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# Peracchi: What is the Right Result?

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# *Peracchi*: What is the Right Result?[*]

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In *Peracchi v. Commissioner*,[1] the Ninth Circuit held that a taxpayer who transferred his own promissory note to his wholly owned corporation avoided gain recognition under section 357(c) on a transfer of encumbered property to that corporation. Under section 357(c), a taxpayer who transfers encumbered property to a corporation in a transaction that otherwise would qualify as a tax-free exchange of property for stock under section 351 must recognize gain if and to the extent that the amount of the liabilities encumbering the transferred property exceeds the adjusted basis of all property transferred to the corporation in the same transaction. The Ninth Circuit held that the taxpayer in *Peracchi* was not required to recognize gain, even though the amount of the liabilities exceeded the basis of the transferred property, because the taxpayer's basis in the promissory note transferred to the corporation was equal to its face amount.

*Peracchi* offers taxpayers an easy way to avoid gain recognition under section 357(c), as well as an easy way to increase a shareholder's stock basis. Under section 358, the basis of a shareholder's stock received in a section 351 transaction generally is equal to the basis of the property transferred to the corporation, decreased by the fair market value of property other than stock and the amount of money ("boot") received by the shareholder, and increased by the amount of gain recognized by the shareholder on the transaction.[2] If a taxpayer has a basis in the taxpayer's own promissory note, the taxpayer can create stock basis simply by issuing a note to a corporation in exchange for stock.

While stock basis has significance for shareholders in a C corporation, stock basis is even more important for S corporation shareholders. Under subchapter S of the Internal Revenue Code, a shareholder may deduct a pro rata share of the corporation's net losses only to the extent of the shareholder's stock basis and to the extent of the basis in any indebtedness of the corporation to the shareholder.[3] An S corporation shareholder generally may receive tax-free distributions from the corporation only to the extent that the amount distributed does not exceed the adjusted basis of the shareholder's stock.

Equity basis has the same significance for partners. A partner may deduct the partner's distributive share of partnership losses only to the extent of the

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1. 143 F.3d 487 (9th Cir. 1998), 98-1 U.S.T.C. para. 50,374, *Doc 98-14167 (21 pages), 98 TNT 86-11, rev'g* 71 T.C.M. (CCH) 2830, *Doc 96-12055 (16 pages), 96 TNT 80-13* (1996).

2. Section 358(a). For this purpose, the amount of liabilities assumed by the corporation or taken subject to the transferred property is treated as money. Section 358(d)(1). Section references are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder, except as otherwise noted.

3. Section 1366(d).

adjusted basis of the partner's interest in the partnership[4] and may receive tax-free distributions of cash only to the extent of the adjusted basis of the partner's interest in the partnership.[5]

Concerned that allowing a taxpayer a face-amount basis in a promissory note could cause "mischief" if a taxpayer transferred the promissory note to a partnership or an S corporation, the Ninth Circuit limited its holding to C corporation shareholders.[6] The Ninth Circuit, however, cited no authority for so limiting its holding. This article argues that the transfer of a shareholder's own promissory note to a wholly owned corporation should not prevent the shareholder from recognizing section 357(c) gain. On the other hand, if the Ninth Circuit was correct, there is no legal basis for limiting the holding in *Peracchi* to C corporation shareholders.

Both President Clinton and the Senate have proposed amendments to section 357(c) that would eliminate the need for a taxpayer to contribute a promissory note to avoid section 357(c) gain in many cases. Under the proposals, a taxpayer would not recognize section 357(c) gain on the transfer of encumbered property to a corporation if the taxpayer remained personally liable for payment of the liabilities. The proposed amendments may not necessarily be appropriate for C corporation shareholders, who may enjoy an economic benefit in transferring encumbered property to a corporation even if they remain personally liable for repayment of the liabilities encumbering the transferred property. The proposals may be more appropriate for S corporation shareholders. If the proposals are adopted, however, there may be a need for further guidance before S corporation shareholders may take advantage of them.

## I. THE *PERACCHI* CASE

Donald Peracchi and his wife owned 100 percent of the stock of NAC Corporation ("NAC"), which had two wholly owned subsidiaries. The subsidiaries needed additional capital to comply with a state law minimum premium-to-asset ratio for insurance companies. To satisfy state law requirements, Peracchi contributed three parcels of improved real estate to NAC, along with his unsecured promissory note with a face amount of $1,060,000. The real estate had a total adjusted basis of $981,400 and was encumbered by liabilities of $1,548,200. The corporation did not assume the liabilities, for which Peracchi remained personally liable.

The government argued that Peracchi should recognize $566,800 gain under section 357(c), the amount by which the liabilities exceeded the adjusted basis

4. Section 704(d).

5. Section 731(a)(1).

6. *Peracchi*, 143 F.3d at 494 n.16. The court also limited its holding to cases in which the note is contributed to an operating business that is subject to a non-trivial risk of bankruptcy or receivership, as compared to a shell corporation or a passive investment company and to cases in which the note is in fact worth approximately its face value. *Id.*, at 493, n.14, 494, n.15.

of the property transferred to NAC, and that Peracchi should not avoid gain recognition because he transferred his promissory note to NAC in the same transaction. In similar cases, both the Tax Court[7] and the IRS[8] have taken the position that since a taxpayer incurs no cost in issuing a promissory note, the taxpayer's basis in the note is zero. Under this approach, the transfer of a promissory note to a corporation will not provide sufficient basis to offset liabilities encumbering property transferred to the corporation to avoid gain recognition under section 357(c).

In *Peracchi*,[9] the Tax Court did not rely on the zero-basis analysis. Instead, the Tax Court held that Peracchi was required to recognize gain under section 357(c) because the note that he transferred to the corporation did not represent true indebtedness. Since the Peracchis owned 100 percent of the stock of NAC and Donald Peracchi was the sole director of the corporation, the corporation could not be expected to enforce the terms of the note against Peracchi. The terms of the note required Peracchi to pay NAC interest at the rate of 11 percent per year in monthly installments. However, no interest payments had been made for the first two years that the note was outstanding. In fact, Peracchi did not begin to make interest payments until an IRS audit of his return had been underway. While the terms of the note provided for acceleration in the event of default at the option of the corporation, NAC never enforced its option. The Tax Court concluded that Peracchi had no intention of making timely payments on the note.

