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COMMENTS

Assumption of Liabilities in Otherwise Tax-Free Transfers Under I.R.C. § 351

The beginning of a business venture in corporate form frequently involves an exchange of property for shares of the stock of the corporation. This transfer is a "sale or other disposition" of the property within the meaning of section 1001 of the Internal Revenue Code. Were it not for specific statutory treatment to the contrary, the transferor would have to recognize gain or loss resulting from any difference between the value and the basis of the property.[1]

Section 351 of the Code provides that no gain or loss shall be recognized if property is transferred to a controlled corporation solely in exchange for stock or securities of that corporation.[2] One rationale for this treatment is that the transfer of property to a controlled corporation is not a termination of the transferor shareholder's relationship to the property, but only a change from direct to indirect ownership. Moreover, it is argued that to treat this formal change in ownership as a recognition event would unnecessarily impede incorporation.[3]

In *Peter Raich*,[4] the Tax Court held that, in a tax-free incorporation, section 357(c) of the Code[5] required a taxpayer using the cash-

1. I.R.C. §1002 requires the recognition of gain from the sale or exchange of property.

2. I.R.C. § 351(a) reads:

> 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 (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

3. *See* Portland Oil Co. v. Commissioner, 109 F.2d 479, 488-89 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940); H.R. REP. No. 350, 67th Cong., 1st Sess. 10 (1921); S. REP. No. 275, 67th Cong., 1st Sess. 11-12 (1921).

Any potential gain (or loss) on the property is preserved in the hands of the transferee corporation by requiring a carry-over of the transferor's basis to the corporation. I.R.C. § 362(a). Potential gain to the transferor shareholder is also preserved by giving him a basis in the corporation's stock equal to that of the assets transferred. I.R.C. § 358(a).

4. 46 T.C. 604 (1966).

5. I.R.C. § 357(c)(1) reads:

> In the case of an exchange—
> (A) to which section 351 applies, or

receipts-and-disbursements method ("cash method") of accounting to recognize the amount by which liabilities assumed by the corporation exceeded the basis of assets transferred to it, despite a simultaneous transfer of accounts receivable greater than this amount. For ten years, the Tax Court stood doggedly by this literal reading of the statute, despite unanimous criticism from commentators[6] and reversal by the Second Circuit.[7]

In the recent cases of *Thatcher v. Commissioner*[8] and *Focht v. Commissioner*,[9] however, the Ninth Circuit and the Tax Court, respectively, have rejected, by different routes, the *Raich* reasoning and result. In *Thatcher*, the Ninth Circuit held that the transfer should be treated as a taxable sale of accounts receivable in exchange for assumption and payment of liabilities. In *Focht*, the Tax Court chose a different approach, holding that a deductible liability was not a "liability" within the meaning of sections 357 and 358 of the Code and, therefore, did not require any recognition of gain. Both decisions achieve the result long sought by critics: the cash method taxpayer is no longer inhibited from incorporating by the prospect of a sudden, potentially burdensome tax. The two approaches, however, may have different consequences when applied to many taxpayers, a result that could substantially affect the operation of this area of the Code.[10]

This Comment reviews the background of the *Raich* controversy and sets out the reasoning of the *Thatcher* and *Focht* opinions. The alternative approaches of those two opinions are then evaluated in terms of both their consistency with legislative intent and the practical consequences of their adoption. In light of this analysis, it is argued that the theory applied by the Ninth Circuit in *Thatcher*, allowing set-off of the accounts payable recognized in the transfer by a constructive deduction purchased by the transfer of accounts receivable, is the more practical and equitable solution to the problems posed by section 357(c).

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D),

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 transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

6. *See* Burke & Chisholm, *Section 357: A Hidden Trap in Tax-Free Incorporations*, 25 TAX L. REV. 211 (1970); Wellen, *New Solutions to the Section 357(c) Problem*, 52 TAXES 361 (1974); Comment, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154 (1967); Note, *Sleepers That Travel with Section 351 Transfers*, 56 VA. L. REV. 37 (1970).

7. Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972).

8. 533 F.2d 1114 (9th Cir. 1976).

9. 68 T.C. 223 (1977).

10. See text at notes 55-58 *infra*.

I
THE PROBLEM OF SECTION 357(c)

When, as part of a transaction governed by section 351, the transferor receives money or property in addition to stock or securities of the transferee corporation, a portion of the transferor's interest in the transferred property has to that extent been cashed out. Accordingly, the taxpayer has realized the gain, if any, on that property. Section 351(b) requires recognition of the gain realized by receipt of this "boot."[11]

When part of the consideration received in a section 351 exchange takes the form of an assumption of the transferor's liabilities, however, special statutory rules apply to prevent immediate recognition of gain. Section 357(a)[12] provides as a general rule that an assumption of liability or an acceptance of property subject to a liability by the transferee corporation is not to be treated as the receipt of money or other property.[13] Instead, the basis of the stock received by the transferor is to be reduced by the amount of the liabilities assumed, thus preserving any potential gain for eventual recognition at the time of the stock's final disposition.

