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BONGIOVANNI v. COMMISSIONER:
FALSE HOPES FOR CASH BASIS TAXPAYERS

INTRODUCTION

Cash basis taxpayers attempting a tax-free incorporation of a sole proprietorship or a partnership under Section 351 of the Internal Revenue Code¹ have had to be extremely cautious to avoid the pitfall created by Section 357(c).² Basically, 357(c) provides

1. INT. REV. CODE OF 1954, § 351.

This section provides generally:

- (a) General Rule.—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 358(c)) of the corporation.

2. INT. REV. CODE OF 1954, § 357(c).

Section 357 (Assumption of liability) provides in relevant parts:

- (a) General Rule.—Except as provided in subsections (b) and (c), if

(1) the taxpayer receives property which would be permitted to be received under section 351 . . . without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability,

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. . . .

- (b) Tax Avoidance Purpose.—

(1) In General.—If taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such a purpose, was not a bona fide business purpose, then such assumption or acquisition . . . shall, for purposes of section 351 . . . be considered as money received by the taxpayer on the exchange.

- (c) Liabilities in Excess of Basis.—

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

(A) to which section 351 applies, . . .

if the sum of the amount of the liabilities assumed, plus the amount of liabilities to which the property is subject, exceeds the total of the adjusted basis of the property trans-

that the taxpayer, when transferring property to a corporation in what would otherwise be a tax-free Section 351 exchange, must recognize income to the extent his transferred liabilities exceed the adjusted basis of his transferred assets. The Second Circuit Court of Appeals' decision in *Bongiovanni v. Commissioner*³ applied a novel interpretation of Section 357 which, to a certain extent, has worked to abolish this pitfall. "Liabilities" as referred to in Section 357 was construed not to include such liabilities as trade accounts payable. This holding, if followed, is a major victory for cash basis taxpayers in that it would remove one of the more serious obstacles to tax-free incorporation. Because the case stands alone in its reasoning, however, tax advisors should view its advantages with cautious optimism. Supreme Court review seems imminent due to the fact that *Bongiovanni* is in direct opposition to Tax Court precedents⁴ and a similar case decided by the Seventh Circuit.⁵

BONGIOVANNI

John Bongiovanni operated a masonry contracting business as a sole proprietorship. He was a cash basis taxpayer, reporting income only when collected and deducting expenses only when actually paid. In April of 1965, Bongiovanni transferred all the assets and liabilities of his sole proprietorship to the Keystone Masonry Corporation in return for all of the stock issued by the corporation which was valued at \$26,000, together with the corporation's note for \$51,253, payable on demand.⁶

The figures⁷ on page 859 reflect both the fair market value and Bongiovanni's adjusted basis in the assets transferred, as well as the liabilities assumed by the corporation.

The Commissioner determined that Section 357(c) required Bongiovanni to be taxed on the difference between his liabilities,

ferred pursuant to such an 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.

(2) Exceptions.—Paragraph (1) shall not apply to any exchange to which—

(A) subsection (b) (1) of this section applies.

3. *Bongiovanni v. Comm'r*, 470 F.2d 921 (2d Cir. 1972) *rev'g* P-H TAX CT. REP. & MEM. DEC. 71-262.

4. See Peter Raich, 46 T.C. 604 (1966); N.F. Testor, 40 T.C. 273 (1963), *aff'd*, 327 F.2d 788 (7th Cir. 1964); Arthur Kniffen, 39 T.C. 553 (1962).

5. *Testor v. Comm'r*, 327 F.2d 788 (7th Cir. 1964), *aff'g* 40 T.C. 273 (1963).

6. 470 F.2d at 922.