The Tax Court also concluded that the transfer of the note served no purpose other than that of a makeweight to avoid potential gain recognition under section 357(c). Peracchi's accountants had advised him that the note would be treated as a nonadmitted asset for purposes of computing the subsidiary's capital-to-premium ratio. Accordingly, there was no business purpose for issuing the note.

The Ninth Circuit reversed, holding that the Tax Court was clearly erroneous in finding that Peracchi's note did not represent genuine indebtedness. Notwithstanding Peracchi's "imperfect attention to his obligations under the note,"[10] the Ninth Circuit held that the note was bona fide. The parties had stipulated that Peracchi was creditworthy and solvent; the note had a market rate of interest; the note had a fixed term; and the note was fully transferable and enforceable by third parties. In the event of NAC's bankruptcy, the note would be an asset of the estate, enforceable for the benefit of creditors.

The Ninth Circuit also held that Peracchi incurred a cost in issuing his note because the note was enforceable by NAC's creditors. The amount of the cost to Peracchi, in the Ninth Circuit's opinion, was equal to the face amount of the note. Thus, under section 358, the basis of Peracchi's NAC stock included the face amount of his promissory note.

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7. *See, e.g., Velma W. Alderman v. Commissioner*, 55 T.C. 662 (1971).

8. Rev. Rul. 68-629, 1968-2 C.B. 154.

9. *Peracchi v. Commissioner*, T.C. Memo 1996-191, 71 T.C.M. (CCH) 2830 (1996), *rev'd* 143 F.3d 487 (9th Cir. 1998).

10. 143 F.3d at 495.

## II. WAS THE NINTH CIRCUIT CORRECT?

A taxpayer like Peracchi should not be permitted to avoid application of section 357(c) by contributing the taxpayer's own promissory note to a wholly owned corporation. Economically, the shareholder's note offers the corporation's creditors little more than a shareholder's guarantee of a corporate obligation. If Peracchi had guaranteed $1,060,000 of NAC's debts rather than transferring his promissory note, Peracchi would be liable to creditors in the same amount in the event of NAC's bankruptcy. In most cases, a shareholder's guarantee is insufficient to increase the shareholder's stock basis, especially if the creditor looks to the corporation, rather than to the shareholder, for repayment of the debt.[11] The tax consequences should not differ if a shareholder transfers a promissory note to a controlled corporation instead of guaranteeing the corporation's debts.

Under section 357(c), a shareholder recognizes gain on the transfer of encumbered property to a corporation if, and to the extent that, "the sum 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 [the] exchange."[12] The Ninth Circuit agreed that the fact that Peracchi remained personally liable for repayment of the transferred liabilities was irrelevant for purposes of section 357(c) because the corporation took the property subject to the liabilities.[13]

It seems that the possibility that Peracchi might be required to pay NAC's creditors with respect to the transferred liabilities is too remote a contingency to give him current basis to avoid gain recognition under section 357(c). It is difficult to see why the possibility of the corporation's bankruptcy should have more significance when Peracchi transfers his promissory note to the corporation. In allowing Peracchi to avoid gain recognition by transferring his own promissory note to the corporation, the Ninth Circuit practically reads section 357(c) out of the code.[14]

Furthermore, it seems strange that Peracchi should have any basis in his own note. A taxpayer's own note should not constitute property in the taxpayer's

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11. *See, e.g., Uri v. Commissioner*, 949 F.2d 371, *91 TNT 239-19* (10th Cir. 1991), *aff'g* T.C. Memo 1989-058, *89 TNT 31-19*; *Harris v. United States*, 902 F.2d 439 (5th Cir. 1990); *Estate of Leavitt v. Commissioner*, *88 TNT 32-8*, 875 F.2d 420 (4th Cir. 1989), *aff'g* 90 T.C. 206 (1988); *Brown v. Commissioner*, 706 F.2d 755 (6th Cir. 1983). *Cf. Selfe v. United States*, 778 F.2d 769, *85 TNT 254-75* (11th Cir. 1985) (shareholder may include corporate debt in basis where shareholder guaranteed the debt and the creditor looked primarily to the shareholder rather than to the corporation for repayment of the debt).

12. Section 357(c)(1).

13. *Peracchi*, 143 F.3d, at 492 n.10. *See also Owen v. Commissioner*, 881 F.2d 832, 835-36 (9th Cir. 1989), *cert. denied*, 110 S. Ct. 1113 (1990).

14. *See* Lee A. Sheppard, "Negative Basis, Economic Exposure, and Runaway Metaphors," *Tax Notes*, May 11, 1998, p. 676.

hands.[15] The note was a liability to Peracchi; it was not an asset. Only assets have basis. If the note is not property in Peracchi's hands, it should have no basis to Peracchi.

## III. BASIS OF THE NOTE TO THE CORPORATION

The Ninth Circuit was concerned that if it held that Peracchi had a zero basis in his note, the corporation also would take the note with a zero basis. Under section 362(a), property acquired by a corporation in a transaction to which section 351 applies has a basis in the corporation's hands equal to its basis in the hands of the transferor, increased by any gain recognized to the transferor. If the corporation later sold the note for its fair market value, the corporation would have to recognize up to $1,060,000 gain. The court concluded, "That can't be the right result."[16] To prevent the "wrong result" in such a case, the Ninth Circuit determined that Peracchi should have a basis in his promissory note equal to its face amount.

It may not be necessary to prevent the shareholder from recognizing gain under section 357(c) to give the corporation a basis in the note. If the note is not property in the shareholder's hands, sections 351 and 362(a) do not apply to the transfer of the note to the corporation.

