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**ASSUMPTION OF DEDUCTIBLE
LIABILITIES UNDER SECTION 357(c)
OF THE INTERNAL REVENUE CODE—
FOCHT V. COMMISSIONER**

A recent Tax Court decision has resolved the serious problem facing cash method taxpayers seeking to incorporate under section 351 of the Internal Revenue Code. The court in *Focht v. Commissioner*¹ held that the assumption of a transferor's deductible obligation by a corporate transferee in a section 351 exchange is not to be treated as a liability for purposes of sections 357 and 358. This decision has significant tax consequences for the incorporating taxpayer and will facilitate the incorporation of businesses. This Note will discuss the problem of treating a cash method taxpayer's deductible obligations as liabilities in a section 351 exchange. It also will review prior case law and congressional purpose in order to facilitate an understanding of the court's holding. Finally, this Note will examine the Tax Court's rationale employed in *Focht*.

SECTION 357(c): THE CASH METHOD TAXPAYER'S PROBLEM

Section 351(a) of the Internal Revenue Code provides the conditions under which a person can transfer property to a corporation without recognition of gain or loss.² First, the transferor must exchange the property³ solely for stock or securities⁴ in the corporation. In addition, the transferor must be in control⁵ of the corporation immediately following the exchange. A transfer of property to a

1. 68 T.C. 223 (1977).

2. I.R.C. § 351 merely postpones the recognition of gain or loss on the transfer since under § 358 the transferor's basis in the stock will be the same as his basis in the property transferred. For example, if a person transfers property to his controlled corporation with a basis of \$50 and a fair market value of \$100 for stock worth \$100, he realizes a \$50 gain on the exchange, none of which is recognized under § 351. His basis in the stock is \$50 and the gain that went unrecognized will be taxed on a subsequent sale of the stock. The corporation's basis in the property transferred is the transferor's basis increased by the amount of gain recognized to the transferor on the transaction or \$50, under I.R.C. § 362(a).

3. I.R.C. § 351(a) expressly excludes services from the definition of "property."

4. See B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 3.04, at 3-14 to 3-17 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE] for a discussion of what constitutes stock or securities.

5. The word "control" in I.R.C. § 351 is defined in I.R.C. § 368(c) as the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation. See also Rev. Rul. 59-259, 1959-2 C.B. 115, where the Treasury Department states that the transferor must own 80 per cent of the total number of each class of outstanding nonvoting stock.

corporation controlled by the transferor which satisfies the described conditions is considered a change of form only and therefore no gain or loss should be recognized at that time.⁶ If the transferor receives property or money ("boot") in addition to the stock or securities in the corporation, gain is recognized to the extent of the amount of money or the fair market value of the property received.⁷ For example, a person transferring property with a \$50 basis and a \$100 fair market value to a controlled corporation in exchange for stock worth \$75 and property worth \$25 will realize a \$50 gain, \$25 of which will be recognized.⁸

In most reorganizations⁹ and incorporations of going businesses, the transferor does not liquidate the liabilities, but rather transfers them to the corporation along with the assets of the business. For years it was assumed that such transfers did not result in any gain to the transferor.¹⁰ However, in 1938, the Supreme Court in *United States v. Hendler*¹¹ held that the corporation's assumption and payment of the transferor's debt by the corporation in a reorganization was identical to receiving cash from the transferee with which to pay the transferor's creditors.¹² In other words, the assumption of the transferor's liabilities constituted boot and resulted in a gain to the transferor to the extent of the liability assumed.

Subsequent to this decision, Congress realized that the usefulness of the nonrecognition provisions would be impaired seriously by such recognition of gain.¹³ Therefore, it enacted present section 357(a),¹⁴ providing that the assumption of a liability or property subject to a

6. BITTKER & EUSTICE, *supra* note 4, ¶ 3.01, at 304. I.R.C. § 351 was enacted to facilitate "necessary business readjustments." S. REP. NO. 275, 76th Cong., 1st Sess., *reprinted in* 1939-1 C.B. (Part 2), 181, 188. A typical § 351 exchange would involve a sole proprietor who decides to incorporate his business in order to limit his liability. In so doing, he transfers the assets and liabilities of the proprietorship to the controlled corporation in exchange for all of the stock of the corporation. Business continues exactly as it did prior to the exchange, only the form of the business is changed.

7. I.R.C. § 351(b). Under § 351(b)(2), no loss is recognized to the recipient.

8. I.R.C. §§ 358(a)(1)(A) and (B) provide for adjustments to basis when "boot" is received in an exchange. The transferor's basis in the stock would be the basis in his transferred property (\$50) decreased by the fair market value of the boot received (\$25) and increased by the amount of gain recognized on the transfer (\$25) for a basis of \$50.