Where the assets transferred have a basis less than the amount of the liabilities assumed, however, section 357(c) requires that gain, to the extent of the excess of assumed liabilities over the basis of the assets transferred, be recognized by the transferor.[14] Otherwise, the adjustment to basis described in section 358(a)[15] would result in a negative basis. Arguably, it would produce no distortion of income or potential

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11. I.R.C. § 351(b) reads:

> If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—
> (1) gain (if any) to such recipient shall be recognized, but not in excess of—
> (A) the amount of money received, plus
> (B) the fair market value of such other property received; and
> (2) no loss to such recipient shall be recognized.

12. I.R.C. § 357(a) reads:

> Except as provided in subsections (b) and (c), if—
> (1) the taxpayer receives property which would be permitted to be received under section 351, 361, 371, or 374 without the recognition of gain if it were the sole consideration, and
> (2) as a 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,
> then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351, 361, 371, or 374, as the case may be.

13. For a statement of the congressional purpose of I.R.C. §§ 357(a) and 357(b), see Arthur L. Kniffen, 39 T.C. 553, 559-60 (1962).

14. For example, if *T* transfers property with a basis of $20,000 to a controlled corporation, *C*, and *C* assumes a mortgage of $10,000 on the property and notes payable worth $15,000, *T* will recognize gain of $5,000 as money or other property received under § 351(b) and the basis of *T*'s stock in *C* will be reduced to zero by §§ 358(a) and 358(d).

15. Section 358(a) provides:

for tax avoidance to use a negative basis in this setting.[16] Congress, however, was apparently persuaded to the contrary and has precluded a negative basis by section 357(c).[17]

Section 357(c) poses the threat of a troublesome tax levy on sole proprietorships and partnerships using the cash method of accounting when they seek to incorporate. When such a business is incorporated, its assets will often include accounts receivable and liabilities that take the form of accounts payable incurred in the operation of the business. A cash method taxpayer does not take the accounts receivable into income until they are paid;[18] therefore, their basis is zero. If the transferor does not have a substantial basis in other assets that are also transferred to offset the accounts payable transferred, these liabilities may trigger recognition as an assumption of liability in excess of basis, even where actual amounts of accounts receivable greatly exceed the payables. The proprietor who is unaware of this situation can be saddled with an unexpected burden after the transfer has been completed. The proprietor who is aware of this recognition requirement may be forestalled or discouraged from incorporating.[19]

In the case of an exchange to which section 351, 354, 355, 356, 361, 371(b), or 374 applies—

(1) The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer, and

(iii) the amount of loss to the taxpayer which was recognized on such exchange, and

(B) increased by—

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) The basis of any other property (except money) received by the taxpayer shall be its fair market value.

16. *See* Cooper, *Negative Basis*, 75 HARV. L. REV. 1352 (1962); *see also* Easson v. Commissioner, 294 F.2d 653, 657-58 (9th Cir. 1961); Parker v. Delaney, 186 F.2d 455, 459-60 (1st Cir. 1950) (Magruder, C.J., concurring), *cert. denied*, 341 U.S. 926 (1951).

17. *See* Easson v. Commissioner, 294 F.2d 653, 655 n.2, 657 (9th Cir. 1961).

18. P.A. Birren & Sons v. Commissioner, 116 F.2d 718 (7th Cir. 1940); Ezo Products, 37 T.C. 385 (1961); I.R.C. § 451(a); Treas. Reg. § 1.446-1(c)(i) (1957).

19. It was this need to reorganize in corporate form that was the original impetus for enactment of the predecessor of § 351. *See* H.R. REP. No. 855, 76th Cong., 1st Sess. 18-19 (1939), reprinted in 1939-2 C.B. 504. Theoretically, this problem could be dealt with by having the transferor retain the payables and enough of the receivables to pay them off. By liquidating the receivables and taking a deduction for payment of the payables, the transferor would achieve the desired "wash" of individual tax liability. In practice, however, this solution may not be available. In some instances the nature of the receivables, their relation to the ongoing business of the enterprise and their involvement in the enterprise's debt structure make it impossible for the transferor to retain the receivables outside of the corporation. For example, in the construction industry it is difficult to structure the transaction in this manner. Fragmentation of the business into separate

As previously indicated, the difficulty that arises in this area of the Code has been presented to several courts in recent years with varying results. It is to these cases that this Comment now turns.

II
THE CASE LAW

A. Peter Raich

In *Peter Raich*,[20] the Tax Court required the transferor, a cash method taxpayer, to recognize gain on the transfer of liabilities in excess of his basis, despite the concurrent transfer of accounts receivable in excess of those liabilities. Initially, the taxpayer had argued that section 357(c) did not apply when the transferor derived no economic benefit from the transaction.[21] In the alternative, he urged that the accounts receivable transferred in fact had a basis at least equal to the amount of liabilities assumed.[22] The court rejected both constructions, despite the inconsistency of the literal result with the well established intent of Congress to foster tax-free business reorganizations.[23] The court argued that "if Congress had so intended to limit this section, it would have employed the necessary language."[24]

B. Bongiovanni v. Commissioner

The Tax Court's insistence on a literal application of section 357(c) in *Raich*, as well as in subsequent cases presenting the same issue,[25] generated vigorous criticism from commentators.[26] The Second Circuit rejected the *Raich* doctrine in *Bongiovanni v. Commissioner*,[27] ruling that the word "liability" in section 357(c) was limited to "liens in excess

parts is impossible unless one has the financial capability to borrow sufficient funds to pay off *all* payables and thereby obtain the deduction at the proprietorship level. This is unlikely in the construction business, where the operator is frequently acting at his credit limit. Letter from Leo S. Meysing, Esq., counsel to Wilford E. Thatcher, to the author (Aug. 18, 1977) (on file at the *California Law Review*).