*Peracchi* is not the first case in which a court has held that a taxpayer could avoid gain recognition under section 357(c) by transferring a promissory note to a wholly owned corporation. In *Lessinger v. Commissioner*,[17] the Second Circuit reached the same result as the Ninth Circuit with respect to the effect of the transfer of a promissory note but employed a different analysis. In *Lessinger*, the Second Circuit acknowledged that a taxpayer's own promissory note should not be treated as "property" or have "basis" for purposes of section 357(c).[18]

The *Lessinger* court, however, like the *Peracchi* court, determined that the taxpayer's note represented a bona fide, enforceable obligation and a valuable asset upon which the corporation's creditors could rely. The court determined that the taxpayer did not realize any gain from the incorporation because he received no economic benefit as a result of the transaction. To prevent the taxpayer from recognizing gain, the Second Circuit engaged in a strained reading of section 357(c). Section 357(c) provides, in part:

> (1) In general.—In the case of an exchange—
> (A) to which section 351 applies,
> * * *

15. *See* John A. Bogdanski, "Closely Held Corporations—Shareholder Debt, Corporate Debt: Lessons from *Leavitt* and *Lessinger*," 16 *J. Corporate Tax'n* 348, 353 (1990).

16. *Peracchi*, 143 F.3d, at 494.

17. 872 F.2d 519, *89 TNT 80-12* (2d Cir. 1989), *rev'g* 85 T.C. 824 (1985).

18. *Lessinger*, 872 F.2d, at 525.

> 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.

The Second Circuit held that the "adjusted basis" to which section 357(c) refers is not the adjusted basis of the transferred property in the transferor-shareholder's hands, but the adjusted basis of the transferred property in the hands of the transferee-corporation. The court then concluded that the corporation should have a basis in the shareholder's note because the corporation incurred a cost by taking the property subject to the liabilities. The court also was concerned that if the corporation took the promissory note with a zero basis, the corporation would have to recognize gain each time the shareholder made a payment on the note. The Second Circuit determined that section 362(a), which requires a carryover basis for "property" transferred in nonrecognition transactions under section 351, cannot be applied to compute the corporation's basis in the note, presumably, because the shareholder's note did not constitute "property" in the shareholder's hands.[19] Since the corporation's adjusted basis in the shareholder's note must be its face amount, the Second Circuit held that the shareholder recognized no section 357(c) gain.

The Second Circuit's reasoning in *Lessinger* is circular. Professor John A. Bogdanski illustrates the problem with the court's logic as follows:

> Section 362(a) gives the corporation a carryover basis in the assets received from the shareholder, increased by any gain recognized on a Section 351 exchange. The classic instance of recognized gain on a Section 351 exchange is under Section 357(c); thus, one cannot determine a corporation's basis in its assets without first determining the shareholder's gain under Section 357(c). To declare, as the Second Circuit did, that the amount of gain generally turns on the corporation's basis in its assets leads to an endless circle.[20]

Professor Bogdanski argues, however, that a shareholder who acquires stock in exchange for encumbered property and the shareholder's note should avoid gain recognition under section 357(c) because the shareholder's note should be included in the adjusted basis of the stock received in the transaction.[21] His argument is based on the interrelationship of sections 357(c) and 358. Under section 358, the basis of shareholder's stock received in a section 351 transaction is the same as the basis of the property transferred to the corporation, decreased

19. 872 F.2d, at 525, n.4.
20. Bogdanski, *supra* note 15, at 352-53.
21. Bogdanski, *supra* note 15, at 354-55.

by the fair market value of property and the amount of money received by the shareholder and increased by the amount of gain recognized by the shareholder on the exchange.[22] For this purpose, section 358(d) provides that the amount of any liabilities assumed by the corporation or taken subject to the transferred property is treated as money received by the shareholder on the exchange.[23] Thus, if no gain were recognized when liabilities transferred to a corporation in excess of the basis of the transferred property, the shareholder would have a negative basis in the stock received in the transaction.

> *Example*: Assume that individual A transfers to A's wholly owned corporation, X Corp, property with an adjusted basis to A of $30,000, subject to $50,000 of liabilities. If section 357(c) did not require A to recognize gain on the transfer, the basis of A's stock received in the exchange would be ($20,000) ($30,000 the basis of the property transferred, minus $50,000, the "money" received, increased by $0, the gain recognized on the transaction).

Thus, section 357(c) serves an important purpose in preventing a shareholder from receiving stock with a negative basis. Professor Bogdanski opines that "[a]ll Section 357(c) problems are essentially Section 358(d) problems."[24] As a corollary to this principle, he maintains that any basis the shareholder takes in the stock received in a section 351 transaction should prevent gain from being triggered under section 357(c).[25]

Unfortunately, this approach ignores the language of section 358, which determines the adjusted basis of stock received in a section 351 exchange. Under section 358, it is necessary first to determine the amount of gain recognized by the shareholder under section 357(c) to determine the shareholder's basis in the stock received in the same transaction. To conclude that the amount of gain recognized under section 357(c) depends on the shareholder's stock basis leads to the same endless circle as was created by the Second Circuit's approach in *Lessinger*.

## IV. HOW TO ACCOUNT FOR THE SHAREHOLDER'S NOTE

Professor J. Clifton Fleming, Jr. has suggested that the transfer of a promissory note by a shareholder to a wholly owned corporation should be treated as if the shareholder had borrowed cash from a third party and contributed the money to the corporation.[26] In such a case, the contribution of cash

22. Section 358(a)(1).
23. Section 358(d)(1).
24. Bogdanski, *supra* note 15, at 354-55.
25. *Id.*, at 355.
26. J. Clifton Fleming, Jr., "The Highly Avoidable Section 357(c): A Case Study in Traps for the Unwary and Some Positive Thoughts About Negative Basis," 16 *J. Corp. L.* 1, 21 (1990).

would supply basis to offset the liabilities transferred to the corporation. Indeed, the Ninth Circuit observed in *Peracchi* that Peracchi could have borrowed $1 million from a bank and contributed the cash along with the properties, thereby avoiding section 357(c) gain recognition.[27]

The Ninth Circuit further postulated that the corporation could have purchased Peracchi's note from the bank for $1 million, assuming that the value of the note was worth its face amount.[28] The court admitted that the Service could apply the step transaction doctrine in such a case, but nevertheless asserted that the economics of the transaction should be respected.[29]

In *Peracchi*, however, there was no third-party creditor to ensure that Peracchi would actually make payments on the note. If Peracchi had borrowed from a third party and contributed the cash to the corporation, in accordance with the Ninth Circuit's suggestion, the corporation's purchase of Peracchi's note would have eliminated the third-party creditor. The absence of a third-party creditor to enforce the note raises a question as to the economic substance of the transaction.