7. *Id.*

Item	Amount or Fair Market Value	Bongiovanni's Basis
Cash	\$ 223	\$ 223
Trade Receivables	57,741	—0—
Office equipment	1,160	1,160
Work-in-process	22,762	—0—
Raw materials	8,029	—0—
Tools and supplies	4,575	—0—
	\$94,490	\$ 1,383
Less: payables	17,237	—0—
	\$77,253	\$ 1,383

\$17,237, and the adjusted basis of his assets, \$1,383—a total difference of \$15,854.⁸ The Tax Court affirmed the Commissioner's position⁹ in a memorandum which the court of appeals stated missed the main issue.¹⁰ The Tax Court, relying on its opinion in *Peter Raich*,¹¹ concluded that the solution came squarely within the scope of Sections 351 and 357(c). The case was appealed by Bongiovanni, and he found a sympathetic forum at the Second Circuit Court of Appeals. Lacking a formal error upon which to reverse, the court merely pointed out the hardship suffered by cash basis taxpayers and reasoned that this inequity could not be allowed to stand, adverse statutory language and case law notwithstanding.

The court referred generally to the legislative history of Section 357(c) to support its premise that the use of the word "liability" in Section 357(c) was not used in the sense of trade account payable, which was a mere "accounting liability," but rather in the sense of a lien on property, i.e., a "tax liability."¹²

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 (because he is on the cash basis) but whose "liabilities" (although unpaid) are recognized for purposes of Section 357(c).¹³

Finding no justification for such harsh discrimination against cash basis taxpayers, the court refused to follow the previous cases¹⁴ and instead held that Bongiovanni had no "liabilities" in the

8. *Id.*

9. P-H TAX CT. REP. & MEM. DEC. 71-262.

10. 470 F.2d at 923.

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

12. 470 F.2d at 924.

13. *Id.*

tax sense and therefore recognized no taxable gain. The plain language of the Code was stretched by the court in order to arrive at what it considered the only just result. This is a step the Tax Court refused to take in *Peter Raich*¹⁵ although it recognized the unfairness of the literal interpretation of the Code in noting:

[W]e are not unmindful that the result reached may conflict with the well established intent of Congress to foster tax-free reorganizations.¹⁶

The Second Circuit, however, had no problem in ensuring that a "just" result occurred. Determined not to frustrate the "well established intent" of Congress, it cited the Supreme Court¹⁷ saying:

When . . . [plain] meaning has led to absurd or futile results . . . this Court has looked beyond the words to the purpose of the act. Frequently . . . even when the plain meaning did not produce absurd results but merely an unreasonable one "plainly at variance with the policy of the legislation taken as a whole" this Court has followed that purpose, rather than the literal words.¹⁸

CASH BASIS V. ACCRUAL BASIS

Section 357(c) has vastly different tax consequences for the cash basis taxpayer as opposed to an accrual basis taxpayer. Both methods of accounting are authorized by the Code,¹⁹ but once adopted, the taxpayer may not change his method without the consent of the Secretary or his delegate.²⁰ Under the cash receipts and disbursements method of accounting, income is not reported until cash or items which can be valued in terms of money are received or constructively received and similarly, expenses are not deducted for tax purposes when they are incurred, but rather when they are actually paid. Under this method, accounts receivable, not having been reported as income, have an adjusted basis of zero in the hands of the taxpayer because he has incurred no tax liability for them. Conversely, trade accounts payable are valued in full because they have not yet been deducted as an expense by the taxpayer, i.e., he has received no "tax benefit" from them. There are therefore two aspects which must be considered when dealing with receivables and payables—their actual fair market value and their adjusted basis or "tax value". Suppose

14. See notes 4 and 5, *supra*.

15. 46 T.C. 604 (1966).

16. *Id.* at 611.

17. *United States v. American Trucking Ass'ns, Inc.*, 310 U.S. 534 (1940).

18. 470 F.2d at 924 (quoting *United States v. American Trucking Ass'ns, Inc.*, 310 U.S. 534, 543 (1940) (footnote omitted).

19. INT. REV. CODE OF 1954, § 446(c).

20. *Id.* § 446(e).

A's business had accounts receivable of \$50,000, property with an adjusted basis \$10,000 and a fair market value of \$30,000, and accounts payable of \$15,000. Looking at the balance sheet from the aspect of fair market value, there are assets of \$80,000 (accounts receivable plus the fair market value of the property) and liabilities of \$15,000 or a net worth of \$65,000.