20. 46 T.C. 604 (1966).

21. *Id.* at 608.

22. *Id.* at 609-11.

23. *Id.* at 611.

24. *Id.* at 609. Considering the general willingness of courts to infer doctrinal limitations in applying the Code in order to effectuate the congressional intent underlying the statute, this insistence on literal interpretation was neither necessary nor justified. The classic example of such an inference is the "business purpose test" inferred in the sections of the Code dealing with corporate reorganizatiou. See Gregory v. Helvering, 293 U.S. 465 (1935), where the Court found § 368 inapplicable despite literal compliance by the taxpayer with its provisions.

25. Thatcher v. Commissioner, 61 T.C. 28 (1973), *rev'd in part*, 533 F.2d 1114 (9th Cir. 1976); Rosen v. Commissioner, 62 T.C. 11 (1974); Bongiovanni v. Commissioner, 30 T.C.M. (CCH) 1124 (1971), *rev'd*, 470 F.2d 921 (2d Cir. 1972); Alderman v. Commissioner, 55 T.C. 662 (1971).

26. *See* the authorities cited in note 6 *supra*.

27. 470 F.2d 921 (2d Cir. 1972).

of tax costs" and that, therefore, the accounts payable of a cash method taxpayer were not among the "liabilities" to which the section applies.[28]

The *Bongiovanni* opinion focused intensely on the unfairness of taxing a transaction in which there was no possibility of tax avoidance and on the arbitrariness of allowing the amount of tax responsibility to turn on whether the taxpayer used the cash method or the accrual method of accounting.[29] Unfortunately, neither the analytical justification for the court's holding nor the proposed scope of the term "liabilities" was clearly delineated.[30] The case, therefore, did not establish a comprehensive theory to guide other courts in dealing with the problem raised by the *Raich* opinion.

C. *Thatcher v. Commissioner*

In *Thatcher v. Commissioner*,[31] the Ninth Circuit also rejected the *Raich* result. The court characterized the transfer as a sale of the accounts receivable for consideration, the consideration being the assumption and payment of the accounts payable.[32] The opinion argued that since the taxpayer had used his receivables to obtain payment of his deductible liabilities, he was entitled to a deduction in the amount of the liabilities, but only to the extent of the amount of the receivables transferred.[33] For the taxpayer, the assumption of the payables thus produced a recognition of gain and an offsetting deduction. The consideration found by the court was both the assumption *and* payment of the liabilities. Only those amounts actually paid by the corporation could be deducted, and only then if paid within the year of the transfer.[34]

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28. *Id.* at 923-24. "Tax costs" apparently means nothing more than "adjusted basis."

29. *Id.* at 924-25. Presumably there was no possibility of tax avoidance because there was no economic gain in the transaction on which tax could be avoided.

30. In *Thatcher*, the Ninth Circuit stated its concern that in *Bongiovanni* "the court defined liabilities in an *ad hoc* manner that may have worked equity in that case, but the definition is likely to produce unforeseen results in other cases." 533 F.2d 1114, 1117. In a footnote, the Ninth Circuit further commented that the Second Circuit's apparent limitation of the term "liabilities" "to mean the excess of secured debts over the transferor's adjusted basis in the assets transferred" had previously been rejected by the Seventh Circuit in Testor v. Commissioner, 327 F.2d 788 (7th Cir. 1964). 533 F.2d at 1117 n.6.

To the extent that the *Bongiovanni* solution applies to deductible and nondeductible liabilities alike (if one can imagine a deductible secured liability) so long as there is no tax avoidance potential in the particular situation, it is consonant with the analysis in the text at notes 51-53 *infra*. In *Bongiovanni* there was no exploration of a tax avoidance analysis to make this point clear, however.

31. 533 F.2d 1114 (9th Cir. 1976).

32. *Id.* at 1117-18.

33. *Id.* at 1118.

34. *Id.*

Insight into the *Thatcher* analysis is provided by Judge Hall's dissent in the Tax Court, the rationale of which guided the Ninth Circuit. She pointed out that section 357(c) makes the assumption of the transferor's liabilities by the corporation a receipt of "boot" property under section 351(b).[35] Under the terms of section 351(b), the transaction is, to the extent that the assumption is in excess of basis, taken out of the general nonrecognition provision of section 351(a) and made an ordinary recognition event. She argued that the statutory purpose requires that the accounts receivable that are transferred to obtain payment of the payables by the corporation also be removed from the nonrecognition provision and treated as a deductible payment of expenses.[36]

D. Focht v. Commissioner

After the reversals by the Second and Ninth Circuits, the Tax Court took the opportunity in *Focht v. Commissioner*,[37] to abandon its strict interpretation of section 357(c), ruling that deductible liabilities are not "liabilities" for purposes of section 357(c). Relying extensively on an argument first made by commentators,[38] the court's decision rested on two premises.