Kenneth P. Brewer has argued that a taxpayer like Peracchi should get some credit for transferring his promissory note to the corporation.[30] Indeed, he contends, the taxpayer incurs a cost in issuing the note.[31] The issuance of the note reduces the taxpayer's net worth by diminishing the amount of assets that the taxpayer otherwise might have available to put to other uses. Thus, a taxpayer who issues a promissory note in exchange for property in a transaction that is not governed by section 351 generally takes a "cost" basis in the property that includes the amount of the promissory note.[32]

Most of the cases in which a taxpayer includes the amount of a purchase money note in the basis of the acquired property, however, can be distinguished from a case in which a shareholder acquires stock from a wholly owned corporation in exchange for the shareholder's promissory note. When a taxpayer issues a purchase money note to a third-party seller, it is likely that the seller will enforce the taxpayer's obligation. In the case of a note issued to a wholly owned corporation, the debtor is essentially the same person as the creditor. Because the shareholder controls the corporation, there is no certainty at the outset whether the corporation will enforce the obligation. Indeed, in *Peracchi*, no payments were made on Peracchi's note until the IRS audited Peracchi's tax return.

Admittedly, a shareholder who purchases property other than stock from a wholly owned corporation by issuing a promissory note takes the property with

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27. *Peracchi*, 143 F.3d, at 493.

28. *Id.*

29. *Id.* at 494, n.15.

30. *See, e.g.*, Kenneth P. Brewer, "The Zero Basis Hoax," *Tax Notes*, Apr. 25, 1994, p. 457.

31. *Id.*, at 459.

32. *See Crane v. Commissioner*, 331 U.S. 1 (1947) (taxpayer's basis in property includes the amount of a mortgage incurred to acquire the property).

a cost basis that includes the amount of the promissory note. Of course, such a transaction will be subject to close scrutiny because it is a sale between related parties. While it may not be certain whether the shareholder will actually make payments on the note, there is likely to be a toll charge for the sale that does not exist in the case of a contribution of a promissory note. On the sale of the property, the corporation must recognize gain to the extent that the amount of the note exceeds the adjusted basis of the property transferred to the shareholder.[33] While the corporation's gain may be deferred under the installment method of reporting until the shareholder makes payments under the note,[34] deferral is not permitted if the transferred property is depreciable.[35] If the corporation realizes a loss on the sale of property to the related shareholder, the loss is disallowed.[36]

Moreover, there is no statute preventing a taxpayer from including the amount of a purchase money mortgage in the basis of property other than stock. In contrast, section 358, which determines the basis of stock received in a section 351 transaction, provides no method for including a shareholder's promissory note in stock basis.

The Ninth Circuit, however, determined that Peracchi should include the amount of the note in the basis of his stock because the corporation's creditors could enforce the obligation in the event of NAC's bankruptcy. It is questionable whether such a contingency should be significant enough to require recognition of the note for tax purposes. In the normal course of events, the corporation will pay its debts as they become due. Peracchi's note would be used only as a matter of last resort.

Professor Elliot Manning has suggested that, in the case of a shareholder who issues a note to a controlled corporation, the transaction should remain open until the shareholder actually makes payments on the note.[37] In that case, each payment on the note would constitute a capital contribution, and the shareholder's stock basis would increase with each payment.[38] If the shareholder is required to pay the corporation's creditors pursuant to the terms of the note, the shareholder should be treated as making a capital contribution at that time.

Treating a shareholder's payments on the note as capital contributions makes sense if the corporation retains the note. It may be more difficult to view the payments as capital contributions if the corporation factors the note and the shareholder makes payments to a third party rather than to the corporation. The

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33. Section 1001(a), (c).
34. Section 453(a).
35. Section 453(g)(1)(A).
36. Section 267(a)(1). For this purpose, an individual and a corporation are related persons if the individual owns, directly or indirectly, more than 50 percent of the corporation's stock, by value. Section 267(b)(2).
37. Elliot Manning, "The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries," 39 *Tax L. Rev.* 159, 194 (1984). *See also* Michael M. Megaard & Susan L. Megaard, "Can Shareholder's Note Avoid Gain on Transfer of Excess Liabilities?" 71 *J. Tax'n* 244, 249 (Oct. 1989).
38. *Id.*

Ninth Circuit was concerned that if the transaction were left open, the corporation would not have sufficient basis in the note to offset the cash proceeds on a sale of the note.

It may not be necessary to give the corporation a basis in the shareholder's note when the note is issued to prevent the corporation from recognizing gain on a later sale of the note. If the corporation does not sell the note, the shareholder should be treated as making capital contributions to the corporation with each payment. In that case, shareholder's stock basis will increase as the payments are made. It is not necessary for the corporation to have any basis in the note to avoid gain recognition on each payment because capital contributions are not taxable to the corporation.[39]

Basis could be provided if and when the corporation sells the note.[40] It may be appropriate to treat the shareholder as making a capital contribution when the corporation realizes the value of the note by factoring it to an unrelated party. When the note is sold, the shareholder's obligation becomes fixed because the purchaser is more likely than the corporation to enforce the shareholder's obligation.

## V. LIMITING THE HOLDING TO C CORPORATIONS

If the Ninth Circuit was correct in holding that a shareholder has a basis in the shareholder's own note, there is no basis for limiting the holding to C corporation shareholders. The identity of the issuer of the note should not make a difference. A taxpayer incurs the same "cost" in issuing the note, regardless of whether the note is issued in exchange for stock in a C corporation, stock in an S corporation, or an interest in a partnership. Moreover, if the note is sufficient consideration to avoid gain recognition under section 357(c), it should not matter whether the shareholder is a C corporation shareholder or an S corporation shareholder. The rules that apply to C corporations and their shareholders generally apply to S corporations and their shareholders, except as otherwise provided and except to the extent that they are inconsistent with subchapter S.[41] The Service has ruled that section 357 applies to an S corporation.[42] If section 357(c) applies to an S corporation, the rules concerning its application should be consistent under both subchapters C and S.