9. I.R.C. § 354 and § 361 apply to corporate reorganizations and are analogous to § 351.

10. BITTKER & EUSTICE, *supra* note 4, ¶ 3.07, at 3-23.

11. 303 U.S. 564 (1938).

12. *Id.* at 566.

13. BITTKER & EUSTICE, *supra* note 4, ¶ 3.07 at 3-23. See H.R. REP. NO. 855 76th Cong., 1st Sess. 19 (1939), *reprinted in* 1939-2 C.B. 504, 507.

14. Section 112(k) of the Internal Revenue Code of 1939 was the predecessor of §§ 357(a) and (b) of the 1954 Code.

liability in a section 351 exchange should not be treated as boot.¹⁵ However, section 357(c)¹⁶ provides that if the total of the liabilities assumed exceeds the adjusted basis of the property transferred, the excess amount will be recognized as gain. For example, a person transferring property with a basis of \$50 and worth \$170 subject to a \$70 mortgage, in exchange for stock worth \$100 plus the transferee's assumption of the \$70 mortgage, will recognize a gain of \$20. This is the amount by which the liability assumed by the transferee (\$70) exceeds the adjusted basis of the assets transferred (\$50).¹⁷ Under the basis adjustment provisions of section 358, the deferred gain of \$100 will be recognized upon a later disposition of the stock.¹⁸

Section 357(c) has resulted in serious problems for cash method taxpayers¹⁹ transferring the assets and liabilities of a going business to

15. I.R.C. § 357(b) provides an exception to the general rule of § 357(a). If the taxpayer's principal purpose is to avoid tax on the exchange or is not a bona fide business purpose, then the total amount of all liabilities will be considered as boot.

16. I.R.C. § 357(c) Liabilities in Excess of Basis.—

(1) In General—In the case of an exchange—

(A) to which section 351 applies, or

(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.

17. Under I.R.C. § 1001(a), gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis of the property. Under § 1001(b), the amount realized is the sum of the money received plus the fair market value of the property (other than money) received.

The assumption and payment by another of one's personal obligation is income to the original obligor. *See* *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929) (employer paid employee's federal income tax). If property is taken subject to a liability, the amount of the liability is part of the amount realized under the doctrine established in *Crane v. Comm'r*, 331 U.S. 1 (1947) (purchaser took building subject to a mortgage). Therefore, the amount realized on this exchange is \$170, the fair market value of the stock (\$100) plus the amount of the liability assumed (\$70). The realized gain is \$120, the excess of the amount realized over the adjusted basis.

18. Since § 358(d) provides that the amount of the liability is to be treated as money received on the exchange for the purpose of determining basis, the transferor's basis in the stock would be zero, his basis in the property transferred (\$50) decreased by the amount of money and fair market value of other property received (\$70) and increased by the amount of gain recognized (\$20). The corporation's basis in the transferred asset is \$70 under § 362(a), the transferor's basis plus the amount of gain recognized on the the transaction.

19. As *Treas. Reg.* § 1.446-1(c)(1)(i) explains, for a cash method taxpayer, all items which constitute gross income are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted in the taxable year in which actually made. An account receivable that arises in year one and is received in year two is income in year two. Since an account receivable does not affect the cash method taxpayer's tax liability until it is received, if he transfers it prior to any of it being paid, it has a zero basis. This fact is well

a controlled corporation in a section 351 exchange. An "unexpected pitfall"²⁰ results when the cash basis transferor transfers accounts receivable for stock and an assumption of his accounts payable. The Tax Court held in *Raich v. Commissioner*²¹ that trade accounts payable constitute liabilities within the meaning of section 357(c), while recognizing that accounts receivable of the cash method taxpayer have a basis of zero.²² Therefore, a transfer will result in taxable income to the extent that the liabilities, including accounts payable, exceed the zero basis of the receivables. For example, a cash method taxpayer transfers accounts receivable of \$1000, at zero basis, and other property with a basis of \$100 to a controlled corporation in a section 351 exchange for stock and the assumption of his accounts payable of \$1000. Under section 357(c) a \$900 gain is recognized and the basis of the stock is zero.²³ If the transferor had kept the receivables and payables, his net income would have been zero—\$1000 offset by a \$1000 deduction. He could then transfer the other property for the stock, resulting in a \$100 basis in the stock and a lesser gain upon subsequent disposition than in the first example. Although this problem could be avoided by the transferor's payment of the liabilities with his own money, in light of the purpose of section 351²⁴ and the practice of most transferors,²⁵ this is unnecessarily hazardous.