Looked at from a tax aspect, the same business has assets valued at \$10,000 (the adjusted basis of the property) and liabilities of \$15,000 for a net worth of minus \$5,000. A taxpayer who utilizes this method of accounting acquires a "basis" in his receivables equal to the amount of income recognized. As he collects the receivables, he recognizes no income unless he collects an amount in excess of his basis. Similarly, once liabilities are incurred and deducted, the taxpayer has received a "benefit" and will realize income on an exchange in which his liabilities are assumed or canceled.

Section 357(c) of the Code²¹ operates in a fair and consistent manner in the instance of the accrual basis taxpayer and seems to have been written with him in mind.²² If, pursuant to a Section 351²³ exchange an accrual basis taxpayer transfers assets which have a greater basis than the amount of liabilities assumed by the corporation, he will recognize no gain. The amount of liabilities assumed by the corporation is treated as if the corporation had paid the transferor cash in addition to the stock issued to him. The taxpayer's basis in the stock he receives is reduced by the amount of the liabilities assumed.²⁴ Thus, if the taxpayer transferred assets with a fair market value of \$40,000 and an adjusted basis of \$20,000 and liabilities of \$20,000 in return for stock with a fair market value of \$20,000, the taxpayer's basis in the stock would be zero, i.e., his basis in the property transferred less the amount of the liabilities assumed.²⁵ When the taxpayer disposes of the stock,

21. See note 2, *supra*, for this section's relevant provisions.

22. Both the House and Senate Reports dealing with Section 357(c) as well as the Regulations fail to address themselves to the peculiar problem of cash basis taxpayers. All hypotheticals given to illustrate the section's effect deal only with mortgaged property and do not touch on accounts receivable or payables. See 3 U.S. CODE CONG. & AD. NEWS 4064, 4267-69, 4908 (1954).

23. See note 1, *supra*, for the relevant provisions of Section 351.

24. INT. REV. CODE OF 1954, §§ 358(a), (d).

25. *Id.*

he will have \$20,000 which he must recognize as income. The purpose of Section 351 is accomplished by postponing the recognition of the income. The economic status quo has been maintained in that had the taxpayer been paid \$40,000 by the corporation in return for his assets, he would recognize \$20,000 on the sale and would have \$20,000 left after liquidating his liabilities. He would receive no deduction when he paid his liabilities because as an accrual basis taxpayer he had already deducted them when they were incurred. The taxpayer is free to decide whether or not to incorporate without regard to the immediate tax consequences of income recognition.

Section 357(c) becomes operative when the corporate transferee assumes more liabilities than the taxpayer's basis in the transferred assets. The taxpayer is required to recognize income on the difference between the two. Assume that the accrual taxpayer transfers assets with a fair market value of \$40,000 and an adjusted basis of \$5,000 and liabilities of \$20,000 in return for stock with a fair market value of \$20,000. Section 357(c) would require the taxpayer to recognize \$15,000 of income, the amount by which his liabilities exceeded the adjusted basis of the transferred assets. The basis of the taxpayer's stock would be the basis of the property transferred (\$5,000) less the liability assumed (\$20,000) plus the gain recognized on the transfer (\$15,000), a total of zero. The taxpayer's position is still the same as if he had sold the property for \$40,000, realizing a gain of \$35,000 over his basis. He would have \$20,000 left after liquidating his liabilities. The only difference is that he would recognize the whole \$35,000 gain at once. By transferring the assets and liabilities to the corporation subject to Section 351, he recognizes income only to the extent required by Section 357(c) (\$15,000) and postpones recognition of the remaining \$20,000 of income until he sells the stock which has a basis of zero in his hands.

A cash basis taxpayer, on the other hand, does not fit so neatly into the statutory scheme, especially when considering assets such as accounts receivable. Because the taxpayer has never recognized the receivables as income, his basis is zero. Suppose that the taxpayer transfers accounts receivable of \$70,000 with a basis of zero and accounts payable of \$15,000 for stock with a fair market value of \$55,000. Section 357(c) demands that income of \$15,000 be recognized. The taxpayer's basis in the stock received would be his basis in the assets transferred (zero) less the amount of liabilities assumed by the corporation (\$15,000) plus the gain recognized on the exchange (\$15,000), a total of zero. When he sells

