basis. In such cases, the liability assumption absorbs the basis without a correlative loss recognition. Perhaps this is the intent of the statute, at least with respect to nonrecourse debt. Illustrative of this intent is the 1984 enactment of § 7701(g) which provides that in such cases, the fair market value is presumed to be not less than the debt, in which case, there would be no loss. In such cases, the taxpayer may well be wise to sell the asset, recognize the loss, and contribute the cash.

46. 294 F.2d 653 (9th Cir. 1961), rev'd, *Easson v. Commissioner* 33 T.C. 963 (1960) (a pre-1954 Internal Revenue Code case). These figures are rounded for simplicity. The actual figures were a fair market value of $320,000, an adjusted basis of $87,214.86, and a mortgage balance of $247,064.01. *Id.* at 654. Apparently the property had appreciated significantly during its ownership by Mr. Easson and he elected to withdraw part of the appreciation in a tax-free refinancing. This refinancing did not affect his basis in the property since he did not use the proceeds to improve the property. Regarding tax-free refinancing see *Woodsam Assocs., Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952).


Mr. Easson appeared to have a tax-free incorporation followed by a negative basis in his stock of $160,000. The Internal Revenue Service took issue with Easson’s reasoning.

Adopting a circular analysis, the tax court assumed that since a taxpayer could not have a negative basis in property, Easson’s resultant basis was zero. This resulted in the elimination of the gain inherent in the carryover basis of the stock. This flawed analysis resulted in an unwarranted increase in the basis of the stock from a negative $160,000 to zero. The court then taxed Easson on the liability in excess of basis, or $160,000, at the time of the transfer. With regard to the tax court’s assumption that property could not have a negative basis, the court reasoned:

It is a fundamental concept of income taxation to tax gain when its fruits are available for payment of the tax. If a negative basis were allowed then recognition of gain could be deferred until a subsequent loss sale or even an abandonment, and unless [the] taxpayer had other resources the tax would never be collected.

The tax court’s result can be rationalized more as resisting a taxpayer windfall than as being anti-negative basis. Nevertheless, the question remained whether the Easson court’s assumption regarding negative basis was accurate.

The Ninth Circuit Court of Appeal’s review of Easson was more considered of the negative basis concept than was the tax court’s footnote assumption. The court of appeals concluded that there was no authority or practical reason why the taxpayer could not have a negative basis. The court viewed the matter as any other nonrecognition event with the resulting stock basis, negative or positive, simply reflecting the untaxed gain or loss inherent in the taxpayer’s transaction. Thus, the court reasoned that the taxpayer would recognize all his gain on the subsequent disposition of the stock, including the

50. The $247,000 amount of the mortgage less the $87,000 amount of pre-existing basis in the land and building transferred to the corporation.
51. 33 T.C. at 969-70.
52. Id. at 970.
53. Id. at n.8. The fruit metaphor presumably springs from the famous fruit and tree income tax metaphor of Eisner v. Macomber, 252 U.S. 189 (1920) popularized in Lucas v. Earl, 281 U.S. 111 (1930).
54. 294 F.2d 653, 660-61 (9th Cir. 1961).
55. Id.
Notwithstanding the Ninth Circuit’s decision in *Easson*, the advent of section 357(c) in the Internal Revenue Code of 1954 itself raised the question of whether Congress intended to preclude a negative basis in a tax-free transfer. Although it is not entirely free from doubt, it appears that Congress did consider the issue of negative basis. Consequently, any resolution of the section 357(c) problem must not be resolved by a negative basis analysis, at least in light of a legislative change of posture.

### b. Legislative History of Section 351

Prior to the Internal Revenue Act of 1921, property received as part of an exchange was treated as the equivalent of cash to the extent of its fair market value for purposes of determining gain or loss. Such exchanges included contributions of property to newly created corporations in exchange for the corporation’s stock. This tax result proved to be too restrictive and was seriously interfering with necessary business readjustments because it resulted in taxation of technical gains often represented by only a change in the form of the investment.

In order to facilitate mere change in form incorporation transfers, Congress enacted section 202(c)(3) as part of the

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56. *Id.* at 661.
57. See *Cooper, Negative Basis*, 75 Harv. L. Rev. 1352, 1360 (1962).
58. The Revenue Act of 1918, § 202(b), 40 Stat. 1057, 1060 (1918) (repealed 1921), read as follows: “When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any.”
60. Section 202(c)(3) provided, in part:

Sec. 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—

(c) For purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, re-
Revenue Act of 1921 ("1921 Act"). The statute was designed to permit formal and organizational business readjustments without the recognition of technical or paper profits created by transfers to controlled corporations.\(^{61}\) Under section 202(d)(1), the transferor was given a substituted basis in the stock and/or securities received in the exchange; the same as the basis of the property transferred to the corporation.

However, if in addition to receiving nonrecognition property in the form of stock or securities of the transferee corporation, the transferor also received money and/or other property, section 202(e) provided that the amount of money and the readily realizable market value of the other property received was to reduce the basis of the property transferred (and hence the basis of the nonrecognition stock and/or securities received). The transfer was taxable to the extent of the excess over the basis of the property transferred.

This version of section 202(e) was amended in 1923.\(^{62}\) The amendment provided that the receipt of property other than nonrecognition property would cause any gain realized to be

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recognized to the extent of the amount of the money received plus the fair market value of any other property received.64

The Revenue Act of 1924 ("1924 Act") made only minor changes to these provisions, though the language and the section numbers changed somewhat.65 Section 202(a) of the 1924 Act provided that the gain or loss from the sale or other disposition of property was to be determined by comparing the amount realized in the disposition to the basis of the property surrendered. The amount realized was defined as the amount of money received plus the fair market value of any other property received under section 202(c). This language was the genesis of the current counterpart found in sections 1001(a) through (c) and was designed to eliminate the confusion with regard to determinations of whether property had a readily realizable value.66

The language of the gain and basis provisions of the Revenue Act of 1921, as modified in 1923, found in 202(c)(3), (d)(1), and (e), was replaced by 203(b)(4),67 (d)(1),68 (i),69 and

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63. The idea was that the only portion of the taxpayer's gain realized on the exchange which should qualify for deferral under the statute was the amount not represented by the receipt of boot. See S. Rep. No. 1113, 67th Cong., 4th Sess. 3 (1923).

64. The language of § 202(e) was altered by adding the following: "[T]he amount of the gain resulting from such exchange shall be computed in accordance with subdivisions (a) and (b) of this section, but in no such case shall the taxable gain exceed the amount of the money and the fair market value of such other property received in exchange." Act of March 4, 1923, § 2, 42 Stat. 1560 (1923).


66. Id.

67. See id. Sections 203(a) and (b) provide in relevant part:

(a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

(b)(4) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.


68. H.R. Rep. No. 179, supra note 61, at 14. Section 203(d)(1) provides in relevant part:

If an exchange would be within the provisions of paragraph (1), (2), or (4) of subdivision (b) if it were not for the fact that the property received in the exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or
204(a)(6). In addition, 204(a)(8) was added to provide the transferee corporation a carryover basis from the shareholder, increased or decreased by the amount of gain or loss recognized by the shareholder on the transfer.

There were no changes to these provisions in the Revenue Act of 1926, and the Revenue Act of 1928 only changed the section numbers. These section number revisions stayed with the provisions until they were modified by the Internal Revenue Code of 1954. The general nonrecognition rule of section 203(b)(4) was renumbered as section 112(b)(5); the boot gain provision of section 203(d)(1) was changed to section 112(c)(1); and the control definition was changed from section

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money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.


69. Section 203(i) provides in relevant part: "As used in this section the term "control" means the ownership of at least 80 percentum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation." Revenue Act of 1924, § 203(i), 43 Stat. 253, 258 (1924).