Although the Tax Court had approved the *Raich* reasoning on several occasions,²⁶ it reversed itself in *Focht*, holding that the assumption of a deductible obligation of a cash method taxpayer in a section 351 exchange is a nonrealizable event.²⁷ Both the Second and Ninth Circuits have likewise rejected the *Raich* analysis, employing different rationales. However, the Third Circuit, to which appeal of *Focht*

settled. See *P.A. Birren and Son v. Comm'r*, 116 F.2d 718, 720 (7th Cir. 1940) cited with approval in *Raich v. Comm'r*, 46 T.C. 604, 610, n.9 (1966); Rev. Rul. 69-442, 1969-2 C.B. 53.

Treas. Reg. § 1.446-1(c)(1)(ii) provides that an accrual method taxpayer includes an account receivable in income in the tax year in which it arises, regardless of whether or not it is actually received in that year. He deducts an account payable in the year it arises, whether or not he actually pays it in that year. Rev. Rul. 69-442, *id.*, points out that because accounts receivable are included in the income of an accrual basis taxpayer, he does not have a zero basis in his receivables.

20. BITTKER & EUSTICE, *supra* note 4, ¶ 3.07 at 3-27.

21. 46 T.C. 604 (1966).

22. See note 19 *supra*.

23. See notes 8 & 18 *supra*.

24. See note 6 and accompanying text *supra*.

25. See text accompanying notes 9 and 10 *supra*.

26. *Rosen v. Comm'r*, 62 T.C. 11 (1974), *aff'd without opinion* 515 F.2d 507 (3rd Cir. 1975); *Thatcher v. Comm'r*, 61 T.C. 28 (1973), *aff'd in part and rev'd in part* 533 F.2d 1114 (9th Cir. 1976); *Bongiovanni v. Comm'r* 30 T.C.M. 1124 (1971), *rev'd* 470 F.2d 921 (2d Cir. 1972).

27. 68 T.C. at 229, 237.

did lie,²⁸ had previously affirmed the *Raich* approach.²⁹ In order to appreciate the significance of the *Focht* holding and to understand the court's rationale, it is necessary to take a brief look at *Raich* and several prior decisions and the Congressional purpose behind the enactment of section 357(c).

SECTION 357(c): PRIOR CASE LAW

In *Raich* the taxpayer transferred to a controlled corporation assets with a book value in excess of \$88,000 and an adjusted basis of \$11,250. The low basis in these assets was a result of the zero basis given to over \$77,000 in accounts receivable.³⁰ In exchange, the transferor received stock and the assumption of his liabilities of \$46,000, of which almost \$38,000 were attributable to trade accounts payable. The result was a recognized gain of \$34,750.

The taxpayer argued that Congress intended section 357(c) to apply only where the transferor would have a present economic gain if a tax was not imposed at the point of transfer.³¹ For support, he cited a prior case³² in which the liabilities assumed exceeded both the adjusted basis and the book value of the assets, resulting in real economic benefit to the transferor. He also stated that the example Congress used³³ to explain the application of section 357(c) involved

28. 68 T.C. at 229. The appeal was dismissed by agreement of the parties.

29. *Rosen v. Comm'r*, 62 T.C. 11 (1974), *aff'd without opinion* 515 F.2d 507 (3rd Cir. 1975). *Rosen*, however, involved an accrual basis taxpayer.

30. *Raich v. Comm'r*, 46 T.C. 604, 609 (1966). See also note 19 *supra*.

31. *Raich v. Comm'r*, 46 T.C. 604, 609 (1966), citing S. REP. NO. 1622, 83d Cong., 2d Sess. 270 (1954), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4908; H.R. REP. NO. 1337, 83d Cong., 2d Sess. A129 (1954), reprinted in [1954] U.S. CODE & AD. NEWS 4017, 4267.

32. *Testor v. Comm'r*, 40 T.C. 273 (1963), *aff'd* 327 F.2d 788 (7th Cir. 1964). The taxpayer in *Testor* argued that § 357(c) applied only where encumbered property was part of a transfer of assets and liabilities. The Seventh Circuit rejected this argument, holding that § 357(c) was meant to apply wherever liabilities were assumed or property was transferred subject to a liability. *Id.* at 790. Under the Tax Court's decision in *Golsen v. Comm'r* 54 T.C. 742 (1970), *aff'd on the substantive issue* 445 F.2d 985 (10th Cir. 1971), where the Court of Appeals to which appeal lies has already passed on an issue, "efficient and harmonious judicial administration" calls for the Tax Court to follow the decision of that court. *Id.* at 757. If the Tax Court were faced with a *Focht*-type case that was appealable to the Seventh Circuit, it could circumvent its *Golsen* rule by distinguishing *Testor* on the ground that the liabilities assumed exceeded the book value as well as the adjusted basis of the transferred assets. *Focht* can be harmonized with *Testor* in that the transfer of encumbered property is not the only means of invoking § 357(c). Under *Focht*, if a cash method taxpayer transfers any nondeductible liability, it will trigger gain recognition to the extent it exceeds the basis of the assets transferred. 68 T.C. at 237-38.