First, the court argued that the assumption of a deductible liability should not be viewed as generating economic gain that the taxpayer is required to recognize,[39] a position it based on a footnote to the 1947 Supreme Court opinion in *Crane v. Commissioner*.[40] The Tax Court found in the language of that footnote an apparent approval of the Commissioner's decision not to treat the assumption of the obligation to pay the past due interest on a mortgage as a realization event because the interest itself would have been deductible if paid by the original obligor.[41]

As a second step in its rationale, the *Focht* court maintained that section 357(c) was not intended to apply to deductible liabilities assumed by a transferee. It declared that Congress had enacted the predecessor of section 357(a) to postpone the recognition of gain derived from the assumption of liabilities by a transferee only in those instances where the assumption would have resulted in such recognition under

35. 61 T.C. 28, 42 (1973) (Hall, J., dissenting).

36. *Id.*

37. 68 T.C. 223 (1977).

38. *Id.* at 2746, citing Kahn & Oesterle, *A Definition of "Liabilities" in Internal Revenue Code Sections 357 and 358(d)*, 73 MICH. L. REV.461 (1975).

39. 68 T.C. at 230-35.

40. 331 U.S. 1, 4 n.6 (1947). The footnote reads: "The Commissioner explains that only the principal amount, rather than the total present debt secured by the mortgage, was deemed to be a measure of the amount realized, because the difference was attributable to interest due, a deductible item."

41. 68 T.C. at 234.

the Supreme Court's doctrine, announced in *United States v. Hendler*, that an assumption of liability was to be treated as recognizable gain.[42] Because it considered *Hendler* to foreshadow the rationale later expressed in *Crane*, and because it read the *Crane* footnote to stand for the proposition that the assumption of deductible liabilities is not a source of gain, the Tax Court concluded that the exclusion of deductible liabilities from recognition as gain was implicit in *Hendler* as well. It would then follow, the court reasoned, that section 357(a) was not meant to affect deductible liabilities. Since section 357(c) was enacted as an adjunct to section 357(a), the court ascribed the same limited scope to each, thus extending the exclusion of deductible liabilities from the reach of section 357(c) also.[43]

III
EVALUATION OF *THATCHER* AND *FOCHT*

The approaches of the courts in *Thatcher* and *Focht* represent the primary vehicles proposed for resolving the problems created by the language of section 357(c). As such, they will be examined for their consistency with congressional intent and for the practical consequences of their adoption on the inequities of taxing apparent economic gain. On the basis of this analysis, it will be argued that *Thatcher* provides the more acceptable interpretation of section 357(c).

A. Legislative Intent

Perhaps because the Tax Court in *Raich* demanded a showing of clear congressional intent to avoid the harsh result of that case, much of the energy of the commentators has been devoted to creating a legislative pedigree for the various solutions to the section 357(c) dilemma.[44] Despite these efforts, it is nevertheless apparent that Congress did not anticipate this special case when it designed section 357, as neither the legislative nor the judicial history speaks to the problem. The setoff theory proposed by Judge Hall and adopted by the Ninth Circuit in *Thatcher*, while not within the original contemplation of Congress, is at least consistent with the legislative scheme it created. *Focht*, by contrast, brings a completely new theory to the analysis of section 357(c), without any evidence of legislative support.

In enacting the predecessors to section 357(a), Congress intended to allow the postponement of recognition of gain that was only technically realized in a business reorganization.[45] Section 357(a) included

42. United States v. Hendler, 303 U.S. 564 (1938).

43. 68 T.C. at 235.

44. *See* Kahn & Oesterle, *supra* note 38; Wellen, *supra* note 6.

45. 303 U.S. 564 (1938).

the transfer of liabilities within the scope of nonrecognition transactions along with the transfer of assets.[46] The Internal Revenue Service's procedures had previously allowed such transfers, but the Supreme Court's decision in *United States v. Hendler*[47] had ruled that a transfer of liabilities required a recognition of gain in such situations. Congress enacted section 357(a) to reinstate the pre-*Hendler* treatment. While Congress clearly sought to reestablish the tax-free transfer of liabilities under the customary scheme, there is, however, no evidence of a congressional intent to distinguish between types of liabilities, particularly not on the basis of deductibility.

Under section 357(c), Congress did intend, however, that the assumption of liability in excess of basis would be taken out of the nonrecognition provisions. It further intended that the gain inherent in the transfer of assets, such as the accounts receivable of a cash basis taxpayer, would be realized in the amount of the boot, if any. Under established doctrine, in a genuine novation that relieved the transferor of all liability through the corporate assumption, the transferor would be entitled to a deduction for the constructive payment of any deductible liabilities.[48] The basic concept of Judge Hall's setoff approach is consistent with this legislative scheme. Judge Hall's approach follows this scheme by classifying the assumption in excess of basis as boot, by recognizing gain on accounts receivable, and by treating the assumption and actual payment by the corporation as tantamount to contracting for a novation.

In ruling that Congress had not intended a buyer's assumption of a *deductible* liability to be an event that caused the seller to recognize economic gain under section 357, the *Focht* majority relied on its reading of *Crane v. Commissioner*[49] that a seller's gain did not include the buyer's assumption of overdue interest on a mortgage. The *Crane* Court had excluded the interest amount because the Commissioner had not assessed a deficiency on it. The Commissioner had reasoned that no recognition occurred on the assumption of a deductible expense.