In limiting its holding to C corporation shareholders, the Ninth Circuit also seems to have ignored some of the rules of partnership tax. The transfer of a partner's promissory note may increase the basis of the partner's interest in a partnership. Under subchapter K, each partner's share of a partnership liability

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39. Section 118(a).

40. *See* Jasper L. Cummings, Jr., "Zero Basis Hoax or Contingent Debt and Failure of Proof? Sorting Out the Issues in the *Lessinger* Case," 2 *Fla. Tax Rev.* 283, 320 (1994).

41. Section 1371(a).

42. *See, e.g.*, LTRs 8647059; 8613051; 8545099.

is included in the adjusted basis of the partner's interest in the partnership.[43] Under the rules for determining a partner's share of partnership liabilities, the transfer of the partner's promissory note to a partnership may cause the partner's share of partnership liabilities to increase.

Treasury regulations issued under subchapter K provide that a partner's share of a partnership's recourse liability is the amount of the liability that the partner or a person related to the partner would be required to pay if the partnership were unable to make payments.[44] In determining the amount of a partnership's liabilities that the partner or a related person would be required to pay, all statutory and contractual obligations are taken into account, including rights of reimbursement.[45] If the terms of a partner's promissory note would require the partner to make payments to the partnership's creditors for which no other partner (or person related to another partner) were liable, the promissory note will be taken into account in determining the partner's share of partnership liabilities, thereby increasing the adjusted basis of the partner's interest in the partnership.[46]

Thus, subchapter K recognizes, for tax purposes, the economic effect of the contribution of a partner's promissory note. Such an approach makes sense in the partnership context because a partnership often is considered as an aggregate of its partners rather than a separate entity. Unlike corporate shareholders, partners share in partnership liabilities. The contribution of a promissory note to a partnership only determines the amount of the partnership's liabilities, if any, that will be allocated to the contributing partner. Permitting a shareholder to increase stock basis on the contribution of a promissory note to a controlled corporation does not serve the same purpose.

Under the debt-sharing rules of partnership tax, a partner does not have any basis in the partner's own note. A contribution of a partner's promissory note

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43. Under section 752(a), any increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership. The basis of a partner's interest in a partnership includes the amount of money contributed by the partner to the partnership. Section 722.

44. Reg. section 1.752-2.

45. Reg. section 1.752-2(b)(3).

46. A partner is considered to bear the economic risk of loss for a partnership liability to the extent of the value of any property that the partner contributes to the partnership solely for the purpose of securing a partnership liability. Reg. section 1.752-2(h)(2). For this purpose, however, a partner's promissory note is not taken into account unless the note is readily tradeable on an established securities market. Reg. section 1.752-2(h)(4). Even if a partner's promissory note is not readily tradeable, however, the partner's promissory note may constitute a general obligation that is taken into account under reg. section 1.752-2(b)(3) in determining whether the partner bears the ultimate economic risk of loss with respect to a partnership liability. If the terms of the promissory note would require the contributing partner to pay part or all of a partnership liability without any reimbursement, the partner bears the economic risk of loss with respect to that portion of the liability. *See* Arthur B. Willis, John S. Pennell & Philip F. Postlewaite, *Partnership Taxation* para. 6.03[3][b] n.199 (6th ed. 1997). A partner's promissory note will be disregarded, however, if the note is subject to contingencies that make it unlikely that the partner's obligation under the note will ever be discharged. Reg. section 1.752-2(b)(4).

to a partnership will not increase the basis of partner's interest in the partnership unless the partnership has outstanding liabilities and the note causes the partner to bear the ultimate economic risk of loss for a partnership liability. Nevertheless, in permitting a C corporation shareholder, but not a partner, to increase basis in an equity interest on the transfer of a promissory note, the Ninth Circuit seems to have confused subchapters C and K.

## VI. PROPOSALS TO AMEND SECTION 357(C)

Notwithstanding the opinions of two circuit courts, it seems that the language of the code does not allow a shareholder to avoid recognizing section 357(c) gain by transferring a promissory note to the corporation. Only Congress can provide such a result. Two proposals have been suggested for amending section 357(c) that would, in many cases, eliminate the problem faced by the taxpayers in *Lessinger* and *Peracchi*. This Section discusses each proposal and the effect it would have.

### *A. President Clinton's Proposal*

President Clinton's 1999 fiscal year Budget contains a proposal that would amend section 357(c) to prevent gain recognition on a transfer of encumbered property to a corporation if the shareholder remained personally liable for repayment of the liabilities. Presumably, such liabilities would be disregarded, both for purposes of determining whether the shareholder recognizes section 357(c) gain and for purposes of computing the shareholder's stock basis under section 358. Disregarding such liabilities under section 358 would prevent the shareholder from taking the stock with a negative basis. Disregarding the liabilities is consistent with the current rules that disregard liabilities, such as accounts payable, that would give rise to a deduction.[47]

In many cases, the president's proposal would eliminate the issue of whether the transfer of a promissory note is sufficient to eliminate gain recognition under section 357(c). Absent the potential for gain recognition under section 357(c), it is unlikely that taxpayers who are personally liable for debts transferred to controlled corporations will also transfer their promissory notes.

The proposal, however, would not eliminate the issue in a case where a shareholder transfers a promissory note to a corporation along with property subject to nonrecourse liabilities. On the one hand, a court could hold, like the Ninth Circuit, that the shareholder has a face-amount basis in the promissory note and may avoid gain recognition under section 357(c) even if the amount of the nonrecourse liabilities exceeds the adjusted basis of the transferred property. On the other hand, a court could agree with Tax Court precedent and hold that a taxpayer has no basis in the taxpayer's own note. Accordingly, it is uncertain

47. Sections 357(c)(3)(A), 358(d)(2).

whether, under the president's proposal, the transfer of a promissory note would eliminate section 357(c) gain on a transfer of nonrecourse liabilities in excess of basis.