33. "[I]f 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 would be subject to tax 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." S. REP. NO. 1622, 83d Cong., 2d Sess. 270 (1954), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4608; H.R.

the assumption of a mortgage liability. In such a case payment of the obligation by the transferor would not have given rise to a deduction and, if not taxed, would have amounted to the receipt and use of money tax-free. The court, however, found nothing in either the language or in the legislative history of the Code to indicate any Congressional intent to limit the application of section 357(c) to situations similar to that used in their example.³⁴ Raich also argued that the accounts receivable should be given an adjusted basis equal to the amount of the accounts payable assumed by the transferee. The court also rejected this argument³⁵ while conceding that "the result reached may conflict with the well-established intent of Congress to foster tax-free business reorganizations."³⁶

A Second Circuit case, *Bongiovanni v. Commissioner*,³⁷ involved a factual situation similar to *Raich*. The Tax Court had approved *Raich's* holding that the assumption of the accounts payable should be reflected in taxable gain under sections 351 and 357(c). However, the Court of Appeals reversed, stating that the word "liabilities" as used in section 357(c)

was not meant to be synonymous with the strictly accounting liabilities involved in the case at bar. Section 357(c) was meant to apply to what might be called "tax" liabilities, i.e., liens in excess of tax costs, particularly mortgages encumbering property transferred in a Section 351 transaction. Any other construction results in an absurdity in the case of a cash basis taxpayer whose trade accounts payable are not recognized as a deduction . . . but whose "liabilities" are recognized for purposes of Section 357(c).³⁸

REP. NO. 1337, 83d Cong., 2d Sess. A129 (1954), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, 4267. A similar example appears in Treas. Reg. § 1.357-2(a).

In the above example, the transferor is giving up \$20,000 (his investment in the property) and receiving \$50,000 (the mortgage is part of the amount realized). Due to the nonrecognition provisions of § 357(a), the \$30,000 gain would go untaxed except for § 357(c).

The Tax Court in *Rosen v. Comm'r*, 62 T.C. 11, 19 n.3 (1974), *aff'd without opinion*, 515 F.2d 507 (3d Cir. 1975), cited these Congressional reports as evidence that Congress intended to deal with the case where the transferor takes a deduction for depreciation on assets that were purchased with borrowed money and the transferee repays the loan. Due to the prior tax benefit received when the deduction for depreciation was taken, the assumption of this liability should (to the extent it exceeds the basis in the other assets transferred) be recognized as gain under § 357(c). This approach is similar to that taken by Judge Quealy in his *Thatcher* dissent, see note 39 *infra*, and by Del Cotto in his Article. See Del Cotto, *Section 357(c): Some Observations on Tax Effects to the Cash Basis Transferor*, 24 BUFF. L. REV. 1 (1974).

34. *Raich v. Comm'r*, 46 T.C. 604, 609 (1966).

35. *Id.* at 610. See also note 18 *supra*.

36. *Raich v. Comm'r*, 46 T.C. 604, 611 (1966).

37. 470 F.2d 921 (2d Cir. 1972).

38. *Id.* at 924.

The major problem with the *Bongiovanni* decision is the absence of guidelines for distinguishing a "tax" liability from an "accounting" liability. In addition, the decision does not refer to the basis provisions of section 358. If its rationale were not extended to section 358(d), the taxpayer's stock would take a negative basis and nonexistent gain would eventually be recognized if the stock were sold.