70. Section 204(a)(6) provides in relevant part:

If the property was acquired upon an exchange described in subdivision (b), (d), (e), or (f) of section 203, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by paragraph (1), (2), (3), or (4) of subdivision (b) of section 203 to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it;


71. Section 204(a)(8) provides in relevant part:

If the property (other than stock or securities in a corporation a party to a reorganization) was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in paragraph (4) of subdivision (b) of section 203 (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made;


203(i) to section 112(j). The transferor substituted basis provision was changed from section 204(a)(6) to section 113(a)(6) and the transferee corporation carryover basis provision was renumbered from section 204(a)(8) to section 113(a)(8).

Very minor changes were made as part of the Revenue Act of 1932 to reflect a corporate basis in the case of a contribution of capital.\textsuperscript{73} The Revenue Act of 1936 redesignated and slightly redefined the 80\% control test.\textsuperscript{74} The adoption of the Internal Revenue Code of 1939 brought no changes to these provisions. The Revenue Act of 1939, however, brought the first explicit provisions regarding the treatment of debt and hence may be regarded as the genesis of the current section 357.

In \textit{United States v. Hendler},\textsuperscript{75} the Supreme Court held that when an acquiring company assumed and paid liabilities of the target company in an otherwise tax-free reorganization, the target company must treat the event as the equivalent of the receipt of money. The transfer was therefore taxable as boot. The Revenue Act of 1939 changed this result by adding section 112(k).\textsuperscript{76} This section provided that such liability assump-

\begin{footnotesize}
\begin{itemize}
\item[73.] Revised § 113(a)(8) provided in relevant part:
\begin{quote}
If the property was acquired after December 31, 1920, by a corporation—
\begin{enumerate}
\item[(A)] by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or
\item[(B)] as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.
\end{enumerate}
\end{quote}
\item[74.] Section 112(h) provides in relevant part:
\begin{quote}
As used in this section the term “control” means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.
\end{quote}
\item[75.] \textit{United States v. Hendler}, 303 U.S. 564 (1938).
\item[76.] Section 112(k) provided in relevant part:
\begin{quote}
Where upon an exchange the taxpayer receives as part of the consideration property which would be permitted by subsection (b)(4) or (5) of this section to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as ‘other property or money’ received by the taxpayer within the meaning of subsection (c), (d), or (e) of this section and shall not prevent
\end{quote}
\end{itemize}
\end{footnotesize}
tions were not to be treated as the receipt of money (absent a tax avoidance purpose) for purposes of gain recognition. However, section 113(a)(6) was also amended to provide that such an assumption was treated as the receipt of money for purposes of reducing basis in the stock or securities received. In addition, section 112(b)(5) was amended to provide for the impact of such debt assumptions on the proportionality test of the statute.

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the exchange from being within the provisions of subsection (b)(4) or (5); except that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this section, be considered as money received by the taxpayer upon the exchange. In any suit or proceeding where the burden is on the taxpayer to prove that such assumption or acquisition is not to be considered as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.


77. Section 113(a)(6) provided in relevant part:

If the property was acquired, after February 28, 1913, upon an exchange described in section 112(b) to (e), inclusive, the basis (except as provided in paragraphs (15), (17), or (18) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. 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 the purposes of this paragraph, be considered as money received by the taxpayer upon the exchange.


78. Section 112(b)(5) provided in relevant part:

No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the
There were virtually no changes in these provisions until the enactment of the Internal Revenue Code of 1954. At that time, sections 112(b)(5) and (c)(1) were renumbered as sections 351(a) and (b), respectively. Section 112(k) was renumbered and amended as section 357. Section 113(a)(6) became sections 358 and 1031, and section 113(a)(8) became section 362.

There were two major changes to the incorporation scheme in 1954. First, the House deleted the proportionality test of old section 112(b)(5), because it was causing confusion and uncertainty in practice.79 The Senate agreed.80 Second, section 112(k), treating the impact of liability assumptions, was amended by keeping the provisions of the Internal Revenue Code of 1939 and by adding a new subsection. New section 357(c) was added and provided for the first time that if the amount of liabilities assumed by the corporation or the amount of the liabilities to which the transferred assets were subject exceeded the basis of the assets transferred, gain was to be recognized to the extent of the excess.

The precise reason for this amendment is less clear, although the House Report contains the following passage: "[y]our committee’s bill contains additional safeguards against tax avoidance not found in existing law. It imposes a tax when property subject to liability in excess of its basis is transferred to a controlled corporation."81 In the House Report’s detailed discussion of the technical provisions of the bill, the following explanation for section 357(c)82 is stated:

Paragraph (2) of section 356 which has no counterpart under the 1939 Code, provides that if an exchange to which section 351 (relating to transfers to a controlled corporation) or section 359(d) (relating to corporate separations) is

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82. Although the quoted text refers to § 356, the liability provision was renumbered as § 357 under the Senate’s version of the bill.
applicable, the liabilities are assumed, or the liabilities to which the property is subject, exceed the total of the adjusted basis of the property transferred pursuant to such exchange, such excess shall be considered as gain from the sale or exchange of a capital asset. Thus, if an individual transfers, under section 351, property having a basis in his hands of $20,000 but subject to a mortgage of $50,000, to a corporation controlled by him, such individual will be subject to tax at rates applicable to the sale of capital assets with respect to $30,000, the excess of the amount of the liability over the adjusted basis of the property in the hands of the transferor.

It seems reasonably clear from the language included in the first quotation that the original House bill contemplated that the new section 357(c) was necessary to correct tax avoidance. But what tax avoidance? The 20/50/30 example adopted by both the House and Senate illustrates the operation of the mechanics of the statute but not what would happen if section 357(c) were not enacted—in other words, the perceived abuse at which the provision was aimed.

A glimpse at the perceived evil may be found by exploring the interaction between the stock basis rules of the transferor under section 358 and the liability assumption rules of section 357. Assuming no tax avoidance purpose and no section 357(c) provision, the $50,000 liability in the above example would not be treated as the receipt of money for purposes of gain recognition under section 357(a). But under section 358(d) the assumption would nevertheless reduce the transferor's substituted basis of $20,000 in the stock to be received. Thus, the transferor would have a negative basis of $30,000 in the stock, which would provide a minimum gain on the disposition of the stock of $30,000. Of course, to the extent the fair market value of the property increases, the amount of the subsequent gain would increase. In the example cited by the


84. It is difficult to know the exact consequences of whether § 1014 would eliminate this income potential at death. Presumably it would because it is unlikely that the negative basis amount would be considered income in respect of a decedent under §§ 691 and 1014. A transferee, therefore, would take a stepped-up basis to fair market value.
House and Senate Reports, the value of the property is not stated. If it was $50,000, the amount of the liability, the transferor would realize the same $30,000 gain on the disposition of the stock as would have been realized if the asset had been sold as opposed to transferred to the corporation. Similarly, if the value is greater than the mortgage, this additional gain will also be preserved. So what is the problem with negative basis?

Apparently, at the time section 357(c) was enacted there was some doubt about whether a negative basis was permissible or possible in our tax system. Absent a permissible negative basis, if the section 357(c) gain was not taxed at the time of the transfer, the transferor would permanently escape tax on the amount by which the liabilities exceeded basis. The section 357(c) solution to this problem is to tax the liability excess as gain at the time of the transfer and give the transferor a zero basis under section 358.