It also is not clear under the president's proposal whether a shareholder who is not taxed on the transfer of a liability to a controlled corporation would have to recognize income later when the corporation makes payments with respect to the debt. If the shareholder remains personally liable for repayment of such a debt, each payment to the creditor by the corporation confers an economic benefit upon the shareholder and should be treated as a constructive distribution, taxable as a dividend to the extent of the corporation's earnings and profits.[48]

### B. *The Senate Amendment*

On May 7, 1998, the Senate approved an amendment to the Internal Revenue Service Restructuring and Reform Act of 1998 that would require a shareholder to recognize gain on the transfer of liabilities in excess of basis only if the corporation assumed the liability.[49] For this purpose, a liability would be treated as having been assumed to the extent that the transferor is relieved of the liability or any portion thereof, as determined on the basis of the facts and circumstances.[50] In the case of a transfer of property subject to a nonrecourse liability, the corporation would be treated as assuming a ratable portion of the liability, determined on the basis of the relative fair market values of all assets subject to the liability unless the facts and circumstances indicate otherwise.[51]

The Senate's proposed amendment also would amend section 358 to disregard liabilities that are not assumed by the corporation in computing the shareholder's stock basis.[52] The Senate amendment, however, like the president's proposal, does not address the issue concerning the tax consequences to the shareholder when the corporation repays the liability.

## VII. SHOULD SECTION 357(C) BE REPEALED?

Two courts have allowed taxpayers to easily avoid recognizing section 357(c) gain by transferring their promissory notes to a wholly owned corporation. Both the president and the Senate have advocated eliminating section 357(c) gain when a shareholder remains personally liable for the repayment of liabilities transferred to a controlled corporation. While the Conference Committee

48. *See, e.g., Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972); *Gibbs v. Tomlinson*, 362 F.2d 394 (5th Cir. 1966); *Sachs v. Commissioner*, 277 F.2d 879 (8th Cir. 1960).

49. Internal Revenue Service Restructuring and Reform Act of 1998, H.R. 2676 section 3301A (May 7, 1998).

50. *Id.*, section 3301A(b), *adding* section 357(c)(4)(A).

51. *Id.*, section 3301A(b), *adding* section 357(c)(4)(B).

52. *Id.*, section 3301A(d), *amending* section 358(d)(1).

rejected the Senate amendment,[53] there seems to be strong support for it. Support for the amendment, however, may be misplaced.

In *Peracchi*, the Ninth Circuit implied that the only purpose of section 357(c) was to prevent a shareholder from receiving stock with a negative basis.[54] If preventing negative stock basis is the only purpose served by section 357(c), then there is no policy reason for retaining it, especially in cases where the shareholder remains personally liable for repayment of liabilities transferred to a corporation.[55] The Senate amendment would easily avoid the negative basis problem by disregarding the liabilities in computing the basis of the shareholder's stock.

Section 357(c), however, serves a purpose other than preventing negative stock basis. The legislative history of section 357(c) indicates that Congress enacted that provision as an "additional safeguard[] against tax avoidance. . . ."[56]

Requiring a shareholder to recognize gain on a transfer to a corporation of liabilities in excess of basis is appropriate, at least with respect to a transfer to a C corporation. When a shareholder transfers a liability to a C corporation, the corporation, and not the shareholder, generally will repay the liability with its own income, even if the shareholder remains personally liable for repayment. Thus, the transfer of the liability confers an economic benefit on the shareholder.

In many cases, the amount of the liability exceeds the basis of the encumbered property because the shareholder has enjoyed the benefits of depreciation deductions with respect to the encumbered property. When a taxpayer purchases property with borrowed funds, the taxpayer includes the borrowed amounts in the basis of the property for purposes of computing depreciation deductions.[57] The taxpayer receives the benefit of an increased basis in the asset because it is assumed that the taxpayer will repay the debt.[58] When the taxpayer transfers the property to a C corporation, however, the premise upon which the earlier deductions were based is no longer correct. As a result of the transfer, it is most likely that the corporation, and not the shareholder, will repay the debt, and the shareholder's stock basis must reflect the corporation's assumption of the liability.

53. Conf. Rep. No. 105-206, Internal Revenue Service Restructuring and Reform Act of 1998, 105th Cong., 2d. Sess. 189 (1998).

54. *Peracchi*, 143 F.3d, at 491 n.9. *See also* Bogdanski, *supra* note 15, at 354 (*raison d'etre* of section 357(c) is to prevent negative basis); George Cooper, Comment, "Negative Basis," 75 *Harv. L. Rev.* 1352, 1358-60 (arguing that Congress enacted section 357(c) only to prevent negative basis); Fleming, *supra* note 26, at 27-28.

55. Indeed, several commentators have suggested that there would be no problem in permitting a shareholder to avoid recognizing section 357(c) gain and to receive stock with a negative basis. *See, e.g.*, Cooper, *supra* note 54; Fleming, *supra* note 26, at 27-29.

56. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 40 (1954), *reprinted in* 1954 *U.S. Code Cong. & Admin. News* 4017, 4066.

57. Crane, *supra* note 32.

58. *Id. See also Commissioner v. Tufts*, 461 U.S. 300, 307-09 (1983).

The gain recognized under section 357(c) when the liability exceeds the adjusted basis of the transferred property is consistent with the tax benefit rule. Under the tax benefit rule, a taxpayer must recapture, in the current taxable year, amounts that gave rise to a deduction or other tax benefit in an earlier year if an event occurring in the current year is inconsistent with the premise upon which the earlier deduction was based.[59]

In other cases, the amount of the liability will exceed the adjusted basis of the transferred property because the shareholder used the loan proceeds for a purpose other than acquiring or improving the property. In such a case, the shareholder received the loan proceeds tax-free because it was presumed that the shareholder would repay the liability. As in the case of a purchase money mortgage, the transfer of the property subject to the mortgage to a C corporation is an event that is inconsistent with the premise upon which the earlier tax benefit was based because it is most likely that the corporation will repay the debt. Accordingly, the shareholder's stock basis is reduced and the shareholder must recognize section 357(c) gain to the extent that the amount of the liability exceeds the adjusted basis of the transferred property.