the stock, he will recognize \$55,000, making a total of \$70,000 of income recognized. He has, however, lost the \$15,000 deduction he would have enjoyed had he liquidated his own liabilities. The *Bongiovanni* court points out that "[i]t is no answer to say that the taxpayer's wholly-owned corporation will eventually reap a benefit which will redound to appellant. The corporate taxpayer would be entitled to its deduction whether or not the cash basis individual taxpayer had been taxed under Section 357(c). See Treas. Reg. § 1.146-1(a)(2)."²⁶ It is not clear why the court makes this statement. It seems more likely that the corporate transferee would not receive a deduction, either when assuming the liabilities or when paying them, because such expenditures are not to be considered expenses incurred in the production of income.²⁷

Section 357

The *Bongiovanni* court, dealing with facts similar to the previous example, states that "Congress certainly could not have intended such an inequitable result, especially in light of its expressed purposes in enacting Sections 351 and 357(c)."²⁸ The legislative history of Section 357(c) is not enlightening however. Section (b)²⁹ was apparently added to prevent a transferor from mortgaging property just prior to transfer and then having the transferee accept the property and assume the mortgage.³⁰ This would, in effect, give the taxpayer boot in the form of cash which he would not have to recognize under Section 351. Sub-section (c) is aimed at covering all situations where it does not appear the taxpayer's purpose was tax avoidance, but nevertheless, the transferee assumed more liabilities than the transferor's adjusted basis in the transferred assets. The House Report says:

[I]f . . . the liabilities assumed, or the liabilities to which the property is subject, exceed the total of the adjusted basis of the property transferred . . ., such excess shall be considered as gain from the sale or exchange of a capital asset. Thus, if an individual transfers, under section 351, property having a basis in his hands of \$20,000 but subject to a mortgage of \$50,000, to a corporation con-

26. 470 F.2d at 925.

27. INT. REV. CODE OF 1954, § 162.

28. 470 F.2d at 925.

29. See note 2, *supra*, for relevant provisions of this subsection.

30. See Burke & Chisholm, *Section 357, A Hidden Trap in Tax-Free Incorporations*, 25 TAX L. REV. 211 (1970).

trolled by him, such individual will be subject to tax at rates applicable to the sale of capital assets with respect to \$30,000, the excess of the amount of the liability over the adjusted basis of the property in the hands of the transferor.³¹

The Senate Report is much the same³² as the House Report and used the same hypothetical situation involving a mortgage to illustrate the Section's impact. Neither makes a distinction between cash and accrual basis transferors, nor do the Regulations.³³

At this point, a look at the development of the law which culminated in the enactment of Section 357 may aid in framing the problem. Prior to the 1939 Code,³⁴ the Commissioner took the position that assumption of liabilities by a corporate transferor was to be treated as if the transferee had received cash from the transferor in the amount of the liabilities assumed. This was to be taxable income to the transferor. The Commissioner's position was confirmed by the Supreme Court in 1938 in *United States v. Hendler*³⁵ which held that the Hendler Co. must recognize \$534,297.40, the amount of its debt assumed by the Borden Co., in an otherwise tax-free transaction.

The transaction . . . is to be regarded as though \$534,297.40 had been paid directly to the Hendler Company. Its gain was as real and substantial as if the money had been paid it and then paid over by it to its creditors. The discharge of liability by the payment of Hendler Company's indebtedness constituted income to the Hendler Company and is to be treated as such.³⁶

This holding, in effect, brought the Hendler Co. within the provisions of Section 112 of the 1928 Code³⁷ which provided for recognition of income when "other property" or boot was received in addition to stock in the transferee corporation.

This was the first time that this interpretation was upheld and the Commissioner's victory proved to be a hollow one. If income was to be recognized by the transferor on such exchanges, then the transferee's basis in the property received would be increased by the amount of income so recognized. The Commissioner was faced with a tremendous loss of revenue if all former transferees in such exchanges could successfully claim a stepped up basis on the premise that the transferors *should* have recognized income when their liabilities were assumed.³⁸

31. 3 U.S. CODE CONG. & AD. NEWS 4267 (1954).

32. *Id.* at 4908.

