

Catholic University Law Review

Volume 24
Issue 2 *Winter 1975*

Article 4

1975

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Recommended Citation

Thomas A. Roha, *The Application of Section 357(c) of the Internal Revenue Code to a Section 351 Transfer of Accounts Receivable and Payable*, 24 Cath. U. L. Rev. 243 (1975).

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COMMENTARY

THE APPLICATION OF SECTION 357(c) OF THE INTERNAL REVENUE CODE TO A SECTION 351 TRANSFER OF ACCOUNTS RECEIVABLE AND PAYABLE

*Thomas Arden Roha**

In a typical incorporation of a going business, all assets and liabilities of that business are transferred to a newly formed corporation in exchange for all of that corporation's capital stock. Section 351 of the Internal Revenue Code provides that no gain or loss shall be recognized on this transaction where only stock or securities are received by the transferors and where immediately after the exchange the transferors are in control of the transferee corporation.¹ Section 357(c), however, spells out an exception to the tax-free nature of this exchange where the sum of the liabilities assumed by the corporation exceeds the total adjusted basis of the property transferred.² This excess, under the exception, must be considered gain to the transferor from the sale or exchange of a capital asset or property which is not a capital asset, whichever the case may be.

Oftentimes in an incorporation, the going business will simply transfer to the corporation its entire operation, including all accounts receivable and

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1. INT. REV. CODE OF 1954, § 351 reads in pertinent part:

(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 368(c)) of the corporation. . . .

INT. REV. CODE OF 1954, § 368(c) defines "control" to mean the ownership of stock possessing at least eighty per cent of the total combined voting power of all classes of voting stock and eighty per cent of all other classes of stock of the corporation.

2. INT. REV. CODE OF 1954, § 357(c), reads in pertinent part:

(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 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. . . .

payable. Situations commonly exist, especially with service-oriented businesses, where accounts receivable constitute the major portion of the business' assets. Where the business is on the cash basis of accounting,³ the accounts receivable will have a zero basis and the accounts payable will be valued at their face amount on the transfer.⁴ This gives rise to the possibility that the tax value of the accounts payable and other liabilities assumed by the corporation will exceed the basis of the assets transferred and that section 357(c) will apply, taxing the transferor on the difference. The circuit courts disagree over whether accounts payable are the type of liabilities to which section 357(c) should apply. In *Testor v. Commissioner*,⁵ the Seventh Circuit held that section 357(c) does apply and that the cash basis transferor is taxable on the excess of the liabilities assumed over the basis of the property transferred.⁶ In *Bongiovanni v. Commissioner*,⁷ the Second Circuit held that because its application would precipitate results which Congress could not have intended, section 357(c) does not apply. The Tax Court has consistently followed the *Testor* approach and applied section 357(c) to such transfers.⁸

This article will review section 357(c), its background, legislative history, and judicial interpretations, in an effort to fully analyze this conflict and other related problems caused by the section and to determine if a legislative solution to these problems is appropriate.

I. BACKGROUND AND LEGISLATIVE HISTORY

Subsection (c) was added to section 357 by the Internal Revenue Code of 1954. The legislative history behind the 1954 amendment, surprisingly,

3. Under the cash method of accounting, receipts and income items are reported for tax purposes in the year received and deductions and credits are reported in the year paid. The cash method of accounting is contrasted with the accrual method, under which income items and deductions are reportable when the right of receipt or obligation to pay arises. The cash method of accounting is used by most individuals and many small businesses. See J. CHOMMIE, *FEDERAL INCOME TAXATION* § 73 (1st ed. 1968).

4. See *P.A. Birren & Sons v. Commissioner*, 116 F.2d 718 (7th Cir. 1940); Paul H. Travis, 47 T.C. 502 (1967); Peter Raich, 46 T.C. 604 (1966); *Ezo Prods. Co.*, 37 T.C. 385 (1961).

5. 327 F.2d 788 (7th Cir. 1964).

6. Although *Testor* involved unsecured liabilities generally and not accounts payable specifically, its reasoning would apply to all types of unsecured liabilities, including accounts payable.

7. 470 F.2d 921 (2d Cir. 1972), noted in 35 U. PITT. L. REV. 158 (1973) and 26 VAND. L. REV. 887 (1973).

8. See, e.g., Wilford E. Thatcher, 61 T.C. 28 (1973); John P. Bongiovanni, 30 CCH Tax Ct. Mem. 1124 (1971), *rev'd*, 470 F.2d 921 (2d Cir. 1972); Peter Raich, 46 T.C. 604 (1966).

gives no indication of Congress' purpose in adding it.⁹ Some evidence of congressional intent can be derived, however, by analyzing problems which arose under prior law to which the section was directed.

Before the enactment of the Revenue Act of 1921,¹⁰ if a proprietorship or partnership transferred assets to a corporation and received stock in exchange, a tax was levied to the extent that the fair market value of the stock received exceeded the basis in the assets transferred.¹¹ Recognizing that this tax seriously impeded necessary incorporations,¹² Congress provided in section 202 of the Revenue Act of 1921 that no gain or loss would be recognized by the transferor when he conveyed assets to the corporation, so long as he was in control of the corporation after the transfer.¹³

Section 202 was reenacted without major modification in section 112(b)(5) of the 1939 Code.¹⁴ Added, however, was subsection (c)(1), which required that if the transferor received from the corporation "property or money" other than stock or securities in the corporation, the gain would be recognized to the extent of the fair market value of that "other property or

9. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. A129 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 270 (1954).