Professor J. Clifton Fleming, Jr., has rejected the depreciation recapture rationale or the loan recapture rationale for section 357(c) because section 357(c) functions too erratically to be explained on this basis.[60] Professor Fleming uses the following example to illustrate his point:

> Blackacre is a tract of raw land owned by A that A previously purchased for cash. A borrows $100, secured by a mortgage on Blackacre, and uses the money as working capital in an unrelated retail business. Later, A transfers Blackacre, still encumbered by the $100 debt, to Newco in exchange for all of it stock. If A paid $10 when A purchased Blackacre, A has $90 of section 357(c) gain on the exchange with Newco; however, if A paid $50 for Blackacre, A has $50 of section 357(c) gain, and A has none if the cost was $100 or more. This range of results occurs in spite of the fact that in each of these three situations, A received $100 tax-free in the loan transaction and is shifting the repayment obligation to Newco. Thus, it is difficult to justify section 357(c) by characterizing is as a device which insures that debtors will include unrepaid loan funds when they transfer the repayment burden to a controlled corporation in a section 351 exchange.[61]

Notwithstanding the range of results in Professor Fleming's example, section 357(c) can be justified as a depreciation recapture or loan recapture provision. In the example, A's basis in Blackacre represents A's initial investment in the

59. *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983).

60. Fleming, *supra* note 26, at 24.

61. *Id.* (Footnote omitted.)

property. In transferring Blackacre to Newco, A not only enjoys the benefit of relief of the liability, but A also gives up property in which A has invested cash. To the extent that the $100 liability exceeds A's investment, A realizes an economic benefit on the transfer of the encumbered property to Newco. If Blackacre had been depreciable property, A would give up the opportunity to claim future depreciation deductions to the extent of A's undepreciated basis in Blackacre. Thus, on the transfer, A realizes an economic benefit only to the extent that the transferred liability exceeds A's undepreciated basis in Blackacre.

Arguably, the tax results under section 357(c) are more favorable to taxpayers than they should be. When a taxpayer transfers property to a controlled corporation in a section 351 transaction, the taxpayer does not recognize gain or loss if the taxpayer receives nothing other than stock in the transferee corporation.[62] Nonrecognition is appropriate because the taxpayer's investment in the transferred property continues through the taxpayer's investment in the corporation. However, a taxpayer who transfers property to a controlled corporation is required to recognize gain to the extent of any money or property other than stock in the transferee corporation ("boot") received in the same transaction.[63] Gain recognition on the receipt of boot in a section 351 transaction is appropriate because, to the extent that the shareholder receives boot, the shareholder has "cashed-in," or withdrawn the shareholder's investment in the transferred property.

Before section 357 was enacted, the Supreme Court had held, in an analogous reorganization transaction, that when a taxpayer transferred liabilities to a corporation, the full amount of the transferred liabilities constituted boot.[64] Realizing that such a rule would inhibit corporate formations, Congress enacted the predecessor of section 357(a).[65] Section 357(a) provides the general rule that the transfer of a liability to a corporation in a section 351 transaction is not treated as boot.

The shareholder pays for the tax-free relief of the liability, however, in the form of a reduction in the shareholder's stock basis.[66] To the extent that the shareholder cannot make an immediate payment for the relief of liabilities because the shareholder has insufficient basis in the transferred property, section 357(c) requires the shareholder to recognize gain.

Moreover, the tax consequences to the shareholder might be worse if the proposed amendments to section 357(c) are adopted. When the corporation later repays a liability for which a shareholder is personally liable, each payment should constitute a constructive distribution, taxable as a dividend to the extent of the corporation's earnings and profits.[67] A constructive dividend does not

62. Section 351(a).
63. Section 351(b).
64. *United States v. Hendler*, 303 U.S. 564 (1938).
65. H.R. Rep. No. 855, 76th Cong., 1st Sess. (1939), *reprinted in* 1939-2 C.B. 504, 518-19.
66. Section 358(a)(1), (d)(1).
67. *See* cases cited *supra* at note 48.

result on the corporation's payment of liabilities transferred in a section 351 exchange because the tax consequences of the assumption already have been taken into account by virtue of the reduction in the shareholder's stock basis.[68]

Thus, if section 357(c) were amended to preclude gain recognition on a transfer to a corporation of liabilities for which a shareholder remained personally liable, the shareholder ultimately would pay tax on all payments of principal and interest with respect to the liability. Under current law, the shareholder only pays tax on the amount by which the liability exceeds the total adjusted basis of the property transferred to the corporation in the same transaction. In some cases, the gain recognized under section 357(c) is capital gain,[69] whereas a constructive dividend results in ordinary income to the shareholder. The greater amount of tax liability that could be incurred may outweigh any economic benefit that may be achieved by the deferral of the tax liability under the proposed amendment to section 357(c).

On the other hand, there may be a stronger argument for repealing section 357(c) with respect to a transfer of encumbered property to an S corporation. Unlike a C corporation shareholder, an S corporation shareholder does not enjoy an economic benefit on the transfer of encumbered property to a wholly owned corporation. While corporate profits, rather than the shareholder's separate assets, may be used to repay the liability, the profits of an S corporation actually belong to the shareholder.

Under subchapter S, the income of an S corporation is taxed to the shareholder, and not to the corporation, regardless of whether the corporation's income is distributed,[70] and distributions of previously taxed income generally are tax-free to the shareholder.[71] Thus, the corporation will repay the liability with income on which the shareholder has paid tax. The corporation's repayment of a liability also reduces the amount of cash that the corporation has available to distribute tax-free to the shareholder. Accordingly, a shareholder should not incur a tax liability on the transfer of encumbered property to an S corporation. Instead, the repayment of the liability by the corporation should be treated as a constructive distribution to the shareholder. To the extent that the repayment

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68. *See* Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* para. 8.05[8], at n.221 (6th ed. 1994). *Cf. Jewell v. United States*, 330 F.2d 761, 764-67 (9th Cir. 1964); *Stockton Harbor Indus. v. Commissioner*, 216 F.2d 638, 646, 649-50 (9th Cir. 1954), *cert. denied*, 349 U.S. 904 (1955).

69. If a shareholder transfers a capital asset or section 1231 property to a corporation, the character of the shareholder's section 357(c) gain is capital or section 1231 gain (except for depreciation recapture) unless the shareholder owns, directly or indirectly, more than 50 percent of the corporation's stock and the property is depreciable in the hands of the transferee-corporation. Section 1239.