33. Treas. Reg. § 1.337-2 (1960).

34. INT. REV. CODE OF 1939.

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

36. *Id.* at 566.

37. INT. REV. CODE OF 1928, § 112.

38. See Burke & Chisholm, *supra* note 30, at 213.

Because the *Hendler* decision seriously hampered tax-free transactions, Congress overruled it by Section 112(k) of the 1939 Code.³⁹ Section 112(k), the forerunner of Section 357 of the 1954 Code,⁴⁰ provided that liabilities assumed by a corporation were not boot unless it appeared that the transferor had a tax avoidance motive or that there was no legitimate business purpose for the assumption of the liability.

In addition to incorporating Section 112(k) into the 1954 Code in the form of Section 357(a) and (b), Congress saw fit to add Section 357(c) as well. This appears to be a significant point which the Second Circuit overlooked in *Bongiovanni*. If, as the Court implied, Congress' apparent purpose in enacting Section 357(c) was to prevent tax avoidance,⁴¹ then Section 357(b) and (c) are synonymous. It is more reasonable to assume that Congress was not deliberately enacting a redundancy and that they intended subsection (c) to mean what it said. If tax avoidance is the motive for the transaction, 357(b) applies; if not, then 357(c) is applicable.⁴²

Section 357(c) was tested in the courts and given a literal interpretation.⁴³ The only appellate level court to deal with its effect on cash basis taxpayers, prior to *Bongiovanni*, was the Seventh Circuit in the case of *Testor v. Commissioner*.⁴⁴ The section was literally interpreted in that case as well and the petitioner was forced to recognize income. *Testor* may be distinguished from *Bongiovanni* in that the taxpayer's liabilities exceeded not only the adjusted basis of his assets, but also their fair market value which equalled their basis. The case remains strong authority for the Commissioner's position, however.

A later Tax Court case, *Peter Raich*,⁴⁵ is factually identical to

39. INT. REV. CODE OF 1939, § 112(k).

40. INT. REV. CODE OF 1954, § 357; see note 2, *supra*.

41. 470 F.2d at 924. The court says, "[A]pparently the purpose of that section (357(c)) was to prevent a taxpayer's acquiring a permanently tax-free gain by mortgaging certain of his property for an amount in excess of basis and then transferring property and mortgage under Section 351. In the present situation there is no such tax avoidance purpose . . ."

42. See INT. REV. CODE OF 1954, § 357(c)(2)(a); *Section 357, A Hidden Trap In Tax-Free Incorporations*, *supra* note 30.

43. See *Peter Raich*, 46 T.C. 604 (1966); *N.F. Testor*, 40 T.C. 273 (1963), *aff'd*, 327 F.2d 788 (7th Cir. 1964); *Arthur Kniffen*, 39 T.C. 553 (1962).

44. *Testor v. Comm'r*, 327 F.2d 788 (7th Cir. 1964).

45. *Peter Raich*, 46 T.C. 604 (1966).

the *Bongiovanni* case and once again the Commissioner prevailed although the court expressed its own reservations about the fairness of the results.⁴⁶

The taxpayer in *Raich* argued first that Congress intended Section 357(c) to operate only when liabilities exceeded both the adjusted basis of the assets, as well as their fair market value. The Court had little trouble rejecting this argument which had little support.⁴⁷ Secondly, the taxpayer argued that for purposes of Section 357(c), accounts receivable should have a basis at least equal to liabilities transferred.⁴⁸ Perhaps this would solve the inequities toward the cash basis taxpayer, but once again the taxpayer had no support for his position.

In finding for the Commissioner, the court in *Raich* refused to disturb the "obvious meaning" of 357(c) and held that Section to be both clear and unambiguous.⁴⁹

The Service was quick to adopt *Raich* as its guideline. It issued a Revenue Ruling⁵⁰ stating that that holding would be applied to situations involving similar facts "inasmuch as such section *literally* applies and the legislative history *clearly* supports the application of that section under such circumstances."⁵¹

The results of *Raich* have been criticized on the grounds that it was incongruous "for the court to value receivables at zero and payables at face. Either both might be valued at market or both might be valued at zero, but to combine the two results makes neither tax nor accounting good sense."⁵² While it may or may not have been incongruous for the court to use this "double standard" in *Raich*, there was no concrete basis on which to justify a different result. The Code and the cases left the court no avenue of escape.