The court's reliance on *Crane* is misplaced, and it broadly misreads the *Crane* footnote. In that footnote the Supreme Court had addressed an issue of jurisdiction, not of substance, merely citing the Commissioner's rationale for not assessing the amount of the interest on the mortgage as unreported income in order to explain why this amount was not under consideration. The Court said nothing that could properly be understood as approval of the Commissioner's rationale. Instead, the footnote reflected the established principle that

46. *See* note 13 *supra.*

47. 303 U.S. 564 (1938).

48. *See* James M. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964).

49. 331 U.S. 1, 4 n.6 (1947), quoted in note 40 *supra.*

courts do not have jurisdiction to find a deficiency that the Commissioner has not assessed.[50]

Morcover, even if the *Crane* footnote is a substantive rule that is implicit in the *Crane* doctrine, it does not follow that Congress deliberated in light of it. It is stretching implied intent to its limit to say that when Congress reacted to *Hendler*, which implicitly incorporated the *Crane* doctrine, which in turn might have contained a rule that the assumption of deductible liabilities by another party does not produce recognizable gain, Congress "intended" that its enactment should not apply to deductible liabilities. Congress most probably did not anticipate such developments and did not express any intention on the matter either way.

Since there is no basis for the *Focht* analysis in the legislative or judicial histories, and since the *Thatcher* approach is consistent with the legislative scheme, the *Thatcher* analysis is preferable.

B. Equity and Economic Gain

Under section 357(c), an unjust tax burden can occur when an incorporator using the cash method of accounting transfers liabilities and assets of *equal after-tax value*.[51] The unfairness arises when an appreciated asset is transferred to the corporation in a section 351 exchange, as the transferor forgoes the amount of appreciation that would have been retained had he sold the asset in a recognition transaction. Since there has been no recognition event to take the after-tax value of the appreciation into account,[52] the forgoing of this amount is not credited

50. *Crane* originated in the Tax Court, Beulah B. Crane, 3 T.C. 585 (1944). The Commissioner had not assessed a deficiency for the amount of interest due on the mortgage and assumed by the purchaser of the property. The Tax Court rejected the Commissioner's assessment and ruled that there was a deficiency only to the extent that the taxpayer's gain could not be considered a capital gain and that a depreciation deduction from a zero basis in the year at issue could not be allowed. The matter of the interest due on the mortgage had not figured in the Commissioner's notice of deficiency, and was not ruled on by the Tax Court.

It is established that the Tax Court will not decide an issue not raised by the Commissioner's notice of deficiency or in the pleadings before the Tax Court. Warner G. Baird, 42 B.T.A. 970 (1940); *see also*, Mississippi Steel Corp., 30 T.C.M.(CCH) 18 (1971); Dean v. Commissioner, 57 T.C. 32 (1971); Philip W. Conrad, 24 T.C.M. (CCH) 790 (1965). Furthermore, unless an issue has been finally decided by the Tax Court, there is no appellate jurisdiction to review or to enter a finding on that issue. Helvering v. Cement Investors, Inc., 316 U.S. 527, 535 (1942); Michael v. Commissioner, 56 F.2d 825 (2d Cir. 1932). *See also* Porter v. Commissioner, 453 F.2d 1231 (5th Cir. 1972); Commissioner v. S. Frieder & Sons Co., 228 F.2d 478 (3d Cir. 1955).

Thus, the absence of the issue of whether gain was realized by the assumption of interest due on the mortgage from the notice of deficiency and the proceedings in the Tax Court precluded review or assessment of deficiency by the court of appeals or by the Supreme Court.

51. This was evident in the taxpayer's arguments in *Raich*, the Second Circuit's opinion in *Bongiovanni*, as discussed at note 29 *supra*, and the Ninth Circuit's opinion in *Thatcher*. The commentary following *Raich*, cited in note 6 *supra*, seems also to indicate that the common perception is that recognition in this area is unnecessary and, at best, merely technical.

52. This is done by giving a basis to the proceeds of the sale equal to the total value of the

to the transferor in computing net gain in the transaction. Yet, a concomitant transfer of deductible liabilities to the corporation is treated as gain for the transferor.

For example, a taxpayer who pays a liability of $100 that has been incurred as a deductible business expense and takes the resulting $100 deduction, can shield $100 of other income from taxation. If this is a conventional recognition situation and the taxpayer is in a forty percent marginal tax bracket, the tax on that $100 of income would be $40. Thus, the taxpayer has paid out $100 and saved $40 of taxes—a net loss of $60. Were that deductible liability paid by another entity, without recognition of gain for the assumption of liability, the taxpayer would thereby realize a true gain of $60. This gain is less than the full amount of the liability because of the potential deductibility of the expense, but it remains a real economic gain.

At the same forty percent marginal rate, the loss on the transfer of an asset that has appreciated by $100 is $60. Thus, when there is both an assumption of a $100 liability, with a net *gain* to the transferor of $60, and a transfer of $100 of appreciated value in an asset,[53] with a net *loss* of $60 to the transferor, the transferor has no economic gain and no true realization for tax purposes.

Transactions involving nondeductible liabilities may raise similar inequities. The assumption of a nondeductible liability of $100 would provide a gain of $100 to the transferor. The transfer of appreciated value equal in face value to the liability would not produce a wash because of the tax rate factor avoided by the transfer of the appreciated value. It would be possible to compute the amount of appreciated value that would have sufficient potential after-tax value that its transfer would equal the gain inherent in the assumption of the nondeductible

asset's basis and the appreciated gain that has been recognized and taxed. I.R.C. §§ 358(a) and 362(a).