10. Ch. 136, 42 Stat. 227.

11. See Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1060, which reads in pertinent part:

When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange

12. "Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business readjustments." S. REP. NO. 275, 67th Cong., 1st Sess. 11 (1921).

13. Revenue Act of 1921, ch. 136, § 202, 42 Stat. 230 reads in pertinent part:

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

. . . .

(3) When . . . a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation

14. Revenue Act of 1939, ch. 1, § 112(b)(5), 53 Stat. 37, reads in pertinent part: No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation

money.”¹⁵ Left unanswered was whether a debt of the transferor assumed by the corporation constituted “other property or money.” The Supreme Court, in *United States v. Hendler*,¹⁶ answered in the affirmative. Because in a typical incorporation the transferor does not liquidate the liabilities, but instead transfers them to the corporation unpaid, Congress feared that *Hendler* could deter necessary incorporations and thus defeat the purpose of section 112(b)(5).¹⁷ Congress, therefore, added section 112(k) to the Code, which provided that the assumption of a liability by the corporation was not “other property or money” unless it appeared either that the transferor’s purpose in having the corporation assume the debt was tax avoidance or that the transaction was not a bona fide business deal.¹⁸ Section 112(k) was subsequently reenacted without major change as sections 357(a) and (b) of the 1954 Code. Without explanation, however, Congress added section 357(c) to the 1954 Code. The section provides that if the sum of the liabilities assumed by the corporation plus the sum of the liabilities to which the transferred assets are subject exceed the total adjusted basis of the assets transferred, then the transferor shall be taxed on the difference.¹⁹

The situation most frequently presented in cases involving the assumption of liabilities is the transfer of mortgaged property. How to handle the situation when the mortgage exceeded the basis caused courts much difficulty prior to the enactment of section 357(c). In *Parker v. Delaney*,²⁰ decided in 1950, Judge Magruder, in a concurring opinion, suggested an approach

15. Revenue Act of 1939, ch. 1, § 112(c)(1), 53 Stat. 39.

16. 303 U.S. 564 (1938). Although *Hendler* arose under the Revenue Act of 1928, the pertinent provisions of that Act were unchanged in the Revenue Act of 1939.

17. This congressional fear was reflected in the House Report:

In a typical transaction changing the form or entirety of a business it is not customary to liquidate the liabilities of the business and such liabilities are almost invariably assumed by the corporation which continues the business. Your committee therefore believes that such a broad interpretation as is indicated above [in *Hendler*] will largely nullify the provisions of existing law which postpone the recognition of gain in such cases

H.R. REP. NO. 855, 76th Cong., 1st Sess. 19 (1939).

18. Revenue Act of 1939, ch. 1, § 112(k), 53 Stat. 870, reads in pertinent part:

Where . . . as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as ‘other property or money’ received by the taxpayer within the meaning of subsection (c) . . . except that if . . . it appears that the principal purpose of the taxpayer . . . was a purpose to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose, such assumption or acquisition (in the amount of the liability) shall . . . be considered as money received by the taxpayer upon the exchange. . . .

19. See note 2 *supra*.

20. 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951).

that has come to be known as the "negative basis doctrine." Judge Magruder argued that the mortgage should not be taken into consideration in determining the basis; when depreciation deductions, determined with the mortgage included, are deducted from the basis to arrive at the adjusted basis, a negative basis will result. Where someone takes the property solely for an assumption of the mortgage, the transferor has a zero amount realized. His gain on the transfer would be the difference between his negative basis and his zero amount realized.²¹

A problem similar to that in *Parker* was presented in *Woodsam Associates, Inc. v. Commissioner*.²² In *Woodsam*, a corporate stockholder mortgaged property with a \$270,000 adjusted basis for \$400,000 and transferred the property to his corporation. The corporation argued that the stockholder-transferor realized \$130,000 of gain on the transfer and that its basis in the property for purposes of depreciation was, therefore, \$400,000. The Second Circuit held, however, that the stockholder never sold or otherwise disposed of the property and therefore never realized any gain. The basis thus remained \$270,000.²³ Under the court's holding, it would be possible for the stockholder to avoid the recognition of gain altogether by mortgaging property for more than its basis and then transferring the property to a controlled corporation. Because the stock received by the stockholder would have a basis equal to the basis in the assets transferred,²⁴ complete tax avoidance would be accomplished if the stockholder were not to dispose of the stock during his life, allowing his successors-in-interest to take the stock at a basis equal to its fair market value. The corporation, which took the property with the same basis it had in the hands of the transferor, might never recognize gain on the difference between its basis and the property's fair market value if it were never to sell the property or if the property subsequently decreased in value.²⁵

Although section 357(b) was effective in taxing a transaction made primarily for the purpose of tax avoidance,²⁶ where a non-tax avoidance pri-

21. See Comment, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154, 1158 (1967), for a more detailed analysis of Judge Magruder's negative basis concept.

22. 198 F.2d 357 (2d Cir. 1952).

23. *Id.* at 359.

24. See INT. REV. CODE OF 1954, § 358.

25. See Jack L. Easson, 33 T.C. 963 (1960), for a discussion of the tax avoidance aspects.

26. INT. REV. CODE OF 1954, § 357(b) reads in pertinent part:

If . . . it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition . . .

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

(B) if not such purpose, was not a bona fide business purpose, then such assumption or acquisition (in the total amount of the liability assumed or ac-

mary purpose existed, section 357(b) could not apply. It appears that Congress intended section 357(c) to reach this gap left in section 357(b) and, at the same time, assure that there would be no possibility for a complicated negative basis concept. No pre-1954 cases have been found that deal with situations where non-mortgage liabilities such as accounts payable exceeded the basis of the assets transferred. In the House and Senate Reports that accompanied section 357(c), and in the present Regulations, all of the examples deal with property mortgaged in excess of basis.²⁷ No mention is made of unsecured liabilities exceeding basis.

Despite the fact that Congress apparently directed section 357(c) at a transfer of property mortgaged in excess of basis, the section was drafted to cover both secured and unsecured liabilities. An unexplained Senate amendment to the House version of section 357(c) raises at least some doubt about this, however. As the 1954 Code passed the House of Representatives, the section provided that if "the liabilities assumed or the liabilities to which the property is subject, exceed the total of the adjusted basis of the property transferred pursuant to such exchange, such excess shall be considered as gain from the sale or exchange of a capital asset."²⁸ Clearly the House version included unsecured liabilities. When the bill reached the Senate, however, the words "the liabilities assumed, or the liabilities to which the property is subject" were struck and the phrase "the sum of the amount of the liabilities assumed plus the amount of the liabilities to which the property is subject" was substituted.²⁹ No mention of this change was made in the Senate Report. The House-Senate Conference adopted the Senate language, but, again, the Conference Report gives no indication of the reason for the change.³⁰ Although a reasonable explanation would be that the conferees felt that the Senate language was clearer than the House provision, an argument, albeit unsuccessful, has been advanced that the Senate, by specifying "sum" of the secured and unsecured liabilities, required that both be present in order for section 357(c) to apply to a transaction.³¹

Assuming that Congress intentionally broadened section 357(c) to include an assumption of unsecured as well as secured liabilities, it is likely that it did so because it saw that the same possibilities for a negative basis and for

quired pursuant to such exchange) shall . . . be considered as money received by the taxpayer on the exchange.

27. H.R. REP. No. 1337, 83d Cong., 2d Sess. A129 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 270 (1954); Treas. Reg. §§ 1.357-1, 1.357-2 (1961).

28. U.S. CODE CONG. & ADMIN. NEWS 4267 (1954).

29. See *id.* at 4908.

30. See *id.* at 5280-5348.

31. See *Testor v. Commissioner*, 327 F.2d 788 (7th Cir. 1964), discussed pp. 248-50 *infra*.

tax avoidance existed for both.³² The legislative history and background to section 357(c) is so limited, however, that an analysis of the section results in little more than speculation as to the scope Congress intended for the section.

II. CASES APPLYING SECTION 357(C) TO A TRANSFER OF THE ACCOUNTS PAYABLE AND RECEIVABLE OF A CASH BASIS TAXPAYER

The first case to deal with a section 351 transfer of assets and unsecured liabilities where the unsecured liabilities exceeded the basis of the property transferred was *N.F. Testor*,³³ decided in 1963. In this case, Testor was the sole proprietor of a chemical business who filed his income tax on the cash basis. On the incorporation of the business the Commissioner argued that Testor must recognize \$193,447.28 gain under section 357(c) due to the fact that the liabilities (all unsecured) assumed by the corporation exceeded Testor's basis in the assets transferred by that amount. Testor argued that the Senate must have intended its amendment to the House version to have a different meaning than the language it was replacing, and that section 357(c), literally read, applies only "if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject" exceed the basis of the assets transferred. Testor noted that there was no "sum" in his case because there were no secured liabilities, and therefore, he argued, the section simply did not apply. The Tax Court held that sec-

32. Section 358(a) states that the basis of the taxpayer's stock in the corporation shall be the same as his basis in the property transferred, decreased, *inter alia*, by "the amount of any money received by the taxpayer . . ." and increased by "the amount of gain to the taxpayer which was recognized on such exchange . . ." Section 358(b) states that an assumption of liability by the corporation shall "be treated as money received by the taxpayer on the exchange." Where liabilities exceed basis, without § 357(c), it is clear that the taxpayer's basis in his stock would come out to a negative number. This is avoided by § 357(c)'s requirement that gain be recognized to the extent that liabilities assumed exceed basis, which will require that the taxpayer's basis in his stock be at least zero. For example, if a taxpayer transfers property with a basis of \$50,000 and liabilities totaling \$100,000 to a controlled corporation under section 351, his basis in his stock will be calculated as follows:

\$ 50,000	§ 358(a)(1)—"same as that of property exchanged."
—100,000	§ 358(a)(1)(A)(ii)—"the amount of money received" with § 358(d) requiring that the assumption of liability be treated as money received.
50,000	§ 358(a)(1)(B)(ii)—"the amount of gain . . . recognized" with § 357(c) requiring the recognition of \$50,000 gain.

—0—

taxpayer's basis in his stock.

33. 40 T.C. 273 (1963), *aff'd*, 327 F.2d 788 (7th Cir. 1964).

tion 357(c) applied even if there were only secured or only unsecured liabilities transferred. Despite the fact that the language of section 357(c) came from a Senate amendment to the Act,³⁴ the court supported its argument by noting that the House Report was phrased in the disjunctive rather than the conjunctive.

