THE MIDSTREAM INCORPORATION OF A CASH-BASIS TAXPAYER: AN UPDATE*

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Historically, a cash-basis proprietorship or partnership desiring to incorporate tax-free under section 351 was faced with a variety of tax problems. The first such problem concerned whether the transfer of zero-basis trade accounts receivable to a controlled corporation in exchange for its stock or securities resulted in the recognition of income to the transferor, either at the time of the incorporation transfer or at the later date when the accounts receivable were collected by the transferee corporation. Today, it seems clear that the cash-basis transferor will not be taxed on the gain inherent in the accounts receivable either at the time of their transfer to the corporation or at the time of their collection by the transferee corporation. Rather, the corporation will be taxed when it collects such receivables.4

A second question arising out of the incorporation of a cash-basis taxpayer concerned the tax consequences if the transferee corporation assumed5 previously undeducted trade accounts payable of the cash-basis transferor.6 The question was which party, if either, received a deduction for those payables. The traditional answer seemed to be that neither party received a deduction.7 It later

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1. Under the cash receipts and disbursements method of accounting, income is realized in the year that cash (or its equivalent) is received and deductions are taken in the year that payment is made. I.R.C. §§ 451(a), 461(a); Treas. Reg. § 1.446-1(c)(1)(i) (1957).
2. Unless otherwise noted, all section references in this Article are to the Internal Revenue Code of 1954, as amended. I.R.C. § 351(a) provides in 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.
3. Because a cash-basis taxpayer has neither paid for trade accounts receivable nor taken them into income, he has no cost basis in them. E.g., Raich v. Commissioner, 46 T.C. 604, 610 (1966).
4. See notes 52 to 68 and accompanying text infra.
5. For convenience, the assumption of liabilities by a corporation or the transfer to the corporation of property subject to liabilities will be referred to as the assumption of liabilities or liabilities assumed.
6. For a cash-basis taxpayer "amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid." Treas. Reg. § 1.461-1(a) (1957).
7. See notes 111 to 152 and accompanying text infra.

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appeared that only the transferee corporation would be given such a
deduction, but then only if it had entered into a prior closing
agreement with the Internal Revenue Service under which it agreed
to report as its income any trade accounts receivable transferred to
it.\textsuperscript{8} More recently, however, there has been an indication by the IRS
that, even in the absence of a prior ruling or closing agreement, the
Service will generally permit the transferee corporation a deduction
for the assumed trade payables of a cash-basis transferor, as long as
the corporation, in fact, reports the receivables as income.\textsuperscript{9} There has
not yet, however, been a definitive resolution of this problem by the
courts or by Congress, nor has the IRS published a ruling on this
subject.

A third question was whether, when a cash-basis taxpayer
transferred to a controlled corporation assets subject to previously
undeducted trade accounts payable, those trade payables would be
considered "liabilities" for purposes of sections 357(c)\textsuperscript{10} and 358(d).\textsuperscript{11} If so, the transferor would be required by section 358(d) to reduce the
basis of the stock and securities received in the exchange by the
amount of the trade payables. In addition, under section 357(c) he
would, to the extent that the trade payables, when combined with
other assumed liabilities, exceeded the total basis of the assets
transferred, be required to recognize immediate gain on the
incorporation transfer. The traditional response of the Tax Court
and the IRS was that the word "liabilities" as used in sections 357(c)
and 358(d) included trade accounts payable of a cash-basis
transferor.\textsuperscript{12} Then, in 1977, the Tax Court decided \textit{Focht v. Commissioner},\textsuperscript{13} in which it dramatically reversed its prior position.
The Tax Court held in \textit{Focht} that cash-basis accounts payable were
not "liabilities" for purposes of sections 357 and 358 if the payment
of such obligations by the transferor would have resulted in a
deduction for him.\textsuperscript{14} As part of the Revenue Act of 1978,\textsuperscript{15} Congress

\begin{enumerate}
\item Id.
\item See text accompanying notes 129 to 130 infra.
\item I.R.C. § 357(c), as amended in 1978, is quoted in full in the text accompanying
      notes 93 & 94 infra.
\item I.R.C. § 358(d), as amended in 1978, is quoted in full in the text accompanying
      notes 93 & 94 infra.
\item See notes 80 to 89 & 168 to 172 and accompanying text infra.
\item 68 T.C. 223 (1977). The government's appeal to the Third Circuit was
dismissed by agreement of the parties on March 27, 1978.
\item Id. at 229.
\end{enumerate}
amended sections 357(c) and 358(d) to "codify the approach taken by the Tax Court in the Focht case."\textsuperscript{16}

A fourth question in this area was whether the cash-basis transferor and corporate transferee would receive the tax results described above if the transferor (i) did not transfer all of his receivables or payables to the controlled corporation but retained part or all of the receivables or payables for collection or payment outside the corporation, or (ii) otherwise transferred his receivables and payables at such time or in such a manner as to cause a distortion of income. The answer under existing law is that the previously described tax consequences will not necessarily apply if any of the transfers are considered by the Service to be for tax avoidance purposes, or otherwise carried out in such a way as to cause a distortion of income. In such cases the Service still retains a variety of judicially developed and statutory weapons that it may use to prevent tax avoidance.\textsuperscript{18}