Similar facts existed in *Thatcher v. Commissioner*,³⁹ in which the Tax Court rejected the Second Circuit's holding in *Bongiovanni*, finding that the court's treatment of liabilities could not be reconciled with the language of section 357(c).⁴⁰ The Tax Court, therefore, reaffirmed its *Raich* rationale.⁴¹ The Ninth Circuit reversed on appeal. Although it agreed with the end result of *Bongiovanni*, the court felt that the Second Circuit had "defined liabilities in an *ad hoc* manner" which would likely "produce unforeseen results in other cases."⁴² In contrast, the *Thatcher* court looked at the cash-basis transferor as having sold his accounts receivable to the corporation in exchange for payment of his accounts payable.⁴³ Under this approach, gain is recognized to the extent that the liabilities assumed exceed the adjusted basis in the assets transferred. However, the taxpayer could set-off the deductible and paid trade accounts which are allocable to the purchase of the receivables.⁴⁴ In other words, the transferor receives a deduction for his trade accounts payable to the extent of the accounts receivable or the gain recognized under section 357(c), whichever is less.⁴⁵

Unfortunately, unless a cash method taxpayer transfers a large amount of receivables he does not benefit under this approach. Sup-

39. 61 T.C. 28 (1973), *aff'd in part and rev'd in part* 533 F.2d 1114 (9th Cir. 1976).

40. *Id.* at 36. Judge Quealy's dissent, *id.* at 39-42, attempted to clarify the Second Circuit's approach to the term "liabilities." If a liability had been "reflected in determining the income and expense of the taxpayer," it is a § 357(c) liability. His example is as follows:

Where a taxpayer buys a depreciable asset with borrowed funds, the deduction for depreciation enters into the taxpayer's income on a cash basis of accounting. . . .

On the other hand, where the liability represents an inventoriable or deductible expense, it cannot be reflected in the computation of income on a cash basis until paid.

Id. at 40-41. This is similar to the rationale used in *Focht*.

41. *Thatcher v. Comm'r*, 533 F.2d 1114, 1117 (9th Cir. 1976).

42. *Id.* There is some basis to this criticism. As Judge Hall points out in her dissent in *Focht*, the word "liability" appears 400 times in the Code. The ordinary meaning of the word is "an amount that is owed, whether payable in money, other property or services." WEBSTER'S THIRD NEW INT'L DICTIONARY 1302 (17th ed. 1976). If the courts give it different meanings for different Code sections, the result will be confusion.

43. *Thatcher v. Comm'r*, 533 F.2d 1114, 1117 (9th Cir. 1976).

44. *Id.* at 1118.

45. Kahn & Oesterle, *A Definition of 'Liabilities' in Internal Revenue Code Sections 357 and 358(d)*, 73 MICH. L. REV. 461, 481-82 (1975) [hereinafter cited as Kahn & Oesterle].

pose, for example, a taxpayer transfers \$100 in receivables with a zero basis and property worth \$500 with a basis of \$100 in exchange for stock and the assumption of his accounts payable of \$500. His recognized gain is \$400, the amount by which the liabilities assumed exceed the adjusted basis of the property transferred. He could offset this gain by only \$100 (the lesser of the accounts receivable or gain recognized), which leaves him with a net taxable gain of \$300 and a basis in his stock of zero, since the basis provisions of section 358 are not affected by the setoff allowed for section 357(c) purposes.⁴⁶

If the taxpayer in the above example transferred only the property and the accounts payable, he would recognize the entire gain of \$400, but receive no offsetting deduction. If instead his receivables were \$500, he would recognize the \$400 gain but would be entitled to an offsetting deduction of \$400 (the lesser of the receivables or gain recognized). Under this approach, the amount of the receivables transferred determines whether there is recognized gain. However, as will be discussed subsequently,⁴⁷ the problem is that the assumption of a deductible obligation does not trigger gain recognition. Therefore, the entire rationale of the *Thatcher* approach falls through.

THE FOCHT DECISION

The Tax Court in *Focht* saw the opportunity to correct its past position and to present a rationale that would resolve the conflict between the Second and Ninth Circuits. The taxpayer in *Focht* had owned and operated a plumbing and heating service as a sole proprietorship using the cash method of accounting.⁴⁸ In 1970, the taxpayer, in a section 351 exchange, transferred all of the assets of the sole proprietorship to a corporation in exchange for all of the stock and the assumption by the corporation of all of the liabilities of the business.⁴⁹

46. *Thatcher v. Comm'r*, 533 F.2d 1114, 1118 (9th Cir. 1976).

47. See notes 56-64 and accompanying text *infra*.

48. 68 T.C. at 224.

49. *Id.* The petitioner's assets and liabilities consisted of the following:

<u>Assets</u>		<u>Adjusted Basis</u>
Accounts receivable	\$42,237.10	0
Cash	959.00	\$ 959.00
Inventory	18,320.00	18,320.00
Fixed Assets:		
Cost of assets	\$39,741	
Less accelerated depreciation		
as of 12/31/69	23,553	<u>\$16,188.00</u>
Total assets	<u>77,704.10</u>	<u>35,467.00</u>

Although the taxpayer's assets totalled over \$77,000, their adjusted basis was only \$35,467, since the accounts receivable had a zero basis.⁵⁰ The liabilities assumed totalled \$88,979, including \$73,729 in accounts payable. The Commissioner, using the *Raich* approach, found that the taxpayer recognized an ordinary gain in the amount of \$53,512,⁵¹ the amount by which the liabilities assumed exceeded the adjusted basis of the assets transferred.