In introducing H.R. 8300, Dan Reed, then chairman of the House Ways and Means Committee, indicated that one of the purposes of the bill was to close numerous tax avoidance loopholes. Rather than detailing these, he entered into the record a list of over fifty of such loopholes of which the section 357(c) version was number twenty-one. Reed's commentary provided, in part, as follows:

Twenty-first. Assumption of liability in excess of basis, section 356: If an individual transfers property with a basis of $200,000 subject to a mortgage of $100,000 to a corporation controlled by him in exchange for its stock, the stock will have a basis in his hands of $200,000 less the amount of the mortgage: that is $100,000. This is so because the individual has been relieved of paying the mortgage. However, if the individual had borrowed $500,000 against the property, it is doubtful whether, under existing law, the basis can be reduced to less than zero for the stock. In other words, under existing law he can escape completely from any tax liability for the $300,000 by which the amount of the liability exceeds his basis for the property in the example given above.

The new code closes this loophole by levying a tax on the amount by which the liability assumed exceeds the basis of the property when property is transferred to a controlled

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3. Limitations of the Statutory Negative Basis Approach

Fundamentally, the same circular analysis first exhibited in Easson is troublesome in addressing the array of planning solutions to a taxpayer facing a section 357(c) transfer. In short, immediate recognition of gain is not the only solution to the problem where the taxpayer adds assumed value to the assets transferred to the corporation by giving a note, guaranteeing liabilities and even pledging assets to secure a guarantee. This happens to be the choice of section 357(c), but not a necessary result, where these additional value added components are present in the exchange. Moreover, consistent with the legislative history of section 357(c), negative basis need not be created in the transaction if the value added transfers are evaluated in consistent terms with other judicial doctrines regarding the treatment of debt in connection with the acquisition of property.

In considering the matter exclusively from the plain language of section 357(c) one not only suffers from tunnel vision but may miss the point of other more searching solutions which do not result in a negative basis. In the case of a note transfer, exemplified by Lessinger II, this may simply entail granting the taxpayer a basis in the stock consistent with the principles discussed below in Crane and Tufts. This is not to be confused with the analysis of granting the taxpayer a basis in her own note, although this statement more or less begs the question. 87 Granting a taxpayer a basis in property acquired with debt necessarily assumes that the debt will be repaid in the future with after-tax dollars, creating a basis at that time. The immediate grant of basis in the property for the debt simply reflects an accelerated basis grant on the assumption that the debt will actually be paid in the future. The Crane and Tufts decisions have firmly imbedded this concept in tax law. If it is imbedded in taxable transactions, it is imbedded in nontaxable exchanges. 88

86. Id.


88. The taxpayer in Crane did not acquire the property in a taxable transaction albeit it was not a carryover basis transaction. The taxpayer inherited the property
The approach might necessarily be somewhat different with property transferred where the taxpayer remains liable on the debt because of the financial weakness of the corporate transferee. Yet this alone does not suggest that the approach of section 357(c) is superior to others or that another more satisfactory approach cannot be crafted without creating a negative basis. One idea would be to analyze the shareholder guarantees. If in fact the lending institution required a guarantee as a prerequisite to allowing the asset transfer, an assumption could be made that the debt will actually be paid by the shareholder and not the corporation. If such an assumption were allowed, the taxpayer would simply create additional basis after the exchange which would not be of benefit at the time of the exchange by virtue of section 357(c).

To avoid this nasty and somewhat draconian result, another idea would be to treat the guarantees the same as if the shareholder had given a new note. If the corporation, as opposed to the taxpayer, ultimately pays the debt, the taxpayer would have income at that time. Moreover, an extension of the statute of limitations might even be extracted as part of the bargain.

III. JUDICIAL TREATMENT OF "TRUE ACQUISITION DEBT"

A. Crane v. Commissioner

In Crane v. Commissioner, Beulah Crane inherited an apartment building in 1932 as the sole beneficiary of her husband's will. The building was appraised for estate tax purposes at a value exactly equal to the amount of its secured indebtedness; a nonrecourse obligation. Mrs. Crane therefore inherited the property with no realizable equity and subject to an inter-

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from an estate receiving a § 1014 stepped-up basis. Depreciation was nonetheless taken on the value of the property including the mortgage not net of the mortgage.

89. This argument is at odds with the current interpretation of § 357(c). See, e.g., Rosen v. Commissioner, 62 T.C. 11 (1974), aff’d, 515 F.2d 507 (3d Cir. 1975). Contra Jackson v. Commissioner, 708 F.2d 1402 (9th Cir. 1983).

90. Another obvious reason for not distinguishing between these two kinds of continuing shareholder liabilities is that even where the taxpayer has guaranteed such liabilities he could simply execute new notes to make the guarantees like the notes in form as well as in substance.

91. 331 U.S. 1 (1947).

92. In this context, the term nonrecourse means the exclusive remedy of the lender on default is to foreclose on the collateral (apartment building) securing the loan. The lender could not pursue Mrs. Crane either personally or through any of
est default. The lending institution allowed Mrs. Crane to continue to operate the property notwithstanding the default provided she pay all operating expenses, hold back a monthly amount for the payment of the real estate taxes, and pay the balance of the net rentals over to the bank on a monthly basis. She was entitled as the tax owner of the property to take depreciation deductions. After seven years of operation under this arrangement, the interest default had doubled and the taxpayer sold the property under a threat of foreclosure for $3,000 cash, subject to the nonrecourse mortgage, but less $500 in closing expenses.

The taxpayer claimed that the gain from the sale was only $2,500, the amount of cash received less the expenses of sale. Crane, however, took $28,045.10 in depreciation deductions as a result of an inclusion of the mortgage in the original depreciable basis of the property. The government contended that her gain from the sale was actually $23,767.03. The difference in positions was attributable to the government's inclusion of the mortgage's outstanding principal balance in the amount realized.

The central issue was the Court's treatment of the amount of the nonrecourse liability on the taxpayer's original depreciable basis. The government argued that acquisition indebtedness must be included in original basis for three reasons. First, if

93. Crane v. Commissioner, 331 U.S. 1, 3 (1947). The building was subject to a mortgage of $255,000 with unpaid and accrued interest in default of $7,042.50 and the property was included in the husband's estate at a value of the sum of the two or $262,042.50. Id.

94. Id. The amount of interest default at the time of sale was $15,857.71.

95. The statutory definition of "amount realized" under § 1001(b) is the sum of the amount of money received plus the fair market value of any other property received. As discussed, Crane and Tufts add a third element to the statute, the face amount of any debt on the property regardless of whether the amount of such debt exceeds the fair market value of the property.

96. This amount was calculated by subtracting from the taxpayer's original basis of $262,042.50 the depreciation allowed of $28,045.10 and comparing that amount to the $2,500 net proceeds of sale, along with the principal amount of the mortgage. The government did not treat the deducted and defaulted interest as part of the sale proceeds.


98. Id. at 1052-53.
the depreciation deductions, ostensibly representing fictional economic decline in value of the property, were based only upon the taxpayer’s equity\footnote{In this sense, equity is used to refer to the amount the taxpayer would be entitled to receive on the sale of her property if sold for its fair market value, less the face amount of any debt on the property.} in the property as opposed to its gross fair market value including the amount of any mortgage, the actual depreciation deductions would not bear any resemblance to the economic events affecting the property. Second, if the debt were not included in the original basis of the property, each payment of nondeductible principal on the loan would require an adjustment to the taxpayer’s basis. This is because the taxpayer’s after-tax investment in the property would then increase. The government argued that this would create intolerable administrative burdens on the government as well as taxpayers. Finally, the government argued that if the debt was not included in the taxpayer’s original basis, the taxpayer could manipulate and control the timing of depreciation deductions by simply controlling the timing of principal payments.