The Tax Court's opinion was affirmed by the Seventh Circuit in *Testor v. Commissioner*.³⁵ Adopting the Tax Court's reasoning, the court of appeals noted:

We cannot agree that § 357(c) should be given such a restrictive interpretation. Neither the language used in the section nor its legislative history supports petitioner's contention. We hold that both the language and the legislative history indicate that § 357(c) is meant to apply wherever liabilities are assumed or property is transferred subject to liability.³⁶

The next case dealing with the assumption of unsecured liabilities, and the first case to deal specifically with accounts payable, was *Peter Raich*.³⁷ Raich operated a sheetrock and drywall contracting business as a sole proprietorship. For accounting and tax purposes Raich operated the business on a cash basis. In early 1961 he incorporated his business under the tax free provisions of section 351, transferring to the new corporation all of the assets and liabilities of his business. The assets received by the corporation totaled \$88,613.39, of which \$77,361.66 were accounts receivable. The liabilities assumed by the corporation amounted to \$45,992.81, of which \$8,273.03 were notes payable and \$37,716.78 were accounts payable. The Commissioner argued that a section 357(c) computation was required because the liabilities assumed by the corporation, \$45,992.81, exceeded the adjusted basis of the property transferred to it, \$11,251.73, by \$34,741.08, accounts receivable having a zero basis to a cash basis taxpayer.

Raich countered with two alternative arguments. First, he argued that Congress intended section 357(c) to apply only if the liabilities assumed by the corporation exceeded not only the adjusted basis of the property transferred, but also its book value. Second, Raich argued that the accounts receivable had a basis, for purposes of section 357(c) only, at least equal to the amount of accounts payable also transferred. The Tax Court rejected both of Raich's arguments and held for the Commissioner. Judge Withey's opinion for the court noted that the literal wording of the section compelled

34. See p. 248 & notes 28-31 *supra*.

35. 327 F.2d 788 (7th Cir. 1964).

36. *Id.* at 790. The court found convincing the argument presented by the Commissioner to the effect that "[a]ny other holding would render the statute a dead letter and would open the door to tax evasion." *Id.* Where the principle purpose of the assumption is tax avoidance, however, § 357(b) would apply.

37. 46 T.C. 604 (1966).

its application to this transaction. The judge stated that if Congress had intended that section 357(c) not apply to this situation, it could have so provided. Judge Withey noted in conclusion:

In applying section 357(c) to the facts herein, we are not unmindful that the result reached may conflict with the well established intent of Congress to foster tax-free business reorganizations. However, in the absence of a clearly expressed congressional intent, we decline to adopt a construction of section 357(c) which is supported neither by its language nor its legislative history.³⁸

The next case involving a similar factual situation was *John B. Bongiovanni*,³⁹ decided by memorandum opinion in 1971. Bongiovanni incorporated his masonry business under section 351. On the incorporation Bongiovanni transferred assets including cash, accounts receivable, office equipment, work in progress, raw materials, and tools and supplies with a fair market value of \$94,490 but a basis of only \$1,383. He also transferred to the corporation accounts payable of \$17,237. The Commissioner argued that because the liabilities assumed by the corporation, \$17,237, exceeded the basis of the property transferred, \$1,383, by \$15,854, that amount constituted taxable gain under section 357(c).

The Tax Court, in an opinion by Judge Quealy, found the case indistinguishable from *Peter Raich*. On appeal to the Second Circuit, the Tax Court was reversed.⁴⁰ Convinced that this was not the type of situation to which section 357(c) was intended to apply, the Second Circuit refused to hold the taxpayer liable. Acknowledging that a literal reading of the section would dictate a contrary result,⁴¹ the court stated:

[W]e believe that the word "liability" is used in Section 357(c) in the same sense as the word "liability" referred to in the legislative history of Section 357(c). It was not meant to be synonymous with the strictly accounting liability 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.⁴²

In the court's opinion "[a]ny other construction results in an absurdity"⁴³

The *Bongiovanni* court acknowledged that both a literal reading of the sec-

38. *Id.* at 611.

39. 30 CCH Tax Ct. Mem. 1124 (1971), *rev'd*, 470 F.2d 921 (2d Cir. 1972).

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

41. *Id.* at 923.

42. *Id.* at 923-24.

43. *Id.*

tion and all previous case law supported a contrary result. Nevertheless, it "believe[d] that at least on the facts in this case, a too literal reading of the the words of the statute produces an inequitable result which cannot be allowed to stand."⁴⁴

The court further noted that this situation had become a trap for the unwary; by changing to the accrual method of accounting, the wary taxpayer could avoid the tax.⁴⁵

There is no justification for making an accounting method inadvertently chosen by the taxpayer determinative of the tax benefits and disadvantages of that taxpayer. . . . The application of a combination of Section 351 and 357(c) to trap an individual merely because he is a cash basis taxpayer rather than an accrual basis taxpayer is unacceptable.⁴⁶

As the court indicated,⁴⁷ Bongiovanni was actually disadvantaged twice under the Commissioner's interpretation. First, he must recognize gain on the transfer, and, second, he is denied a deduction for his uncollected liabilities.

The last case to be decided in this area is *Wilford E. Thatcher*,⁴⁸ where the Tax Court, rejecting *Bongiovanni*, reaffirmed its earlier decision in *Peter Raich*.⁴⁹ In *Thatcher*, the taxpayer incorporated his contracting business, transferring all of its assets and liabilities to his controlled corporation under section 351. The assets transferred had a basis of \$325,892.33, including accounts receivable of \$317,146.96 which had a zero basis. The corporation assumed notes and mortgages payable of \$264,194.52 and accounts payable of \$164,065.54. The Commissioner argued that the total amount of liabilities, including accounts payable, assumed by the corporation, \$428,260.06, exceeded the basis of the assets transferred, \$325,892.33, by \$102,367.73,

44. *Id.* In support of its decision not to apply the literal language of section 357(c), the court quoted the following language from *United States v. American Trucking Ass'ns, Inc.*, 310 U.S. 534, 543 (1940) (footnotes omitted):

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 as a whole" this Court has followed that purpose, rather than the literal words.