The Tax Court recognized its main problem to be an overly literal interpretation of the word "liabilities" in section 357 when it included deductible accounts payable within its definition.⁵² The court abandoned its prior literal approach, influenced by the division among its own members⁵³ and the outpouring of commentary from the tax bar.⁵⁴ The court in essence adopted an argument advanced unsuccessfully by the petitioner in *Raich*,⁵⁵ only the assumption of a liability that triggers real economic benefit to the transferor was intended to be included in section 357 liabilities.

The court's reasoning followed a path well-marked by several commentators.⁵⁶ The predecessor of section 357(a) was enacted to

<u>Liabilities</u>	
Accounts payable	\$73,729.00
Salaries and wages paid by the corporation	1,746.00
Federal income taxes payable on payroll return	8,168.00
Property subject to liabilities which were transferred to the corporation:	
Truck (Clark Sandt)	1,857.00
Auto Loan (Merchant's National Bank)	3,479.00
Total liabilities assumed by the corporation	<u>\$88,979.00</u>

50. See note 19 *supra*.

51. 68 T.C. at 225.

52. The court stated that "[w]e have heretofore held, in a multitude of cases, that the term 'liabilities' as used in section 357 should be given an all-inclusive meaning. These holdings have required an extremely literal interpretation of the statute and the adoption of a mechanical test." 68 T.C. at 226-27.

53. The court noted that there were five dissentors in their *Thatcher* opinion. *Id.* at 229 n.11.

54. *Id.* at 229, n.12. The court cited several articles. The Kahn & Oesterle article, *supra* note 45, appears to have greatly influenced the court's reasoning. Some of the opinion is taken verbatim from the article. This influence is acknowledged by a footnote to Judge Sterrett's opinion, 68 T.C. at 229, n.12, and by Judge Simpson in his concurring opinion, *id.* at 239.

55. See notes 31-36 and accompanying text *supra*.

56. See Kahn & Oesterle, *supra* note 45, at 467-74. See also Del Cotto, *Section 357(c): Some Observations on Tax Effects to the Cash Basis Transferor*, 24 BUFF. L. REV. 1 (1974);

counter the result reached in the *Hendler* decision,⁵⁷ namely that the assumption of a liability in a reorganization constituted boot. Relying on a Congressional committee report,⁵⁸ the court concluded that the provision was intended to affect only liabilities which, if assumed by a transferee in a section 351 exchange, would cause gain recognition.⁵⁹ This rationale had its origin in a 1947 Supreme Court case, *Crane v. Commissioner*.⁶⁰ *Crane* held that if property were taken by a transferee subject to a liability, the amount of the liability was to be treated as part of the amount realized.⁶¹ The purchaser in *Crane* took the property subject to a \$255,000 mortgage and defaulted interest payments in an amount over \$7,000. Only the principal amount of the mortgage was included in the amount realized. The Court in *Crane* noted with approval that the Commissioner had not treated the assumption of the overdue interest liability as an amount realized, since interest is "a deductible item."⁶² Deductible liabilities are excluded from the transferor's amount realized under *Crane*. Since section 357(c) was enacted seven years after the *Crane* decision, the Tax Court reasoned that section 357(c) "should be limited to those obligations which, if transferred, cause gain recognition."⁶³ The court found that the result under *Raich* taxed the transferor on an amount which never would be received by him as an economic gain.⁶⁴

The court also rejected the *Thatcher* approach for two reasons. First, where accounts receivable are less than payables or where no receivables are transferred but payables are assumed, the taxpayer would still have section 357(c) gain.⁶⁵ In addition, the court noted that the regulations to section 357 require any gain to be allocated among the transferred assets according to their fair market values.⁶⁶

Comment, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154, 1157-63 (1967); Note, *Incorporating a Cash Basis Business: The Problem of Section 357(c)*, 34 WASH. & LEE L. REV. 329, 347-49 (1977).

57. See notes 13-15 and accompanying text *supra*. See also Ways and Means Committee Report, H.R. REP. NO. 855, 76th Cong., 1st Sess. (1939), reprinted in 1939-2 C.B. 504, 518-19. The committee thought that the *Hendler* decision would nullify the existing provisions which postponed the recognition of gain.