One commentator, in criticizing the result of *Raich*, but nevertheless agreeing that the court had no choice, states:

Analysis of the statute will not yield a different result without substantial twisting of the statutory language, and it seems unlikely therefore that a court will be persuaded to upset the I.R.S.'s present position. Obviously, where cash basis taxpayers are concerned, payables should be handled with great care.⁵³

46. See text accompanying note 16, *supra*.

47. 46 T.C. at 611.

48. *Id.* at 608-09.

49. *Id.* at 611.

50. Rev. Rul. 69-442, 1969 CUM. BULL. 53.

51. *Id.*

52. Note, *Section 357(c) And The Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154, 1166 (1967).

53. White, *Sleepers That Travel with Section 351 Transfers*, 56 VA. L. REV. 37, 42 (1970).

Another suggests that in the absence of corrective legislation, *Raich* could have avoided his problem by retaining sufficient receivables to liquidate his liabilities, transferring only his net assets (based on book value) to the corporation.⁵⁴

Various attempts at circumventing the results of Section 357(c) have failed⁵⁵ and the *Raich* case had appeared to close the lid on the controversy until *Bongiovanni* was decided.

ECONOMIC REALITIES?

The decision of the Circuit Court in *Bongiovanni* can be characterized as one in which the court chose to look at the economic realities of the facts rather than limiting itself to the narrow view required by the Code. This willingness to elevate substance over form may have been influenced in part by the Supreme Court ruling in *Nash v. United States*⁵⁶ in which the Court followed much the same route in settling a split of the Circuit Courts over the problem of whether to recognize income on the Section 351 transfer of accounts receivable by a taxpayer using a reserve method of accounting. Such an accounting method recognizes that a portion of the receivables will be non-collectible and the taxpayer is allowed a present deduction for that portion of the receivables which are reasonably predicted to be non-collectible, rather than forcing him to wait until they become bad debts.⁵⁷

In 1967 the Commissioner revealed that when a taxpayer who had a cash reserve for bad debt transferred his accounts receivable, he "recovered" his bad debt reserve, and because he had already received a tax benefit by deducting the reserve, he must now recognize it as income.⁵⁸

The Revenue Ruling was criticized⁵⁹ but the Tax Court relied on

54. See Burke & Chisholm, *supra* note 30, at 230.

55. See Velma W. Alderman, 55 T.C. 662 (1971). (Taxpayer who transferred liabilities in excess of assets gave promissory note in amount of difference. Basis of note held to be zero, therefore difference remained.); Rev. Rul. 68-692, 1968-2 Cum. Bull. 154; John Bongiovanni, P-H Tax Ct. Mem. 1971-262. (Taxpayer who attempted to switch from cash basis to accrual basis prior to transfer was denied approval).

56. *Nash v. United States*, 398 U.S. 1 (1970) *rev'g* 414 F.2d 627 (5th Cir. 1969).

57. INT. REV. CODE OF 1954, §§ 166(a), (c).

58. Rev. Rul. 62-128, 1962-2 CUM. BULL. 139.

59. See Arent, *Reallocation of Income and Expenses in Connection with*

it to decide *Estate of Schmidt*.⁶⁰ On appeal to the Ninth Circuit, this decision was reversed⁶¹ as the court chose to look at "economic realities."

Before the transfer of the business, the taxpayer owned all of its assets and was obligated to pay all of its liabilities. He was permitted to estimate in advance and charge against income accrued the losses that would be sustained in collecting the accounts receivable instead of waiting until an actual loss was incurred and charging it off as a bad debt. It is conceded that the reserve was reasonable. This means in economic terms that the value of the accounts receivable was not their face amount, but that amount less the reserve.⁶²

The Commissioner's argument that because the taxpayer received stock of less than the face value of the receivables he incurred a loss (in the amount of the reserve), but that this loss was not recognized under Section 351, failed to sway the court which said, "We are not impressed. We think . . . no income is received unless the consideration received exceeds the net amount of the receivables."⁶³

The Tax Court, however, chose not to follow the Ninth Circuit's view in deciding cases in other circuits.⁶⁴ When the Fifth Circuit upheld the Commissioner⁶⁵ and rejected the Ninth Circuit's reasoning in *Estate of Schmidt*, the controversy went to the Supreme Court.