45. 470 F.2d at 924. See Rev. Rul. 69-422, 1969-2 CUM. BULL. 53: "[T]he trade accounts receivable would not have a zero basis if the taxpayer had been on the accrual method of accounting prior to the transfer of the business under section 351 of the Code."

46. 470 F.2d at 924.

47. *Id.* at 925. But see *Wilford E. Thatcher*, 61 T.C. 28, 42 (1973) (Hall, J., dissenting), discussed pp. 252-55 *infra*.

48. 61 T.C. 28 (1973).

49. See pp. 250-51 *supra*.

creating that amount of section 357(c) recognizable gain.⁵⁰

The Tax Court, in an opinion written by Judge Simpson, held for the Commissioner. The court acknowledged the Second Circuit's decision in *Bongiovanni*,⁵¹ but said that

Bongiovanni cannot be reconciled with the language of section 357(c). . . . If the term "liabilities" was limited to liens, there would be no need to refer, in section 357(c), to liabilities which are assumed as separate from those to which the transferred property is subject.⁵²

The court examined the legislative history and concluded that there was no "reason to believe that section 357(c) was intended never to apply to a transfer of accounts payable."⁵³ The court admitted that its decision might tend to undermine the purpose of section 351.⁵⁴ However, it argued:

[T]here is no support for adopting the definition suggested by the petitioners, and we can find no rational basis for giving the term "liabilities" a restrictive meaning. Under these circumstances, we must assume that Congress intended for the term "liabilities" to have its ordinary meaning.⁵⁵

Five judges dissented from the court's decision. Judge Quealy's dissent noted that it was his decision that was reversed by the Second Circuit in *Bongiovanni*. He was now, however, "in full accord with the decision of the appellate court in the *Bongiovanni* case."⁵⁶ In his view the Second Circuit's opinion more closely reflected the intent of Congress.⁵⁷

Judge Hall's dissenting opinion attempted to reconcile what she considered to be the clear statutory requirement of section 357(c) with the policy behind section 351. She noted that if, in a non-section 351 transaction,

50. Counsel for Thatcher attempted to distinguish *Peter Raich* on the ground that *Raich* involved a sole proprietorship, and *Thatcher* a partnership. Thatcher argued that § 751 and the regulations thereunder provide for a different basis for accounts receivable to a partnership. Treas. Reg. § 1.751-1(c)(2) states: "(a) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previously taken into account under the partnership method of accounting." Thatcher interpreted this regulation to mean that the accounts receivable of a partnership reporting its income on the cash method of accounting have a basis equal to the accounts payable. The Tax Court dismissed this argument, however, by stating that § 751 was written for a different purpose which in no way interacts with the operation of § 357. 61 T.C. at 33-35.

51. See pp. 250-51 & notes 39-47 *supra*.

52. 61 T.C. at 36.

53. *Id.* at 37.

54. *Id.*

55. *Id.*

56. *Id.* at 39.

57. *Id.* at 40.

a cash basis taxpayer transferred \$1,000 worth of receivables and an equal amount of payables to an outside party, there would be no taxable income. However,

[u]nder the majority's reasoning, the same taxpayer making the same exchange with his wholly owned corporation will have \$1,000 of taxable income. Section 351, intended as a shield against recognition of gain on incorporation, thereby perversely becomes a sword to impose a tax where none would be due in an ordinary recognizing transaction.⁵⁸

Attempting to find an analysis that did not strain the language of section 357(c) as, in her opinion, had *Bongiovanni*, Judge Hall said that the taxpayer in *Thatcher* had actually sold his receivables for an assumption of payables.⁵⁹ When, therefore, the transferee pays the accounts payable in the taxable year of transfer, they should be deductible to the transferor to the extent the offsetting receivables are treated as received by him.⁶⁰ In support of this analysis, Judge Hall argued that

[s]ection 357(c) is given full, literal effect. As a matter of appropriate allocation, in the case of incorporation of a cash basis business, the trade accounts payable should, for this purpose, be netted against the trade accounts receivable, up to the lesser of the trade accounts payable or the amount of liabilities treated as paid under section 357(c). Such an allocation is simple, straightforward and best follows the statutory intent.⁶¹

Applying this analysis to the facts in *Thatcher*, the liabilities assumed exceeded the adjusted basis of assets transferred by \$102,367.73, and that amount would be section 357(c) gain. There were \$164,065.54 in unrealized accounts payable, and \$317,146.96 of unrealized receivables. The corporation paid all of the payables in the same year the transfer occurred. All \$102,367.73 of the section 357(c) gain would therefore be allocated to the sale of the receivables, in exchange for assumption and payment of the payables, and Thatcher would be treated as having paid \$102,367.73 of the payables.

58. *Id.* at 42.

59. *Id.*

60. *Id.* at 42-43:

The statutory purpose is far better served if payables paid by the transferee in the taxable year of transfer are treated as deductible to the transferor to the extent the offsetting receivables are treated as received by him. Since payment of a deductible liability by a cash method taxpayer gives rise to a deduction, the same deduction should be allowed on payment when section 357(c) treats the liability as assumed in exchange for receivables.

61. *Id.* at 43.