53. Judge Hall was willing to apply the setoff theory only where accounts receivable were transferred and only to the extent of those accounts receivable. Thatcher v. Commissioner, 61 T.C. 28, 43 (1973) (dissenting opinion). The Ninth Circuit was careful to adopt Judge Hall's theory with a strict limitation to these facts. Thatcher v. Commissioner, 533 F.2d 1114, 1117 (1976). Accounts receivable have no special significance that would make them more worthy of the setoff theory than any other asset. But it is significant that the accounts receivable of a cash method taxpayer have a zero basis and, therefore, their face value is equal to their "appreciated" value (*i.e.*, their entire face value is unrecognized gain). Thus, $100 of deductible liability is exactly offset by $100 of accounts receivable. If the liability were matched against an asset with a basis of $30, there would be an exact match only if the asset had an appreciation of $100 and, consequently, a face value of $130. What Judge Hall and the Ninth Circuit accomplished by limiting setoffs to accounts receivable was a needlessly mechanical assurance that only appreciated value, exclusive of basis, would be matched against the liability. In addition, since accounts receivable are not depreciable, the appreciation would be truly unrealized gain rather than an artificial appreciation created by depreciation of the basis that would give a double tax benefit to the transferor. Once these elements of the situation are understood, the mechanical limitation to accounts receivable can be discarded.

liability.[54]

There are, however, reasons for denying a judicial remedy in such situations. First, these situations are rare. Nondeductible liabilities will usually give rise to an equivalent basis, as is the case with the most common nondeductible, purchase money liens. If so, there is no excess of liabilities over basis. When the basis is reduced because of depreciation deductions, the taxpayer receives a tax benefit in return for the reduced basis, thus the injustice of a failure to give tax effect to the appreciated value of an asset that has not been included for tax purposes does not occur. Also, it is a rare transfer in which the value of appreciated property as gain forgone is equivalent to the amount of gain realized in the assumption of a nondeductible liability. This is due to the great disparity between assets and non-basis-generating, nondeductible liabilities that would have to be transferred.

Moreover, the exact amount of appréciated property value that must be transferred is not tied to the amount of the liability, as it would be in the case of a deductible liability. With a deductible liability, the values of both the liability and the assets, in terms of gain realized and forgone, is established by application of the same tax rate. The amount of appreciated value that must be transferred to offset the assumption of a deductible liability will always be the face amount of the liability, and thus will not affect subsequent tax calculations. When the amount to be transferred must offset the assumption of a nondeductible liability, however, it will differ from the face amount of the liability according to a calculation involving the inverse of the applicable tax rate. Such a computation is subject to change. If any adjustment to the transferor's taxable income is required in later years, the amount of appreciated property that would have had to be transferred would change. As a result, there would always be an uncertain tax on the section 351 transaction and an uncertain basis for the corporate stock and for the corporation's assets.

Because an injustice is likely to occur only rarely where nondeductible liabilities are assumed and because an attempt to remedy these situations will involve administrative difficulties, it is a reasonable policy decision to deal only with the obvious and manageable injustice that occurs when deductible liabilities are assumed and to leave the assumption of nondeductible liabilities outside of the judicial solution.

54. For example, if $100 of nondeductible liability were assumed, and the transferor were in the 40% marginal tax bracket, it would be necessary to transfer $166.67 ($100/(100%-marginal rate)) of appreciated value (*i.e.*, value in excess of basis) in order to create a wash and realize no gain. If the transferor is in the 50% bracket, it would be necessary to transfer $200 of value, and so on.

C. Practical Aspects of the Judicial Solutions

Both the setoff theory applied by the Ninth Circuit in *Thatcher* and the exclusion of deductible liabilities from "liabilities" applied by the Tax Court in *Focht* solve the immediate problem of the proprietor who transfers deductible liabilities and appreciated assets of equivalent value to a controlled corporation by preventing the tax liability that had previously been imposed under section 357(c). Beyond this immediate relief, however, the theories differ greatly in their impact on the transferor, the corporation, and the administration of the Code. Before relying on either theory for universal application the practical consequences of each should be considered.

1. Practical Aspects of Focht

a. Scope of the Theory

The setoff theory is a limited judicial doctrine that, by its terms, applies only when appreciated assets are transferred to the corporation along with the deductible liabilities assumed by the corporation. When there is no transfer of appreciated assets, the recognition mechanism of the setoff theory, which depends on the "purchase" of a novation, is not triggered.

The exclusion theory of *Focht*, however, is a much broader doctrine. Since it is developed in terms of an absolute legislative intent to exclude deductible liabilities from the operation of section 357(c), the logic of the theory is not easily limited to the particular set of facts in which there truly is no economic gain to the transferor as a result of the assumption of the deductible liability. If no appreciated assets are transferred to offset the gain on assumption of the deductible liabilities there is a definite gain to the transferor that will go untaxed under the exclusion theory. The potential for tax avoidance inherent in this situation is exacerbated because a proof that section 357 was not meant to apply to deductible liabilities would also remove the assumption of deductible liabilities from the fail-safe control of section 357(b).[55] The exclusion theory thus inhibits the courts' ability to deal with unanticipated tax avoidance plans so long as the plans use deductible liabilities.[56]

55. I.R.C. § 357(b) allows the courts to step in to prevent the nse of assumptions of liabilities for tax avoidance purposes. *See* Wolf v. Commissioner, 357 F.2d 483 (9th Cir. 1966); Thompson v. Campbell, 353 F.2d 787 (5th Cir. 1965); Campbell v. Wheeler, 342 F.2d 837 (5th Cir. 1965); Bryan v. Commissioner, 281 F.2d 238 (4th Cir. 1960); Arthur L. Kniffen, 39 T.C. 553 (1962).