58. *Id.*

59. 68 T.C. at 233.

60. 331 U.S. 1 (1947). See also *Woodsam Assoc. v. Comm'r*, 198 F.2d 357 (2d Cir. 1952); *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950).

61. 331 U.S. 1, 14 (1947).

62. *Id.* at 4 n.6.

63. 68 T.C. at 235.

64. *Id.* at 237.

65. See text accompanying notes 46-47 *supra*.

66. 68 T.C. at 237 n.28. Treas. Reg. § 1.357-2. See also Kahn & Oesterle, *supra* note 45, at 48.

Therefore, any gain would not necessarily be fully allocable to accounts receivable. If part of the gain were allocable to transferred capital assets, held for more than one year, it would be characterized as a long term capital gain. An ordinary deduction under the *Thatcher* approach would not constitute a "wash" with the section 357(c) gain, since long term capital gains are taxed at a different rate than ordinary income.⁶⁷

The court improved on the *Bongiovanni* approach in two ways. Deductible obligations are not included in the term "liabilities" in the basis provisions of section 358.⁶⁸ When a cash method taxpayer transfers deductible obligations in a section 351 exchange, they will not serve to reduce his basis in the stock received and therefore the nonexistent gain will not be recognized in the future. In addition, the *Bongiovanni* distinction between accounting liabilities and tax liabilities still left the taxpayer in a state of uncertainty. In contrast, the *Focht* rationale is clear and precise.⁶⁹

AN UNRESOLVED ISSUE

The Tax Court left undecided the tax consequences to the transferee corporation when it pays the assumed liabilities.⁷⁰ Some courts⁷¹ and the Internal Revenue Service⁷² have allowed the trans-

67. Judge Hall feels that by not applying § 357(c) as written, the taxpayer is deprived of the tax benefit inherent in obtaining an ordinary deduction on payment of the payables, with an offsetting gain which may in part be a capital gain. 68 T.C. at 248-49. However, if a taxpayer sold the capital asset and paid the deductible payables, he would have a capital gain and an ordinary deduction. Therefore, a similar result should be unobjectionable in a § 351 exchange. See Treas. Reg. § 1.357-2.

68. 68 T.C. at 229, 238.

69. Judge Hall, dissenting in *Focht*, reiterated many objections which were set forth in her *Thatcher* dissent. She viewed the majority's interpretation of section 357(c) as inconsistent with the plain wording of the statute. She also felt that the court constructed a hypothetical legislative history out of a random footnote in *Crane*. 68 T.C. at 244. While a cash method taxpayer gets no deduction for an expense until it is paid, Hall concluded that the majority approach effectively gives the deduction when the liability is assumed, whether or not it is paid. *Id.* at 245. Under Hall's approach the offsetting deduction to the transferor arises only when payment of the deductible liability is made by the transferee. However, the exclusion of a deductible obligation from the amount realized is done for administrative convenience and the practice is well-established. See *Crane* discussion accompanying notes 57-61. See also Kahn & Oesterle, *supra* note 45, at 468-69. Rather than have the taxpayer realize income in the year the liability is assumed and then wait to take a deduction in a later year when the transferee makes the payment, the taxpayer is allowed merely to exclude the amount from income.

70. 68 T.C. at 238.

71. See, e.g., *Bongiovanni v. Comm'r*, 30 T.C.M. 1124 (1971) ("where the acquiring corporation is on an accrual basis [deductible trade accounts payable] are also deductible in [their] initial tax period"). *Id.* at 1126. The Second Circuit in *Bongiovanni v. Comm'r*, 470 F.2d 921 (2d Cir. 1972) cited Treas. Regs. § 1.461-1(a)(2) and stated that "[t]he corporate taxpayer would be entitled to its deduction whether or not the cash basis individual taxpayer had been taxed under § 357(c)." *Id.* at 925.

72. Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 32

feree a deduction for the payables that would have been deductible by the transferor. Rulings issued by the Service along with closing agreements⁷³ allow the transferee corporation to deduct the deductible liabilities assumed in the transaction.⁷⁴ The rationale for this is that since section 351 treats the new corporation as a continuation of the prior business, the new corporation should be regarded as standing in the shoes of the transferor for purposes of taking tax deductions.⁷⁵ However, if the assumed liabilities are considered to be part of the corporation's acquisition cost of the assets, it cannot deduct the amounts paid to discharge these liabilities or add them to its carryover tax basis.⁷⁶

When the Tax Court stated that it would not decide the issue, it cited the case of *Magruder v. Supplee*⁷⁷ in which a purchaser of real estate paid the taxes for which the seller was personally liable. The payment was treated as part of the purchase price and no deduction was allowed.⁷⁸ However, since the taxes were treated as part of the purchase price, the buyer could have added them to his cost-basis in the property, reducing any future gain by the amount of the taxes paid.