Despite the fact that the *Peter Raich* opinion was affirmed by the majority in *Wilford E. Thatcher*, it is clear from the Second Circuit's opinion in *Bongiovanni* and the number of dissenting judges in *Thatcher* that discontent is growing over the application of section 357(c) to the transfer of accounts payable. How far this discontent will spread is unclear, but it may indicate that the Commissioner will have continued difficulty in taxing the transferor on this type of section 351 transaction until a resolution of this issue comes from either Congress or the Supreme Court.

III. THE APPLICABILITY OF SECTION 482 AND THE ASSIGNMENT OF INCOME DOCTRINE

It is a well established principle of income tax law that income from personal services is attributed to the person who rendered the services.⁶² In a personal service organization incorporated under section 351, could this principle operate to tax the transferors on the ultimate collection of the accounts receivable by the corporation? Or, similarly, could the Commissioner successfully use section 482 to allocate the accounts receivable income to the transferors?⁶³

For the moment at least this discussion may be moot since the Commissioner is now giving private rulings to the effect that the transferor need not report the income from the collection of the receivables so long as the transferee corporation reports it.⁶⁴ Unfortunately, this present ruling policy does not insulate the taxpayer from a future change in thinking at the Service.

Also, despite the Service's favorable ruling policy, the assignment of income doctrine has been used to tax the transferor in this type of situation. In *Brown v. Commissioner*,⁶⁵ the Second Circuit held that the transferors were taxable on the transferee corporation's collection of legal fees that were transferred to it under the predecessor of section 351. In *Clinton David-*

62. See *Lucas v. Earl*, 281 U.S. 111 (1930).

63. INT. REV. CODE OF 1954, § 482:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

64. See *Lipoff, Organizing a Professional Service Corporation*, N.Y.U. 28TH INST. ON FED. TAX. 1223, 1235 (1970).

65. 115 F.2d 337 (2d Cir. 1940).

son,⁶⁶ the transferor was taxed on the transferee corporation's collection of insurance commissions under the assignment of income doctrine. Similarly, in *Adolph Weinberg*,⁶⁷ the transferor was taxed on the transferee corporation's sale of growing crops. Bittker and Eustice note in their treatise on corporate taxation,⁶⁸ however, that these cases may not apply where the transferor has been taxed under section 357(c). They state that implicit in *Peter Raich*⁶⁹ and similar cases was the understanding that gain would not have been recognized from the transferred receivables but for section 357(c).⁷⁰

The only case reported dealing with the applicability of section 482 to the transfer of accounts receivable by a cash basis taxpayer is *Thomas W. Briggs*.⁷¹ Briggs was operating Welcome Wagon as a sole proprietor until he incorporated the business in a tax-free transaction, transferring to the corporation all assets and liabilities. Included in the assets were uncollected service fees of \$209,748.20. When collected, these service fees were included in the taxable income of the corporation. The Commissioner attempted, under section 482, to allocate this income to Briggs. The court refused to permit this, however, noting that "[t]he evidence . . . affirmatively shows no evasion or attempted evasion of the taxes in question, but the same were all paid in full by the Corporation, as the collections were made by it."⁷² Aside from the fact that *Briggs* is a memorandum opinion having limited precedential value, it must also be noted that section 482 permits allocation of gross income by the IRS where no tax evasion exists, but where the allocation is necessary solely to more clearly reflect income.⁷³

In the event that the assignment of income doctrine or section 482 applies, it would logically follow that the amount collected by the corporation would be considered a contribution to capital raising the transferor's basis in his stock. There exists the possibility, however, for a type of double taxation. The transferors would be taxable when the accounts receivable are collected by the corporation, and they would be taxable again on salaries received from the corporation on income which resulted, in effect, from the collection of these accounts.⁷⁴ Because the amount collected by the corporation would

66. 43 B.T.A. 576 (1941).

67. 44 T.C. 233 (1965), *aff'd per curiam sub nom. Commissioner v. Sugar Daddy, Inc.*, 386 F.2d 836 (9th Cir. 1967).

68. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 3.17, at 3-59 n.98 (3d ed. 1971).

69. 46 T.C. 604 (1966). See pp. 250-51 & notes 37 & 38 *supra*.

70. B. BITTKER & J. EUSTICE, *supra* note 68, § 3.17, at 3-59 n.98.

71. 15 CCH Tax Ct. Mem. 440 (1956).

72. *Id.* at 451.

73. See note 63 *supra*.

74. See Lipoff, *supra* note 64, at 1231, for a discussion of the possibilities for double taxation.

logically be a contribution to capital raising the transferor's basis in his stock, he would not receive a correlative tax benefit until he sold the stock.

Obviously the state of the law on the applicability of section 482 and the assignment of income doctrine to a transfer of accounts receivable is unclear. The Service's present ruling policy, although it has made this issue dormant for now, is, of course, subject to change. This is an area that may potentially cause difficulty to a transferor in a section 351 transfer of accounts receivable.

IV. THE DEDUCTIBILITY OF THE ACCOUNTS PAYABLE UPON PAYMENT

The question of the deductibility of the accounts payable upon payment, as ordinary and necessary business expenses,⁷⁵ both to the corporation and to the transferor, is also unsettled. Norman Lipoff states in his article, *Organizing a Professional Service Corporation*,⁷⁶ that the former cash basis transferor cannot deduct the expenses for payment of the accounts payable because he did not pay them; and, "[t]he corporation may not be able to deduct the expenses because they were not expenses of the corporation."⁷⁷

Although Mr. Lipoff's conclusion may accurately predict the result that may be reached in any particular case, the case law in this area is in conflict. In *Arthur L. Kniffen*,⁷⁸ the Tax Court held that after a section 351 transfer of assets and liabilities, the stockholder-taxpayer could not deduct the corporation's payment of the accounts payable.⁷⁹ This same conclusion was reached by the Fourth Circuit in *Doggett v. Commissioner*,⁸⁰ and by the

75. See INT. REV. CODE OF 1954, § 162: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ;" INT. REV. CODE OF 1954, § 461: "The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."