56. It might be argued that the courts would never allow this to occur; that deductible liabilities will still be subject to § 357(b). But in order to achieve this, the conrts would have to add another turret onto the cupola of the exclusion theory and the result would not be an elegant judicial structure. If the consequences of the theory are unpalatable, the theory should be abandoned rather than elaborated, especially where there are alternate treatments available.

Moreover, the sweeping exclusion of deductible liabilities suggested in *Focht* is not easily limited to this particular area of the Code. As Judge Hall pointed out in *Focht*, the redefinition of "liability" would lead to uncertainty in other parts of the Code where the term "liability" appears.[57] Admittedly, in some cases the uncertain meaning of the term can be avoided by strict adherence to the distinctions between the legislative purpose of the other sections and that of sections 351 and 357. In many cases, however, congressional intentions are similar enough that a great deal of litigation could ensue as attempts are made to take advantage of *Focht* in other areas.[58]

b. Certainty of Application

The attempt to categorically exclude deductible liabilities from section 357(c) depends on a case-by-case determination of the deductible or nondeductible nature of each liability. Thus, the exclusion of deductible liabilities creates a significant problem of administration. Whether an item is deductible will vary with the particular transferor's tax accounts and will depend on the transferor's income and other deductions in the year of the assumption. For example, a liability that was treated as a deductible during the reorganization may, in the future, be disallowed as a deduction, as in the case of a salary obligation subsequently ruled to be excessive and, therefore, not fully deductible as a business expense. This disallowance would increase the amount of recognition by the transferor, increase the corporation's basis, and decrease the deductions allowed to the corporation for the payment of the liabilities. When assets have already been disposed of and depreciation deductions have already been taken, the change in the deductibility of the liability will create a complex problem of reassessment and will require changes in depreciation schedules that will be both expensive and prone to mistake or abuse.

2. Practical Aspects of Thatcher

a. Timing of Deductions and Payments

Under the setoff theory, there is a recognition by the taxpayer at the time the liability is assumed by the corporation. As a result, the basis of the assets transferred, which carries over to the corporation, is increased.[59] If the initial agreement to pay is the assumption event, the

57. For example, § 752, which deals with treatment of liabilities in computing partnership interests, would be substantially confused and impaired if this new definition of liabilities were applied to it. Judge Hall discussed this possibility in her dissent in Focht v. Commissioner, 68 T.C. at 244-45.

58. *See, e.g.*, I.R.C. §§ 351, 361, 371, 381.

59. If, following this increase in basis, the corporation were allowed to take deductions for amounts paid on the assumed liabilities, as has been the past practice under Treas. Reg. § 1.461-1(a)(2) (1957), the effect would be a double deduction for the same payment of the expenses.

immediate increase in the corporation's basis before any payment has actually been made could distort the corporation's income reporting. The corporation can take depreciation deductions on that basis or sell the assets, taking advantage of the inflated basis, while delaying the payment of the liabilities to other years. Moreover, if the liabilities are never paid, the corporation will gain the benefit of the increased basis without incurring any expense. Such could be the case where a corporation enjoys this increased basis, as through the resale of an asset, and subsequently becomes insolvent before the obligations have been discharged.

The approach taken by Judge Hall and the Ninth Circuit seems to be premised on the judgment that the agreement to pay the transferor's liabilities is an assumption leading to recognition. This approach, however, characterizes the consideration of the agreement as actual "extinguishment of the [transferor's] debt," and limits offsetting deductions to amounts actually paid. Thus it can be inferred that the true premise of this approach is that there has actually been no assumption—and hence no receipt of recognizable boot—until the payment of the liability creates a de facto novation.[60]

That the agreement by the corporation to pay the liabilities is not considered an assumption unless there is an actual novation or until the payment of the liabilities creates a de facto novation, is an implicit, but essential, premise of the setoff theory. As such, it obviates the potential timing discrepancy between a corporate basis increase and the date of actual payment, thus preventing corporate manipulation of inflated basis prior to payment. When there is an actual novation, market forces and the diligence of the creditors will prevent undue delay or avoidance of payment. If payment of the liabilities is delayed past the tax year of the transfer, the transaction can be kept open under *Burnet v. Logan*,[61] again relying on the creditors' self interest to prevent undue

Consistency, therefore, requires that the payment of the liabilities by the corporation be considered as the purchase price of the assets. The payments should not give rise to any further increase in basis because they have already been reflected in the increase of basis at the time of the transferor's recognition.

60. There has been no case in the Ninth Circuit to establish this treatment, but one would anticipate that, in giving effect to this implication, if there is not a novation and the transferor remains liable on the payables (and the corporation makes no payments against the liabilities), there would be no assumption to which § 357(c) is applicable and no recognition at all. So long as the Service requires transferors to transfer liabilities along with their assets, such an application of the theory would never arise and the consequence of this implied premise will appear ouly in the timing of recognition and deduction under the setoff theory.