The taxpayer’s principle argument was that the depreciation deduction belonged to the person who had the risk of loss with regard to the property. In this case, the lender. The Court agreed with the government.\footnote{Id. at 1053.}

The Court concluded that the taxpayer must also include the amount of the mortgage in the “amount realized” on the disposition of the property in order to avoid the absurd result of creating a tax loss or deduction without a concomitant true economic loss. The taxpayer was thus only entitled to deduct the equity investment (zero) and any other uneconomic deductions were required to be included in income at the time of the sale.\footnote{Id. at 1054–55. Curiously, the tax benefit from the interest deductions was excluded from the government’s analysis.} This may be considered the informal birth of the concept of “minimum gain.”\footnote{In partnership tax law, the concept of minimum gain is the amount of deductions taken with respect to a nonrecourse mortgage that result in deferral of income. This is because on the disposition of the property, any deductions attributable to the debt will have to be repaid in the form of gain under the Court’s holding in \textit{Crane}.}
B. Commissioner v. Tufts

In Tufts, the Court revisited Crane to resolve the controversy of whether the amount of a nonrecourse mortgage is still included in the taxpayer’s “amount realized” on the disposition of the property, where the amount of the mortgage exceeded the property’s fair market value because of a post-acquisition decline in the property’s value. The Court concluded that there was no difference created by this factual point and, consistent with Crane, the “amount realized” on the disposition of the property included the face amount of the mortgage.

The Tufts Court questioned why acquisition debt is included in original basis. In addition to affirming the Crane rationale, the Tufts Court added that the justification for granting an accelerated basis for debt is that the loan is treated as true debt.

A true loan is not included in income on receipt because of a concomitant and offsetting obligation to repay. This repayment obligation is also the foundation for including the loan in the original basis. To avoid objections offered by the government in Crane for not including the loan in the original basis, Tufts concluded that all such debt, even nonrecourse debt, must be included in the basis of the property acquired.

C. Application To Section 351 Transactions

What exactly is the impact of Crane and Tufts on section 351 transactions? What is the effect on the shareholder’s stock basis of a continuing economic responsibility for liabilities which appear to have been “transferred” to the corporation? What is the impact of these cases on the shareholder’s presumed economic gain under section 357(c), particularly since the liabilities in Crane and Tufts are nonrecourse?

The issue, of course, is whether there is a meaningful difference between the acquisition of stock in a section 351 incorpo-

104. This question was created by the Crane Court’s now famous footnote thirty-seven. The Court implied that if the value of the property was below the amount of the mortgage it might have reached a different result. 331 U.S. 1, 14 n.37 (1947).
105. 461 U.S. at 317.
106. Id. at 307.
107. Id.
108. Id.
ration transfer and property acquired in a manner contemplated in *Crane* and *Tufts*. The most obvious difference is the nature of the transactions and how the taxpayer’s basis is determined in each.

In *Crane*, the property was acquired through an estate. The taxpayer’s basis was determined under section 1014 and was equal to the fair market value at the date of the decedent’s death. In *Tufts*, the property was acquired in a taxable transaction. The basis of the property was determined under the cost basis approach of section 1012. In *Lessinger* and *Owen*, as described below, the property was acquired in a section 351 exchange. The basis of the stock, therefore, was determined under section 358. The argument asserted here is that there is no economic or tax policy reason to treat debt differently in these transactions, particularly new debt created as part of a transfer to obtain corporate stock.

IV. *Lessinger* Case History

A. *Lessinger* I

In *Lessinger* I, Sol Lessinger transferred to a corporation the majority of the assets and liabilities of an ongoing business. This business had been operated for many years as a sole proprietorship.109

At the time of the transfer, the proprietorship’s books showed that the business liabilities exceeded the aggregate basis of its assets transferred by $255,499.37. After the incorporation, the corporation’s books showed a loan receivable from Mr. Lessinger in the precise amount of the liabilities in excess of basis or $255,499.37. The tax court found that Mr. Lessinger “did not execute a note for this amount nor did he pay or agree to pay interest on this amount.”110

Within one month of the transfers, Mr. Lessinger applied a portion of the proceeds from the sale of some personal mutual funds to pay down the corporate note. The payment was $62,209.35 and reduced the corporation’s loan receivable to a balance of $196,790. No additional payments were made for approximately five years at which time the balance on the corporation’s receivable was $237,044. The increased balance re-

110. *Id.* at 829.
flected accrued interest. Approximately four years after incorporation, a creditor forced Mr. Lessinger to execute a note on behalf of the corporation.111

Before the tax court, Lessinger's only argument concerning section 357(c) was that the corporation did not "assume" all the liabilities, particularly the trade accounts payable in the amount of $416,026.24. The argument was that since Lessinger had retained personal responsibility for these liabilities, the corporation had merely made a loan to Lessinger to pay the accounts payable.112

Although the tax court recognized that the question of whether the corporation actually assumed the liabilities was a matter of state law, in this case the corporation actually paid the liabilities. The tax court determined that the record clearly showed that Lessinger intended the corporation to pay the liabilities in the normal course of its business.113 The court concluded that in such circumstances, a debt could be considered a section 357(c) liability even though Lessinger retained personal responsibility for its payment. The court based its decision on Smith v. Commissioner, and Rosen v. Commissioner.114 Finally, the tax court rejected the contention that a properly executed note would have made any difference. Citing Alderman v. Commissioner, the court held that such a note would have had a zero basis and therefore would not balance the excess liabilities for purposes of section 357(c).115

B. Lessinger II 116

On appeal, Lessinger argued that the tax court had erred in two ways.117 First, the court erred in determining that the corporation had "assumed" the accounts payable. Second, Lessinger argued that the court misunderstood which assets were

111. Id.
112. Id. at 836.
113. Id. at 837.
114. Id. Smith v. Commissioner, 84 T.C. 889, 909 (1985); Rosen v. Commissioner, 62 T.C. 11, 19 (1974), aff’d, 515 F.2d 507 (3d. Cir. 1975). On this point, the tax court also cited Jackson v. Commissioner, 708 F.2d 1402 (9th Cir. 1983), as reflective of a circumstance in which the corporation was not deemed to have assumed the liability.
117. Id. at 520.
transferred to the corporation. Lessinger argued that the court ignored his personal debt to the corporation. He reasoned that this debt should be considered a transferred asset under section 357(c).

The Second Circuit Court of Appeals summarily rejected the taxpayer's first argument that the liabilities had not been assumed by the corporation. The court then proceeded to the second question of whether the "note" transferred to the corporation was an asset with basis equal to its face value for purposes of section 357(c).\textsuperscript{118}

The court first concluded that the debt was not artificial. A due date, interest, and security were not necessary to characterize Lessinger's debt to his corporation as real debt. The court found the debt enforceable because it was evidenced by a note executed subsequent to incorporation.\textsuperscript{119}

The court then considered whether Lessinger had a basis in the note sufficient to be counted in the section 357(c) equation. The court indicated that it thought that basis existed in assets and not liabilities thus rejecting the notion that Lessinger had a "basis" in the note sufficient to offset the excess liabilities under section 357(c). The court reasoned that "[s]ection 357(c) does support the Alderman court's reliance on the concept of basis, but the statutory language is not addressed to a transaction such as Lessinger's, where the transferor's obligation has value to the transferee corporation."\textsuperscript{120}

The court then found section 357(c) inapplicable on two new grounds not addressed by Lessinger at the tax court level. First, the court fashioned a completely new and dubious interpretation of the section 357(c)(1) "adjusted basis" concept. The court reasoned that even though Lessinger had no section 1012 basis in his note liability because basis exists in assets not liabilities,\textsuperscript{121} he nevertheless could not and did not transfer liabilities in excess of basis under section 357(c)(1) because the corporation had a basis in the liability. The court erroneously reasoned that the corporation must have a basis in the shareholder liability otherwise it would recognize income when Lessinger paid the note. Moreover, since the corporation had a

\textsuperscript{118} Id. at 523.
\textsuperscript{119} Id. at 524.
\textsuperscript{120} Id. at 525.
\textsuperscript{121} Id.
basis in the note, and since section 362(a) (governing corporate asset basis) provides that the corporation "acquires" its basis from the shareholder, Lessinger must have had a section 357(c) inferred basis in the note exclusively for purposes of section 357(c).122

The court's second rationale examined the legislative history of section 357(c)(1) and concluded that the purpose of section 357(c) was to tax the shareholder on the "economic benefit" realized by the corporation's payment of liabilities which exceeded basis.123 Using a common sense approach, the court simply believed it counter-intuitive to pretend that Lessinger received any net value from the corporation since he had an offsetting, equal obligation to the corporation.