76. Lipoff, *supra* note 64.

77. *Id.* at 1237. See also Comment, *supra* note 21, at 1167, where the author concludes:

If the payables are valued at market, no one will ever get a deduction when they are liquidated. Because the taxpayer is on the cash basis, he cannot deduct the payables since he did not pay them himself. The corporation, however, also cannot claim a deduction since when it pays the payables, it will merely be paying off an expense already recognized to another taxpayer.

78. 39 T.C. 553 (1962).

79. *Id.* at 566-67.

80. 275 F.2d 823 (4th Cir.), *cert. denied*, 364 U.S. 824 (1960). In *Doggett*, Judge Haynsworth's opinion for the court suggested that this result could be avoided if the transferor were to commission the corporation his agent in the payment of the liabilities. *Id.* at 827.

Ninth Circuit in *Citizens National Trust & Savings Bank v. Welch*.⁸¹

In *Doggett* and *Citizens National* the courts in dictum explicitly stated that a deduction for payment of the liabilities could be had by the transferee corporation that paid them.⁸² Other decisions indicate that this may not be the case. In *Stone Motor Co.*,⁸³ a transferee corporation was not permitted a deduction for the payment of sales taxes imposed on the transferor prior to the transfer.⁸⁴ Similarly, in *Rodney, Inc. v. Commissioner*,⁸⁵ the Second Circuit held that a transferee corporation was properly denied a deduction for interest expenses paid by it, but accruing prior to the tax-free transfer. The Eighth Circuit in *Merchants Bank Building Co. v. Helvering*⁸⁶ reached the same conclusion for a tax liability accruing prior to the transfer but paid by the transferor corporation.

The state of the law, therefore, is not clear as to who, if anyone, may deduct as a business expense the payment of accounts payable transferred in a section 351 transaction. The policy behind section 351, that the corporation is actually the same business enterprise in different form, would appear to militate in favor of allowing the deduction to the corporation. Under present law, however, this may not necessarily apply. This area, as with the applicability of section 482 and the assignment of income doctrine, remains an area of potential confusion and uncertainty to a taxpayer as he approaches a section 351 transaction.

V. THE NECESSITY FOR TAX PLANNING

The application of section 357(c) to these situations can be avoided with proper tax planning. There are essentially three methods for so doing. First, one can avoid having gain recognized under section 357(c) by assuring that a sufficient number of assets are transferred so that their accumulated bases exceed the amount of the liabilities assumed by the corporation.⁸⁷ In

81. 119 F.2d 717 (9th Cir. 1941). See also *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946).

82. 119 F.2d at 719; 275 F.2d at 827.

83. 15 CCH Tax Ct. Mem. 944 (1956).

84. *Id.* at 947.

85. 145 F.2d 692 (2d Cir. 1944).

86. 84 F.2d 478 (8th Cir. 1936). Cf. *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946) (settlement of the transferor partnership's contingent liability by the transferee corporation not deductible by the corporation). See also *Automatic Sprinkler Co.*, 27 B.T.A. 160 (1932) (Delaware corporation successor to New York corporation not permitted to deduct payment of taxes which had been assessed against New York corporation prior to the transfer).

87. See J. CHOMMIE, *FEDERAL INCOME TAXATION* § 180 (1st ed. 1968).

selecting assets to transfer, however, one must carefully avoid being overzealous and triggering the application of section 357(b), under which the entire amount of the liabilities assumed will be considered boot.⁸⁸

Second, section 357(c) can be avoided by changing to the accrual method of accounting prior to the transfer.⁸⁹ Here, the transferor would simply accrue all of the receivables and the payables on the accounting method change. On the section 351 transfer, the receivables would retain their stepped-up basis. Because the accrual method of accounting treats the receivables as received and the payables as paid when the obligation arises, the transferor taxpayer would be required to report the difference between the receivables and the payables as income in the year of the accounting change.⁹⁰

The third, and perhaps the best method of avoiding the application of section 357(c) is simply not to transfer the accounts payable or other liabilities to the corporation.⁹¹ A sufficient amount of receivables could also be retained in the proprietorship or partnership to cover the payables when they fall due. The payment of the payables could be deducted from the receipt of the receivables, leaving no tax due. Here the tax on the accounting method change is avoided, as is the risk of triggering the application of section 357(b) by including extraneous assets. Because the tax law in this area is uncertain, a pre-transfer ruling from the Service may be a necessity to solidify the tax consequences of the transaction.

88. Section 357(b) states that the entire amount of the liabilities assumed by the corporation shall be considered "as money received," where the principal purpose of the assumption or acquisition was the avoidance of income taxes on the exchange. In *W.H.B. Simpson*, 43 T.C. 900 (1965), the taxpayer escaped the application of both subsections 357(b) and (c) by transferring assets of two retail dry goods businesses and selected securities to a newly formed corporation. The taxpayer proved that there was a corporate need for the securities as working capital. The application of section 357(c) cannot be avoided, however, by the transferor making up the difference between basis and liabilities by transferring his personal note for such amount. In *Rev. Rul. 68-629, 1968-2 CUM. BULL. 154*, it was held that the note has a zero basis, thus not increasing the basis of the assets transferred.