70. Section 1363, 1366(a).

71. The income that flows through to the shareholder increases the shareholder's stock basis. Section 1367(a)(1). A distribution generally is tax-free to an S corporation shareholder to the extent that the amount of the distribution does not exceed the adjusted basis of the shareholder's stock. Section 1368.

comes from income on which the shareholder already has paid tax, the constructive distribution should be tax-free to the shareholder.

Subchapter S is designed to allow owners of a closely held corporation to enjoy many of the benefits of flow-through taxation that are available to partners under subchapter K. If section 357(c) were amended to prevent gain recognition by a shareholder on the transfer of encumbered property to an S corporation if the shareholder remained personally liable for repayment of the debt, subchapter S would more closely resemble subchapter K.

A partner seldom recognizes gain on the transfer of encumbered property to a partnership, even if the amount of the liabilities exceeds the basis of the transferred property. If a partner transfers encumbered property to a partnership in exchange for a partnership interest, the basis of the partner's interest in the partnership includes the portion of the liability for which the partner bears the economic risk of loss.[72] If the contributing partner alone remains personally liable for repayment of a debt encumbering the transferred property, the partner includes the liability in the basis of the partner's interest in the partnership and does not recognize gain on the transfer.[73]

There may be a problem, however, in applying subchapter K principles to an S corporation in this context. When a partnership makes payments with respect to a liability, each payment is treated as a distribution of money to the partner that included the liability in the basis of the partner's interest in the partnership.[74] If an S corporation has more than one shareholder, the deemed cash distribution to only one shareholder on the payment of a liability could cause the S corporation to have more than one class of stock.

An S corporation may have only one class of stock.[75] If an S corporation ceases to have only one class of stock, its subchapter S election will terminate.[76] Under Treasury regulations, an S corporation is treated as having one class of stock only if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds.[77] The determination of whether all outstanding shares of stock in an S corporation confer identical rights to distribution and liquidation proceeds is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements (collectively referred to as "binding agreements").[78]

Under these rules, the deemed distribution to the shareholder on the corporation's repayment of the shareholder's debt could be treated as conferring

72. Section 752(a); reg. section 1.752-2(a).
73. *See* reg. section 1.752-1(g) Example.
74. A partner is treated as receiving a distribution of money to the extent that the partner's share of partnership liabilities is decreased. Section 752(b). As the partnership makes payments with respect to the liability, the partner's share of that liability necessarily decreases.
75. Section 1361(b)(1)(D).
76. Section 1362(d)(2).
77. Reg. section 1.1361-1(l)(1).
78. Reg. section 1.1361-1(l)(2)(i).

disproportionate rights to distribution proceeds among the shareholders. Under the regulations, a constructive distribution that results when state law requires an S corporation to withhold state income tax in behalf of some shareholders (such as nonresidents) can cause the corporation to have more than one class of stock unless the corporation makes actual distributions to the other shareholders to account for the difference.[79] Similarly, the deemed distribution to a contributing shareholder on the repayment of the debt could cause the corporation to have more than one class of stock unless offsetting distributions are made to the other shareholders.

On the other hand, some constructive distributions do not result in a finding that an S corporation has more than one class of stock. The regulations provide that a commercial contractual agreement, such as a lease, employment agreement, or loan agreement is not considered a binding agreement relating to distribution and liquidation proceeds and thus will not cause the corporation to have more than one class of stock unless the purpose of the agreement is to circumvent the one-class-of-stock rule.[80] Thus, for example, constructive distributions that result on the payment of excessive salary to an employee-shareholder and a below-market loan from an S corporation that results in a constructive distribution to the shareholder do not cause the corporation to have more than one class of stock.[81] The constructive distribution that would occur as an S corporation repaid a liability for which a shareholder was personally liable could be treated as a loan agreement for this purpose. If Congress enacts a provision permitting a shareholder to avoid section 357(c) gain on the transfer of encumbered property to a corporation, it may be necessary for Congress or the IRS to provide guidance with respect to the tax consequences of the repayment of the loan and the effect of the repayment with respect to the only-one-class-of-stock requirement for S corporations.

## VIII. CONCLUSION

There seems to be no support in the code for the Ninth Circuit's holding in *Peracchi*. In fact, *Peracchi* could create an opportunity for abuse. Under *Peracchi* a taxpayer may avoid section 357(c) gain by transferring a promissory note to a wholly owned corporation even though the taxpayer has no intention of making payments on the note. When the creditor is controlled by the debtor, there may be little incentive to enforce the debt.

While the shareholder's failure to make payments on the note would result in constructive distribution to the shareholder, the shareholder will have the benefit of deferring income until it is certain that the shareholder will not make

79. Reg. section 1.1361-1(l)(2)(ii).

80. Reg. section 1.1361-1(l)(2)(i).

81. *See* reg. section 1.1361-1(l)(2)(v) Example 3 (excessive salary), Example 5 (below-market corporation-shareholder loan).

the payments. Such deferral could last forever if nonpayment eludes detection. It is unlikely that the IRS will notice that a shareholder has failed to make payments on a promissory note issued to a wholly owned corporation unless the IRS audits the return of the corporation or the shareholder. Allowing a shareholder to avoid section 357(c) gain by transferring a promissory note to a wholly owned corporation places a heavy administrative burden on the IRS to monitor future transactions between the shareholder and the corporation.

Peracchi's contribution of the encumbered property was not tax-motivated. He was required to make the contribution to satisfy state premium-to-asset ratio requirements for insurance companies. It could be argued that it is unfair to require Peracchi to recognize section 357(c) gain on the transfer, especially because he remained personally liable for repayment of the transferred liabilities. Nevertheless, it would not be inequitable to require Peracchi to recognize gain. As a result of the transfer, the corporation is most likely to make payments on the transferred liabilities. In this respect, Peracchi enjoys an economic benefit on the transfer.

Notwithstanding the justification for section 357(c), both President Clinton and the Senate have proposed amendments to permit a taxpayer like Peracchi to avoid recognizing section 357(c) gain on the transfer of encumbered property to a controlled corporation if the taxpayer remains personally liable for repayment of the debt. While the amendments may not necessarily be appropriate for C corporation shareholders, they are particularly appropriate for S corporation shareholders. If Congress ever adopts the proposals, however, it will be necessary to provide further guidance with respect to the tax consequences to the shareholders and to the corporation when the corporation repays the liabilities.