The government argued that the court's interpretation would effectively eliminate section 357(c). But the court concluded that its interpretation simply limited section 357(c) to its intended and proper scope.124

1. Analysis

Convinced of the equitable force of the taxpayer's position in its second analysis, the court may well have attempted to craft a solution to the basis "problem" the argument creates. It seems reasonably clear that since one of the central purposes of section 357(c) may have been to eradicate negative basis, any solution proposed by the court to the taxpayer's circumstance must not create a negative basis in the taxpayer's stock. The court's inventive, albeit inaccurate, section 362(a) transferred basis approach may simply be viewed as the best idea they were presented with. There are other ideas which may be better.

First, there does not seem to be any statutory prohibition against an interpretation that suggests that if it is unreasonable to assume or expect the corporation to pay the transferred liabilities to any extent, the amount of liabilities need not be considered "transferred." This would be particularly true in the case of a transfer "subject to" the liabilities as opposed to affirmatively "assumed" by the corporation. If this were the case, that amount of liabilities would not be considered trans-

122. Id. at 525-26.
123. Id. at 526.
124. Id. at 526-28.
ferred for purposes of sections 357 and 358. Since this idea has not been widely accepted because of the apparent simplicity of the "subject to" language of section 357(c), another more creative solution may be necessary.

If the taxpayer's newly created liability is simply viewed as an additional cost of acquiring his stock, and it is arguably nothing more, Crane and Tufts will create a basis in the stock. The fact that section 358(a) does not refer to this kind of a basis increase is not controlling. It certainly was not controlling in Crane and Tufts. A review of section 1012 does not suggest that a taxpayer should be granted basis for debt. Moreover, a review of the amount realized language of section 1001(b) certainly does not refer to debt. The fact of the matter is that the treatment of debt and its impact on basis has been left largely to judicial development. Evolving concepts of liabilities under section 357(c) have no immediate reason to expect a better fate.

Critics of this reasoning for avoiding negative basis may argue that such an analysis spells disaster. What if the corporation rather than the shareholder ultimately pays the liabilities or cancels the note? The answer seems clear and is again found in Crane and Tufts. The taxpayer would have cancellation of debt income at the time the economic benefit arose which is the time of payment of the shareholder's note. No additional stock basis would be achieved since the shareholder already received a full basis at the time of the exchange.

It would also not be accurate to suggest that the Crane and Tufts view of debt is only relevant in taxable acquisitions of property. A simple review of the basis provisions of section 1031(d) for property received in a nontaxable like-kind exchange reveals that a taxpayer is given a basis increase for any amount of net debt increase incurred as a result of the exchange of the properties.


127. In Tufts, Justice O'Connor argued in a concurring opinion that this was exactly what was taking place, as opposed to treating the subsequently realized income as artificially realized "gain" from the sale of the property. This argument would have taxed the income in Tufts as ordinary income. 461 U.S. at 317–20 (O'Connor, J., concurring).
Finally, the government’s argument that this interpretation would effectively eliminate section 357(c) except for those without proper tax planning is also without merit. First, the government’s position suggests that the operation and impact of section 357(c) falls primarily on those who “want” the section 357(c) gain. This is simply not the case.

One must only read the tax court record of *Lessinger I* to understand that Lessinger did not desire a large section 357(c) gain. This fact issue was proven by Lessinger at trial. Moreover, Lessinger had sophisticated counsel and tax advice regarding his incorporation. How many taxpayers don’t? How many bad section 357(c) transfers does the government settle as opposed to try because of little taxpayer hope in the trial? How many bad section 357(c) cases does the government simply never see because of the audit lottery? Finally, and worst of all, how many bad section 357(c) cases are encouraged by this ridiculous system to be cured by forging and backdating documents? The Second Circuit decision, in its own way, addressed this concern.

The second response is the one officially given by the court. If the shareholder received no economic benefit subject to taxation under section 357(c), there is no benefit to tax because there is no “income.” In those circumstances, where the shareholder does receive an economic benefit, the operation of section 357(c) is clear; they would be taxed currently. Thus, in cases like *Woodsam Associates, Inc. v. Commissioner*, the share-
holder would now be taxed under section 357(c) unless a note was given at the time of the incorporation transfer.

V. OWEN CASE HISTORY

A. Owen I

William Owen and Stephen McEachron were involved in many business ventures. In 1977 they formed McO Investment ("McO"), an equal general partnership. McO was formed to invest in real estate ventures. In 1980 they decided to enter the seismic drilling operation business. After failing to successfully purchase such a business, they decided to start their own.

At first, they structured the business by purchasing equipment through McO and causing Western Exploration, Inc. ("Western") to conduct the operations of the business. Western was also equally owned by Owen and McEachron and was a Minnesota corporation since January 1, 1980. The taxpayers hoped that McO would give them the depreciation and investment tax credits associated with the ownership of the equipment, while Western would provide a measure of limited liability.

Under this arrangement, McO entered several lease agreements with Western to enable it to utilize the equipment in its operation of the business. Between March 1980 and May 1981, McO acquired approximately $1,288,164 in equipment including drilling rigs, water and other trucks, and other miscellaneous equipment.

McO financed the equipment acquisitions through loans with a Minnesota bank ("the Bank"). The Bank took purchase money security interests in all of McO's equipment. The total amount of the Bank loan on May 26, 1981 was $1,008,634.

In their individual capacities, Owen and McEachron pledged a $100,000 certificate of deposit on the loan, in addition to the

130. Id. at 1481.
131. Id. The taxpayers also equally owned another company, Western Companies, Inc. ("WCI"), a North Dakota corporation, in the business of providing consulting services for the acquisition and disposition of businesses.
132. Id. at 1486 (Appendix A).
133. Id. at 1482 n.11.
equipment. As general partners of McO, Owen and McEachron were personally responsible for the Bank loan. In addition, they each executed personal guarantees for the McO Bank loan.\textsuperscript{134}

In 1981, Western began to experience financial difficulties due to the faltering oil boom. Western soon began to experience cash flow problems and eventually, it was unable to service its lease payment obligations to McO. This in turn caused McO to experience difficulties in servicing the Bank loan which then began to drain the personal resources of Owen and McEachron, its general partners.\textsuperscript{135} In addition to damaging the financial condition of Western, the faltering oil boom negatively affected the value of the drilling equipment, the primary collateral for the Bank loan. This, in turn, adversely affected the personal finances of Owen and McEachron.