89. See *Rev. Rul. 69-442, 1969-2 CUM. BULL. 53*, where the Service stated that "the trade accounts receivable would not have had a zero basis if the taxpayer had been on the accrual method of accounting prior to the transfer of the business under section 351 of the Code."

90. A calculation would thus be necessary to determine whether the tax saving would be greater under the change of accounting method or under section 357(c) itself.

91. See *Paul & Kalish, Transition from a Partnership to a Corporation*, N.Y.U. 18TH INST. ON FED. TAX. 639, 656-57 (1960).

VI. A RECOMMENDATION FOR LEGISLATIVE CHANGE

After reviewing the state of the law in this area one is left with the unavoidable conclusion that some type of clarification is necessary. The applicability of the assignment of income doctrine and section 482 must be clarified, along with a determination of who gets a deduction for payment of the payables. Beyond this, however, a reexamination of the appropriateness of applying section 357(c) to a section 351 transfer of current payables and receivables is necessary.

The language of section 357(c) clearly applies to a transfer of accounts payable, and to accept the rationale of *Bongiovanni* is to grant that the plain language of the Internal Revenue Code may be ignored. While accepting the rationale of *Testor*, *Raich*, and *Thatcher*, however, one is left with the feeling that a tax is being levied on nothing more than illusory gain.

What may be needed is a closer examination of the negative basis concept. The application of this doctrine appears to be the only way to assure that no gain would be recognized on a section 351 transfer, and yet insure that gain would be recognized on the ultimate disposition of the stock. The negative basis concept is, however, a radical departure from existing law that could have far-reaching and unforeseen ramifications throughout the Code. Not until all of these ramifications are understood should it be considered a workable alternative.

What might best be done presently, however, is to enact a modification of what has come to be the most widely used method of tax planning in this area—the retention by the taxpayer of all of the accounts payable and receivable. Section 357(c) would remain intact. Under an amendment to that section, however, it could be required that all current assets and liabilities not accrued at the time of the transfer (*i.e.*, accounts receivable and payable and short term notes payable in the hands of a cash basis taxpayer under an appropriate definition) be accrued when transferred to the corporation. On the accrual, the transferor would be treated as having received the receivables and paid the payables and would report the income and receive a deduction. This would clearly resolve the controversy over who is entitled to a deduction for payment of the payables, and would eliminate the need for applying section 482 or the assignment of income doctrine.

The amount by which the accrued receivables exceed the accrued payables would be considered a contribution to the capital of the corporation, increasing the transferor's bases in his stock by that amount. The receivables which at a later date become uncollectable by the corporation would give a bad debt deduction to the transferor and lower his basis in his stock. If on the

accrual the amount of the payables still exceeded the amount of the receivables, section 357(c) would apply, taxing the transferor on the difference.

This is a minor change which would not eliminate the problem as effectively as would the adoption of the "negative basis doctrine." Section 357(c) would still apply where the accrued payables exceed the accrued receivables and thus tax the transferor even though he has received no money in hand. This unfortunate result occurs whenever section 357(c) applies. This amendment to the section would effectively eliminate the problem presented by *Testator*, *Raich*, *Bongiovanni*, and *Thatcher*. The facts of *Raich* can be used to show how this proposal would operate.

In *Raich*, a cash basis taxpayer transferred assets having a basis of \$11,251.73 and accounts receivable of \$77,361.66 to his controlled corporation. The corporation assumed notes payable of \$8,273.03 and accounts payable of \$37,716.78. The Court held that Raich was taxable on a gain of \$34,741.08, the amount by which the liabilities assumed, including accounts payable, exceeded the basis of the assets transferred.

Under the proposal outlined above, the short-term receivables and payables would be accrued prior to the transfer. On the accrual, \$39,644.88 would be recognized to the transferor as ordinary income (the accrual of \$77,361.66 in payables, minus \$37,716.78 in payables).⁹² On the transfer, the accounts receivable would simply be another asset to be transferred. Because the basis of the assets transferred, \$88,613.39, exceed the amount of the liabilities transferred, \$45,989.81, by \$42,623.58, that would be the transferor's basis in his stock. Even though the transferor is required to recognize income on the accrual of the receivables and payables, this is income which he has actually earned, but not yet collected. The tax is merely an acceleration of a tax that would otherwise be due at a later date, rather than the creation of an extraneous and unnecessary tax, as section 357(c) now does.

VII. CONCLUSION

Under present law, many questions about a section 351 transfer of accounts receivable and payable by a cash basis taxpayer are left unanswered. Section 357(c) remains ready to trap the unwary taxpayer into paying an unnecessary tax on a gain that may not exist. The taxpayer is left to resort

⁹² Although at first glance this \$39,644.88 in tax may appear to be more severe than the \$34,741.08 gain taxed by the court, it should be noted that the \$34,741.08 is a tax solely on the transfer. A subsequent tax would be levied on the collection of the receivables and payment of the payables. The recommended change simply eliminates the tax on the transfer.

to ruling requests to determine whether he will be taxed on the corporation's collection of the receivables, and who, if anyone, will be permitted a deduction for payment of the payables. Although the problems can largely be avoided through proper tax planning, legislative change is also necessary. The proposal offered in this article, if adopted, would operate to clarify this area of the law and eliminate unnecessary and burdensome taxation.