The Supreme Court reversed the Fifth Circuit's decision in *Nash*⁶⁶ and followed the Ninth Circuit's reasoning as its own. The Court took a practical look at the nature of a reserve for bad debt.

As stated in *Geyer, Cornell, Newell, Inc. v. Comm'r*, 6 T.C. 96, 100:
"A reserve consists of entries upon books of account. It is neither

Formation and Liquidation of Corporations, 40 TAXES 995, 998 (1962).

The net effect of the ruling is to shift the deduction representing the risk of noncollection from the transferor to the corporation, even though it is the transferor who pays the tax on the accrued income. The corporation can collect the accounts tax free since it acquired a substituted basis in the accounts equal to their face amount. Thus, Rev. Rul. 62-128 results in allocating to one entity an item of income and to another entity a direct expense of earning that income—a distortion of net income contrary to the purpose of the reserve method of accounting for bad debts. (footnote omitted).

60. *Estate of Schmidt*, 42 T.C. 1130 (1964) *rev'd*, 355 F.2d 111 (9th Cir. 1966).

61. 355 F.2d 111 (9th Cir. 1966).

62. *Id.* at 113.

63. *Id.* at 114.

64. See *Max Schuster*, 50 T.C. 99 (1968).

65. *Nash v. United States*, 41 F.2d 627 (5th Cir. 1969) *rev'g* *Birmingham Trust Nat'l Bank v. United States*, 22 Am. Fed. Tax. R.2d 5202 (N.D. Ala. 1968).

66. 398 U.S. 1 (1970), *rev'g* 414 F.2d 627 (5th Cir. 1969).

an asset nor a liability. It has no existence except upon the books, and, unlike an asset or a liability, it cannot be transferred to any other entity."⁶⁷

It decided that "[d]eduction of the reserve from the face amount of the receivables transferred conforms to the reality of the transaction as the risk of non-collection was on the transferee."⁶⁸

CONCLUSION

The Second Circuit in *Bongiovanni* chose, as did the Supreme Court in *Nash*, to look at the economic realities to arrive at a "just" result. In so doing, it may have overstepped its authority in attempting to alleviate an inequity which is imposed by a statute which, until now, has been consistently upheld by the courts. Because the Commissioner has taken a firm position on the issue, the only solution seems to lie in a legislative change to Section 357(c) with regard to cash basis taxpayers. Congress might permit, for purposes of that section only, accounts receivable to be valued at their face.⁶⁹ Another solution which has been suggested is that cash basis taxpayers be required to accrue payables and receivables upon transfer to a corporation.⁷⁰ This proposal would correct the result of *Raich* in cases where payables exceed receivables, but would force the cash basis taxpayer to recognize income if the reverse were true—a result contra to the purpose of Section 351.

A plausible solution that might alleviate the inequity and be simply applied is to consider the payables of a cash basis taxpayer *only* in instances where 1) the taxpayer has increased his basis in an asset by incurring the payables, or 2) the taxpayer has received cash, *e.g.*, by mortgaging his property, or 3) the taxpayer has received a tax benefit from the payables, *i.e.*, a deduction. This test is the same one that would be applied in determining whether the cancellation of debt has produced income.

Whatever course is followed, it is clear that the present Section 357(c) is discriminatory and defeats the purpose of Section 351 for certain cash basis taxpayers. Until such time as Congress acts,

67. *Id.* at 4, n.4.

68. *Id.* at 4.

69. See Note, *supra* note 52, at 1166.

70. See Burke & Chisholm, *supra* note 30.

however, the problem will continue to exist. It is unlikely that the Commissioner will acquiesce in *Bongiovanni* or that he will follow its holding in the future. Nor is it likely that the Supreme Court will be able to find a legal foundation for sustaining the "judicial legislation" enunciated by the *Bongiovanni* decision.

R. DENNIS LUDERER