Recognizing the downward economic spiral in which they were trapped, Owen and McEachron decided to limit McO's losses by selling the seismic oil drilling business. It was decided that the sale of the business would be most easily accomplished if the assets were first transferred to Western and the business was sold as a whole.\textsuperscript{136}

The Tax Court found as a matter of fact that:

> Petitioners realized, however, that McO's outstanding indebtedness exceeded McO's adjusted basis in the property. In order to avoid a potential Federal income tax problem, petitioners met with bank officials and discussed the possibility of the bank reducing its security interest in the equipment.\textsuperscript{137}

Owen and McEachron transferred substantially all the equipment to Western on December 31, 1981 but there was no contemporaneous written documentation regarding the transfer. On December 31, 1981, however, Western executed a "Third Party Pledge Agreement" granting the Bank a security interest in all the equipment transferred to Western.

On December 31, 1981, the aggregate unpaid balance on the Bank loan was $988,008.48. McO's records reflected an adjusted basis in the equipment of $781,862.23, although the

\textsuperscript{134} \textit{Id.} at 1482.

\textsuperscript{135} \textit{Id.}

\textsuperscript{136} \textit{Id.}

\textsuperscript{137} \textit{Id.}
government's subsequent notice of deficiency determined an adjusted basis of $763,354.23. Thus, McO's liabilities to which the equipment was subject exceeded the adjusted bases of those same assets by $224,654.25 immediately prior to the transfer of the equipment to Western.

In April of 1982, the Internal Revenue Service began its investigation of this transaction, and on or about June 24, 1982, the agent requested documentation regarding McO’s December 31, 1981 transfer to Western. During June or July 1982, approximately six months after the equipment transfer, counsel prepared a “Transfer Agreement” which was dated “as of” December 31, 1981. The Transfer Agreement provided that Western agreed to pay and assume $781,862.23 of McO’s debt on the equipment and that Western agreed to indemnify McO against all claims arising out of the agreement.\(^\text{138}\)

An “amendment” to the Transfer Agreement, also prepared in June or July of 1982 and approximately six months after the equipment transfer from McO to Western, provided that: (i) the equipment transferred from McO to Western was “‘security for certain purchase money indebtedness in an amount in excess of the indebtedness assumed by Western . . .’”; and (ii) Western would not “‘assume any of said indebtedness in excess of $781,862.23, it being expressly agreed by and between the parties that any of said indebtedness in excess of the amount assumed by Western shall be the sole obligation of McO. . . .’”\(^\text{139}\)

The Transfer Agreement and Amendment were executed during September 1982. On September 3, 1982, the Bank released part of the security interest in the equipment transferred to Western. The fair market value of the equipment on December 31, 1981 was approximately $750,000. This valuation was determined by the sale of McEachron’s 50% interest in Western to an unrelated purchaser on September 2, 1982. Thus, the equipment was worth less than its basis of $763,354.23 and much less than the Bank’s loan of $988,008.48.

The tax court held that section 357(c) governed the transaction and that McO, and therefore Owen and McEachron, realized a taxable gain. In so holding, the court relied on Smith v. Commissioner, Rosen v. Commissioner, and Lessinger v. Commis-
Lessinger was of course subsequently reversed by the Second Circuit.

The court relied upon these cases for the proposition that an assumption and release of liability of the shareholder was unnecessary under section 357(c) since the statute contained provisions including liabilities if the assets were "subject to" the liabilities. Because McO transferred all of the assets subject to the liabilities, the court found that all of the liabilities stated in the security agreement were governed by section 357(c).

The taxpayers argued, nevertheless, that the transfer was not effective because they had an oral agreement with the Bank to release the security interest in the amount of the excess liabilities. Considering the evidence as a whole, the tax court was not persuaded that such an oral agreement existed. Accordingly, the tax court found that: (i) the transferred equipment was security for the entire amount of the liabilities; (ii) there was no contrary oral agreement with the Bank existing on December 31, 1989; and (iii) the taxpayers' personal assumption of a portion of the Western liabilities was irrelevant. The court then held that the full amount of the liabilities were within section 357(c).

In the last paragraph of the opinion, the tax court addressed the impact of the $100,000 certificate of deposit. The certificate was the personal property of Owen and McEachron and was pledged as additional collateral on the Bank loan. Even though the certificate remained the property of Owen and McEachron after the equipment transfer to Western, the court reduced the amount of liabilities McO was deemed to have transferred to Western by the amount of the certificate. The court found that the Bank always considered the certificate as a reduction in the total amount of outstanding liabilities.

B. Owen II

In Owen II, the taxpayer made several arguments regard-

142. Id. at 1486.
143. Id. at 1487.
ing the section 357(c) issue. The first was that since the taxpayers had personally guaranteed the liabilities and remained liable after the transfer, the liabilities should be excluded from the application of section 357(c). Citing Smith and Rosen, the Ninth Circuit Court of Appeals rejected this argument since those cases held section 357(c) applied even if the shareholder remained personally liable on the debt.145 Moreover, the court noted that the issue of whether the assets were subject to the liabilities was a question of fact for the tax court under the holding in Beaver v. Commissioner.146

The taxpayer nevertheless requested the Ninth Circuit to overrule Smith, Rosen, and Beaver, and hold that section 357(c) "only applies where a taxpayer realizes an economic benefit in the transfer."147 The court rejected this argument since the plain language of the statute did not make a special provision for transfers not resulting in an economic benefit.148 Moreover, the court noted that after Commissioner v. Tufts, the taxpayer may realize a taxable gain under section 1001 even without receiving an economic benefit. The court reasoned that:

We decline the Owens’ invitation because section 357(c)’s plain language makes no special provision for transfers not resulting in an economic benefit to the transferor. Cf. Commissioner v. Asphalt Products Co., 482 U.S. 117, 120–21 (1987)(per curiam)(courts must give effect to the plain language of the internal revenue code); Commissioner v. Tufts, 461 U.S. 300, 307 (1983)(taxpayer may realize a taxable gain under I.R.C. § 1001 even without receiving a net economic benefit from the transferee).149

The Ninth Circuit also rejected the taxpayer’s argument that its prior decision in Jackson v. Commissioner, required a different result. Jackson involved a transfer of a joint venture partnership interest to a controlled corporation in the year following the partnership’s deduction of losses. The Commissioner argued that the transfer should result in a taxable gain under section 357(c).150 The Ninth Circuit held that since the trans-

145. Id. at 835.
146. Id. See also Beaver v. Commissioner, 41 T.C.M. (CCH) 52 (1980).
147. 881 F.2d at 835.
148. Id.
149. Id.
150. Jackson v. Commissioner, 708 F.2d 1402, 1405 (9th Cir. 1983).
freee corporation had not assumed any of the taxpayer’s partnership liabilities and the partnership interest itself was not security for a loan, the partnership liabilities were not included under section 357(c).151

Thus, the court distinguished its own Jackson case by noting that in Jackson the asset transferred to the corporation was a partnership interest which itself was not subject to any security interest. In this case the equipment was specifically subject to liabilities recognized under section 357(c).152 Moreover, the court believed that Jackson had been somewhat eroded by the subsequent decision in Tufts. The court stated that:

Furthermore, Jackson was decided without the benefit of the Supreme Court’s opinion in Commissioner v. Tufts, 461 U.S. 300, 307 (1983). Tufts and Jackson were published at approximately the same time. Relying in part on dicta from Crane v. Commissioner, 331 U.S. 1 (1947), Jackson concluded that section 1001, and the tax system as a whole, require that the transferor receive “economically significant consideration.” Jackson, 708 F.2d at 1404. Tufts clarified the scope of Crane and rejected Crane’s “limited theory of economic benefit.” Tufts, 461 U.S. at 307. Tufts undercuts the authority supporting the Jackson decision.153

1. Analysis

The Ninth Circuit’s approach is both surprising and arguably incorrect, at least with respect to its Tufts interpretation of section 357(c). This interpretation considers that the receipt of an economic benefit is no longer a prerequisite to taxation of income generally. The legislative history of section 357(c) does not support the court’s rigid application of the literal language of the statute to produce an unintended result. The legislative history of section 357(c) indicates that it was designed to prevent a shareholder from avoiding a tax on a gain clearly related to the realization of an economic benefit: the transfer of assets subject to liabilities in excess of basis with the corporation accepting future liability payment responsibility. The statute was not intended to reach attenuated shareholder benefit from a corporation accepting assets subject to liabilities

151. Id.
152. 881 F.2d at 835-36.
153. Id. at 836 (parallel citations omitted).
which the corporation is incapable of paying, and does not intend to pay in the future.