J. Tax. 88, 90-91 (1970). The IRS has not applied assignment of income principles to the transfer of accounts receivable in a § 351 exchange. However, the IRS will usually issue rulings to the effect that the transferor should not be taxed on the accounts receivable only where there is a closing agreement which requires the transferee corporation to agree that it will recognize income upon collecting the receivables. In addition, there must be an agreement that such income will be ordinary in character if it would have been ordinary in the hands of the transferee. Usually the transferor must also agree to transfer the accounts payable along with the receivables.

73. Under I.R.C. § 7121 and Treas. Regs. § 301.7121, the Commissioner can enter into a written agreement with any person relating to that person's tax liability.

74. Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 32 J. TAX. 88, 90-91 (1970).

75. *Id.*

76. See Bittker & Eustice, *supra* note 4, ¶ 3.12, at 3-43.

77. 316 U.S. 394 (1942).

78. *Id.* at 398. See also *Holdercroft Transp. Co. v. Comm'r*, 153 F.2d 323 (8th Cir. 1946). The payment of legal claims against a partnership which were assumed by the corporation in a § 112(b)(5) (now I.R.C. § 351) exchange was a part of the purchase price of its assets. The payments were capital expenditures which were not deductible by the corporation. The petitioner asserted that because it had acquired the assets of the partnership in a tax-free transfer, it stood in the same position with respect to expense and loss deductions as the partnership would have been in if there had been no transfer. The court rejected this contention. *Id.* at 324-25. See also *Athol Mfg. Co. v. Comm'r*, 54 F.2d 230, 231 (1st Cir. 1931) (amounts paid out by transferee to satisfy the obligations of transferor which it had assumed were not a deductible business expense but rather a capital expenditure).

The basis provisions of section 362 provide that the corporation's basis in the property transferred shall be the transferor's basis increased by the amount of gain recognized to the transferor on the transaction. Since under *Focht* the assumption of deductible obligations will not trigger gain recognition, it will not affect the corporation's basis in the property either.

If the corporation is not allowed a deduction for the payables, it will still be more advantageous for the transferor to keep his receivables and payables. This undermines the purpose of section 351—to facilitate necessary business readjustments. For example, if A transfers \$100 in accounts receivable, property with a basis of \$50 and \$100 in accounts payable to a controlled corporation, he would have zero gain and a \$50 basis in the stock. The corporation would have a \$50 basis in the property and \$100 income when it collected the accounts receivable, assuming the deduction for the payables is not allowed. If A had kept the receivables to pay the payables the net effect is zero income with the basis in the stock at \$50. The corporation's basis in the property would be \$50 and it would have no income from the receivables since it did not collect them. In addition, since this is a mere formal change in the form of the business, it could be held that the transferee does indeed step into the shoes of the transferor as to deductions for expenses. However, in light of the case history on the subject⁷⁹ and the *Crane* exclusionary approach adopted in *Focht*, allowing the corporation a deduction in addition to excluding the assumption of the liability from income would be deemed a double tax benefit and would not be allowed.

CONCLUSION

The *Focht* holding is of vital importance to all cash method taxpayers contemplating section 351 exchanges. As discussed, several courts have recognized the inherent unfairness of including otherwise deductible obligations in the cash method taxpayer's income. However, the rationales employed to implement this conclusion have been flawed. To date, the most logical analysis and solution to the problem has been presented by the Tax Court in *Focht*. Unfortunately, this

79. See notes 79-80 and accompanying text *supra*.

problem remains unsettled.⁸⁰ The government's appeal to the Third Circuit was dismissed by agreement of the parties, eliminating the opportunity for the Court of Appeals to affirm the *Focht* rationale. The Second and Ninth Circuits also have significant differences in their respective approaches to the problem. In future cases involving this issue, the courts should adopt the *Focht* rationale, thus giving taxpayers the opportunity to plan Section 351 transactions with confidence.

M. Carol Pope

80. Subsequent to this Note going to print, Congress, in the 1978 Revenue Act amended § 357(c) to provide that if a cash method taxpayer transfers a deductible account payable, it is to be excluded when determining the amount of liabilities assumed. See SENATE FINANCE COMMITTEE REPORT, SEN. REP. NO. 95-1263, 95th Cong., 2d Sess. (1978).

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