61. 283 U.S. 404 (1931). Supposing that there has been no assumption because there has been no novation and that in a particular case the corporation has made no payments on the liabilities during the tax year of the transfer, there would be an alternative to keeping the transaction open so that the transferor's return can reflect the recognition and setoff in the year of the transfer. Since there has been no assumption and, therefore, no recognition, there is no need to wait for a constructive payment offsetting the deduction. When payments are made in later years,

delay. Thus, far from creating timing problems, the setoff theory actually provides a well-founded rationale for dealing with timing within the rules established elsewhere by the Code.

b. Conversion of the Nature of Income

The setoff approach involves two steps, recognition and deduction, in achieving a wash for the purposes of the transferor's tax liability, but the two steps do not exactly coincide in their operation. When the assumption of liability is recognized as gain to the transferor, the nature of that gain, either capital or ordinary, is determined by the nature of the assets transferred to the corporation. Although this theory might be applied only where accounts receivable (which are not capital assets) are transferred, the presence of capital property in the transfer would result, under the regulations, in some of the gain being recognized as capital gain.[62] The deduction for constructive payment of the deductible liabilities, however, is not affected by the capital or noncapital nature of the assets transferred. While the gain recognized may in part be capital gain, the deduction will be taken entirely from ordinary income.[63] The setoff is thus not exact and may give the transferor a significant conversion benefit.

The effect of this conversion on the utility or appropriateness of the setoff theory, however, is not very great. A similar conversion is an accepted possibility in all section 351 transfers. Even though the transferor contributes ordinary income property to the corporation, the transferor receives stock that will be a capital asset.[64] The potential ordinary income that has been transferred is thus implicitly converted to potential capital gains income. Income conversions of this sort are apparently not considered by Congress or the courts to be significant enough to outweigh the strong policy of facilitating business reorganizations.

c. Loss of Deduction

Under the setoff approach, the corporation gets an increased basis in the assets it receives[65] as a result of the transferor recognizing gain

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the transferor will receive a dividend that will be recognized as ordinary income but will still obtain the offsetting deduction for the constructive payment of the transferor's deductible liabilities. The corporation cannot be given an increase in basis for the payment of a dividend, so there will be an incentive to make the corporation's payment in the year of the transfer to take advantage of the increased basis.

62. I.R.C. § 357(c); Treas. Reg. § 1.357-2(b) (1955).

63. See note 53 *supra*. As suggested there, this problem may be dealt with explicitly by allowing setoff only where assets that are not capital assets are transferred, or by allowing a deduction only to the amount of gain recognized for tax computation under the capital gains sections.

64. I.R.C. §§ 1221, 1222.

65. In *Thatcher*, Judge Hall stated: "It is not necessary for present purposes to consider the

on those assets, rather than receiving deductions from income when the deductible liabilities were paid, as has been the procedure in the past.[66] The disadvantage for the corporation in the setoff approach is that the deductions for payment that the proprietor would have received but for the transfer, and that would have been transfered to the corporation under past practices, may be converted into basis as a nondepreciable asset. Thus, in liquidating accounts receivable, the corporation will be recognizing the proprietorship's income; but in paying its payables, the corporation will not be able to take a deduction in any form. The result is a distortion of the income picture of the enterprise. The importance of this distortion, however, cannot be assessed in any but a case-by-case fashion, since it is accompanied by what may be an equivalent benefit in the increased basis of inventory.

CONCLUSION

In summary, neither the exclusion nor the setoff theory is neutral in its effect. On balance, however, the problems inherent in the exclusion theory—tax avoidance possibilities, the uncertainties raised in other sections of the Code, and administrative difficulties—appear to be greater than those resulting from the setoff theory as it might be applied, including the conversion of ordinary income into capital gains and the possible distortion of the income picture of the enterprise. The setoff theory is thus a more practical solution, more nearly supported by the intentions of Congress, and more strictly focused on remedying the situation in which a true economic injustice occurs—that is, where appreciated assets are transferred at the same time as deductible liabilities—than is the theory of excluding deductible liabilities from section 357. Although it is encouraging to note the Tax Court's efforts to correct its literal reading of the statute in *Raich*, courts should not rely on the approach subsequently adopted in *Focht*, based as it is on a dubious construction of legislative intent. This is especially true where a more practical theory has been advanced by a distinguished member of the Tax Court and is already in effect in one federal circuit.

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effect, if any, of application of [the setoff] analysis to the subsequent corporate payment of the payables assumed. . . ." 61 T.C. at 44 (1973) (Hall, J., dissenting). However, dissenting in *Focht*, Judge Hall did indicate the appropriate treatment under the setoff theory inferentially. She wrote: "Any deduction should await *payment* but the . . . deduction should be available to the transferor, not the transferee. The transferee corporation should be treated as having purchased [the appreciated asset] with the . . . liabilities it assumed in the taxable transaction." 68 T.C. at 246 (emphasis in original).

66. *See* Treas. Reg. § 1.461-1(a)(2) (1967), cited in Bongiovanni v. Commissioner, 470 F.2d 921, 925 (2d Cir. 1972).

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