In addition, the court's analysis of the economic benefit doctrine, as expressed in *Tufts*, is misplaced. The realization of a *Crane*-type economic benefit was rejected in *Tufts* only as a way to explain the necessity of a system with a cohesive symmetry regarding the treatment of acquisition debt. If all acquisition debt is to be included in the section 357 and section 1012 "cost" basis of the property, then such debt must be included in the amount realized on the disposition of the property. This must be so regardless of whether the depreciation deductions produced a prior economic or tax benefit. Simply stated, *Tufts* established that *Crane* was not bottomed on an economic benefit theory but rather on a theory that nonrecourse and recourse debt is treated as true debt with respect to the determination of basis. The economic benefit doctrine still plays an important role in taxation. The inclusion of both recourse and nonrecourse debt in the amount realized on the disposition of the property, however, does not depend upon a correlative economic benefit from the inclusion of the debt in basis.

VI. Economic Rationality

The tension between *Lessinger II* and *Owen II* exists at two levels. First, the language of section 357(c) creates a gain to taxpayers like Messrs. Lessinger and Owen. *Owen II* adopts this approach notwithstanding the inequitable result. *Lessinger II* refuses to adopt this approach because it produces an inequitable result. The question then is which statutory construction approach is preferable and why?

If the *Lessinger II* statutory construction of section 357(c) is preferred, it must carry the purpose and intent of the statute.

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154. The inclusion of such acquisition debt is subject to the limitation that the amount of nonrecourse debt which may be included in the original acquisition cost basis is limited to the unencumbered fair market value of the property. See Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). This principle prevents the overstatement of basis to produce the tax benefit of deferral.


156. *Tufts* also disclaimed any relationship between its decision and the tax benefit rule. The Court indicated that there are clearly cases in which the inclusion of recourse and nonrecourse debt in the original basis of a nondepreciable, nonwasting asset such as stock will produce the same result. *Id.* at 308 n.5.
As reviewed earlier, the legislative history seems clear enough: at the time of the transfer of assets to a controlled corporation, the taxpayer clearly realized economic gain in the form of liabilities in excess of basis. This is done in order to prevent the shareholder from permanently escaping tax on the gain (presuming a negative basis in the stock received is not permissible) when the corporation pays the liabilities.

In Lessinger II and Owen II, no such economic benefit or permanent tax avoidance is present. Accordingly, an unimaginative reading of the technical language of section 357(c) is unnecessary and is not consistent with the intent of the statute. The only point of such an interpretation would be to force Congress to deal with an artificial and unintended judicial result, a process occupying many Congressional moments.

At another level, Owen II’s analysis of Tufts and its economic benefit doctrine seems clearly wrong. Both Crane and Tufts involved the realization of gain from the disposition of property subject to nonrecourse debt in excess of the basis of the asset transferred. The suggestion in this context is that economic benefit is no longer a fundamental part of the income tax system. This suggestion incorrectly fails to properly identify the context of the Tufts statement and to differentiate between recourse and nonrecourse liabilities. In the section above, the context of the Tufts economic benefit statement was explored. That analysis concludes that the economic benefit doctrine was not eroded in Tufts. In fact, the doctrine was considered in the narrow context of the inclusion of recourse and nonrecourse acquisition debt in the amount realized at the moment of property disposition. The parity argument is based upon similar inclusions in the basis of the property of like debt, when it was acquired. This argument, as Tufts concludes, has little if anything to do with the economic benefit doctrine. But there is another reason to reject Owen II’s Tufts hypothesis. Owen II simply failed to distinguish between recourse and nonrecourse debt in this context.

Dispositions of property subject to nonrecourse debt must force recognition of liability in excess of basis transferred at the time of disposition. There is no other more appropriate opportunity. The disposition is the taxpayer’s final connection to the property and the debt. This is simply not the case with recourse liabilities. If the taxpayer’s liability exposure survives the transfer in the form of guarantees or in additional notes...
created in the transfer, future events may require the taxpayer to make payments on the “transferred” liabilities.

It is at least more appropriate in this context to assess the circumstances surrounding the transfer to determine if the taxpayer or the corporation will pay the liabilities. Subdivision (c) assumes the corporation will. When it cannot, particularly as in Owen when the value of the assets had declined below the basis of the assets, is this assumption realistic or reasonable?

In Owen I, the tax court took the first step in examining this issue. Lessinger II took another step. In Owen I, the tax court reduced the liabilities deemed “transferred” to the corporation by the $100,000 shareholder certificate of deposit pledged on the bank loan. This treatment is an explicit recognition that the corporation would not pay this portion of the liabilities, notwithstanding the fact that the lender had a security interest in all the assets transferred to the corporation. Thus, notwithstanding the fact that the assets were transferred to the corporation “subject to” the full amount of the liabilities, in the form of a bank security interest, the tax court recognized the economic reality that the corporation would not pay $100,000 of the liabilities.

But why not? Does the shareholder pledge of assets destroy or negate the corporation’s obligation or ability to pay the liabilities? Of course not. Yet the tax court nevertheless held that this amount of the liability was not “transferred” to the corporation. This aspect of Owen I was not appealed.

When recourse liabilities are involved, the shareholder has a potential continuing liability even after the transfer. This is not the case with nonrecourse liabilities. When the corporation does not assume the liabilities and the lender does not release the shareholder from liability after the transfer, the economic likelihood of shareholder payment increases proportionately to corporate financial instability. Under these circumstances it more clearly comports with economic reality to treat the liabilities as “retained” and not “transferred” notwithstanding that the lender may have a security interest in all the assets transferred and held by the corporation. This is consistent with the economic benefit doctrine and basis rules of Crane and Tufts. Moreover, it does not create a negative basis under sections 357 and 358. If the corporation subsequently pays the liabilities contrary to this assumption, the shareholder would have
ordinary income from the discharge of indebtedness under section 61(a)(12).\textsuperscript{157}

VII. LEGISLATIVE RECOMMENDATION

Considering the extent of the conflict between Owen II in the Ninth Circuit and Lessinger II in the Second Circuit,\textsuperscript{158} a question remains as to what course to take to best restore predictability to section 357(c) transactions, and to eliminate its current trap for unsuspecting taxpayers and their counsel. One approach would be to allow courts to continue to fashion remedial efforts as each case arises.

This of course lacks the predictability associated with a prescriptive statutory rule. Moreover, Congress and the Treasury may be better equipped to fashion a broad based rule with appropriate limitations and qualifications to assure compliance with the intent of section 357(c). What characteristics should a section 357(c) amendment possess?

Based on the analysis discussed herein, it would appear to be appropriate to distinguish between recourse and nonrecourse liabilities. A nonrecourse lender looks exclusively to its collateral for repayment. If the collateral has been legally transferred to the corporation, there is no reason to expect or anticipate that the shareholder will pay any portion of the liability after the transfer.

It is also reasonable to examine any affirmative corporate acts recognizing its responsibility for and acceptance of a repayment responsibility. One such affirmation would be an express corporate assumption of the liability. Where the

\textsuperscript{157} See Estate of Weeden v. Commissioner, 685 F.2d 1160 (9th Cir. 1982). In Weeden, the court was faced with a determination of the timing of the realization of the donor's economic benefit occasioned by the donee's payment of the donor's gift tax liability in a "net gift." Weeden interpreted the issue left unanswered in Diedrich v. Commissioner, 457 U.S. 191 (1982), and held that the economic benefit was not realized by the donor until the donee actually paid the gift tax liability. Id. at 1161-62.

\textsuperscript{158} Under the tax court's rule expressed in Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971), taxpayers residing in the Second Circuit will be able to rely on Lessinger II in the tax court while taxpayers residing elsewhere will be forced to accept the tax court's normative position as expressed in Owen I and Lessinger I. In addition, as expressed in McEachron v. Commissioner, 873 F.2d 176 (8th Cir. 1988) and Rosen v. Commissioner, 515 F.2d 507 (3d Cir. 1975), it is not at all clear that the conflict is limited to the Second and Ninth Circuits and may well include the Third and the Eighth Circuits as well.
corporation merely accepts the assets "subject to" the liabilities in the form of a security interest, further inquiry is necessary as expressed in Owen I. Such an inquiry is necessary to determine if it is reasonable to assume that the corporation will pay the liabilities.

In cases where the corporation takes the assets "subject to" a recourse liability which is not specifically assumed by the corporation, an examination of the corporation's financial ability to pay the liabilities as they mature should be the focus of the statute. The issue in such cases is whether it is reasonable to assume the corporation, rather than the shareholder, will pay the liabilities. Where the corporation has no operating history (i.e. a new corporation), or where it has an operating history suggesting that it is not reasonable to expect the corporation to pay the liabilities in the future, it is more appropriate to assume that the shareholder will pay the liability rather than the corporation.

**CONCLUSION**

The parallels between the 1978 amendment process which resulted in section 357(c)(3)\textsuperscript{159} excepting cash basis payables from the definition of section 357(c) liabilities, and which applied the economic benefit doctrine to section 357(c), are compelling. In both situations, the statutory language is simple, clear, and produces a straightforward application of the statute and a resulting tax liability. In both situations, the trial courts (principally the tax court) have a consistent record of imposing a tax under the literal language of the statute while at the same time recognizing the harshness of their own interpretation. In both situations, the Circuit Courts of Appeal ultimately fashion inconsistent and often conflicting rationales and results to ameliorate the circumstance.

This set of circumstances simultaneously presents the opportunity for both review by the United States Supreme Court, and legislative amendment, as in 1978. Supreme Court review would resolve the conflict in the Circuit Courts of Appeal. Legislative amendment would serve to provide a more broad based prescriptive rule. Practitioners would thereby be given

\[159.\] Payables are generally excepted from the definition of liabilities to prevent unfairly biasing accounts payable over zero based accounts receivable.
the practical guidance necessary to plan the wide range of transactions arising in this field.

As it is now, most informed practitioners simply plan around the problems presented by section 357(c). A variety of methods and techniques have evolved which include a transfer of additional assets to the corporation which have additional basis equal to or greater than the excess liabilities transferred. Other techniques include holding back part of the liabilities to be transferred to the corporation other than accounts payable.160

The Supreme Court did not review the previous section 357(c) judicial dispute prior to the 1978 statutory amendment. Presumably this was because the Circuit Courts of Appeal were not in serious conflict. The decisions were reasonably consistent in their findings for the taxpayers even if their rationales were somewhat inconsistent.

The Second Circuit Lessinger II and the Ninth Circuit Owen II decisions are in a direct and unexplained conflict with respect to the application of the economic benefit doctrine in section 357(c) transactions. On November 2, 1989, a Petition for a Writ of Certiorari was filed to review this conflict. The Petition was denied on February 20, 1990.

This unexplored conflict will make it difficult for the lower courts to uniformly and consistently resolve disputes turning on the interpretation of section 357(c) and the liabilities issues discussed herein. In the tax court, taxpayers residing in the Second Circuit would benefit from Lessinger II under the tax court's rule expressed in Golsen v. Commissioner.161 Golsen is premised on efficiency. Even though the tax court considers itself a national court, it will follow the law of the circuit in which the taxpayer's case would be appealed, even if that precedent differs from the tax court's independent assessment of the matter. Pursuant to section 7482(b)(1)(A), the decisions of the tax court are appealed to the circuit of the legal residence of the individual taxpayer.162

160. As noted, since 1978, zero based account payables are excluded from the definition of liabilities. As a result, withholding such "liabilities" in a § 351 transfer does not help to correct the § 357(c) imbalance since they are not counted in the liability equation in the first instance.


Under the *Golsen* rule, the tax court would follow the Second Circuit's *Lessinger II* position in cases that could be appealed to the Second Circuit. In cases that could be appealed to the Ninth Circuit, the tax court would be expected to follow *Owen II*. In cases appealable to circuits which have not yet ruled on the matter, the tax court remains free to adopt either circuit's view or some alternative of its own, although thus far its view has been consistent with the view of the Commissioner and the Ninth Circuit.

Other circuit conflicts are arguably involved. *Lessinger II* conflicts not only with the Ninth Circuit's *Owen II* decision, but also with the Eighth Circuit's position in *McEachron v. Commissioner*. The brevity of that court's affirmance of the tax court's consolidated case with *Owen I* makes it difficult to determine whether it also rejected the Second Circuit's interpretation of section 357(c) as requiring an economic benefit for there to be a taxable "gain." Presumably, the Eighth Circuit would follow the Ninth Circuit rationale; it reached the same result as the Ninth Circuit in *Owen II* and it was briefed and argued by the same counsel as *Owen I* and *Owen II*.

The conflict may include the Third Circuit which affirmed without opinion a tax court decision consistent with the Ninth Circuits's later decision in *Owen II*. Because the Ninth Circuit's *Owen II* decision does not analyze the Second Circuit's *Lessinger II* decision, uncertainty continues in all tax forums because of the possibility that the result in *Owen II* might have been different if *Lessinger II* had been considered. Court review should be extended to provide clarity and certainty in this important field of business transactions. The Supreme Court's resolution of the scope of section 357(c) will avoid certain and continued future litigation in the tax court and the circuit courts.

The resolution of these continuing conflicts is not the only reason for the Supreme Court to consider the matter in a case of subsequent conflict. The Ninth Circuit's interpretation of the economic benefit doctrine as applicable to recourse liabilities and hence its interpretation of *Crane* and *Tufts* is equally troubling. Until the application of the economic benefit doc-

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163. 873 F.2d 176 (8th Cir. 1988).
trine is distinguished and explained in the context of recourse and nonrecourse liabilities, confusion and misinterpretation will abound. Supreme Court review can resolve the mystery.

Finally, it is impossible to count on corrective legislation, particularly in the current political environment driven as it is by economic and budgetary concerns. Technical amendments are not likely to be offered or supported by the government until its section 357(c) position and the tax court interpretation is firmly rejected by the Supreme Court. This is one of those moments in the judicial history regarding the development and interpretation of the tax law where the Supreme Court has the opportunity to make tax practice more fair while making it more simple. Hopefully, both the Court and Congress will respond to the pressing need for clarification in this important field of business practice. 165

165. For another view of the direct conflict between Lessinger and Owen, see Bogdanski, Closely Held Corporations, Shareholder Debt, Corporate Debt: Lessons From Leavitt and Lessinger, 16 J. CORP. TAX'N 348, 364 (1990):

[t]he Ninth Circuit's sheepish change of heart [from Jackson to Owen] leaves it in complete harmony with the Fourth Circuit in Estate of Leavitt... but the new case [Owen] seems to be in hopeless conflict with Lessinger. If ever an area was ripe for congressional or Supreme Court review, this is one.