The legislative changes made in response to the Tax Court's Focht decision, and the indication of a more liberal approach by the Service regarding the transferee corporation's ability to deduct assumed cash-basis trade payables, present appropriate circumstances to review both the history and the current status of the various problems involved when a cash-basis business is incorporated. Part I of this Article reviews the basic structure of sections 351, 357, 358, and 362. Part II considers in detail the four special problems described above involved in the incorporation of an existing cash-basis business. Part II demonstrates quite clearly that the results reached by newly amended sections 357(c) and 358(d), when combined with those reached by the IRS in its private rulings, are correct as a matter of tax logic and are superior to other solutions that have previously been proposed to resolve these tax issues.

**PART I. THE BASIC STRUCTURE OF SECTION 351**

**A. Section 351 Generally**

Section 351 of the Internal Revenue Code provides that no gain or loss is recognized if property\textsuperscript{19} is transferred to a corporation


\textsuperscript{18} See notes 196 to 221 and accompanying text \textit{infra}.

\textsuperscript{19} Stock or securities received for services will not be considered as issued in exchange for "property." I.R.C. § 351(a). Property, in § 351, does, however, include cash. Rev. Rul. 69-357, 1969-1 C.B. 101. \textit{See generally} B. BITTKER & J. EUSTICE, \textit{FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS} § 3.03 (3d ed. 1971).
solely in exchange for stock or securities and immediately after the exchange the transferors are in control of the corporation. "The basic premise of section 351 is that a transfer of appreciated or depreciated property to a corporation controlled by the transferor works a change of form only, which should not be the occasion for reckoning up the transferor's gain or loss on the transferred property."24

Thus, if Individual A transfers a capital asset with a basis of $10,000 and a value of $50,000, and inventory with a basis of $30,000 and a value of $50,000, to his newly formed corporation in exchange for all of its stock, A will "realize" a $60,000 gain, but no gain will be "recognized" under section 351. A's realized gain is merely deferred by section 351, however, not permanently exempted. The mechanism of deferral is the carryover basis provision of section 358, which provides, generally, that a transferor takes a basis in the stock and securities received equal to the basis he had in the assets

20. The meaning of the word "stock" is reasonably clear and generally presents little difficulty. Considerably more difficulty is encountered in the definition of "securities." Courts, however, have concluded that long-term debt interests are ordinarily securities, while short-term interests are ordinarily not securities. See Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 468-69 (1933); Turner Constr. Co. v. United States, 364 F.2d 525, 535 (2d Cir. 1966). See generally B. BITTKER & J. EUSTICE, supra note 19, § 3.04, at 3-14 to -17.

21. Under I.R.C. § 351(a), the 80% control test of I.R.C. § 368(c) must be met "immediately after" the transfer. If a transferor, pursuant to a pre-arrangement, promptly sells shares received in the exchange, he does not own those shares "immediately after" the exchange for purposes of the control test. Treas. Reg. § 1.351-1(a)(1) (1955). There has been much litigation over the requirement that the transferors control the transferee corporation "immediately after the exchange." See, e.g., Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976); American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949). See generally B. BITTKER & J. EUSTICE, supra note 19, § 3.10.

22. Section 351 may apply to one transferor or a group of transferors if he or they meet the control requirements of the statute immediately after the exchange. The stockholdings of two or more transferors can be aggregated in determining whether they control the corporation "immediately after the exchange" if their transfers are part of a single transaction. Treas. Reg. § 1.351-1(a)(1) (1955); B. BITTKER & J. EUSTICE, supra note 19, § 3.10, at 3-32 to -33.

23. "Control" is defined in I.R.C. § 368(c) to mean ownership of "at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation."

24. B. BITTKER & J. EUSTICE, supra note 19, § 3.01, at 3-4.

25. The transfer of property to a corporation in exchange for stock and securities results in a realization of gain or loss to the transferor measured by the difference between the value of the stock and securities received and the basis of the property transferred. See I.R.C. § 1001(a). However, when I.R.C. § 351 applies, the realized gain is not recognized; that is, it does not currently enter into the computation of taxable income. Gain is postponed until the eventual disposition of the stock and securities.
transferred.  

In the above example, A's section 358 basis in the stock received will be $40,000 (the total basis he had in the capital asset and inventory transferred), and he will recognize the $60,000 realized but unrecognized gain only when he disposes of his stock.  

On disposition, the deferred gain will be recognized only as capital gain even though the assets originally transferred for the stock were both ordinary and capital assets.

There is a cost at the corporate level for the shareholder's deferral of gain and its possible conversion from ordinary income to capital gain. Under section 362(a), the corporation takes a basis in the property received equal to the transferor's basis in the property. In the example, the corporation's basis would be $30,000 in the inventory and $10,000 in the capital asset. It would presumably recognize $20,000 ordinary income and $40,000 capital gain if it immediately resold the two assets. There is thus a mirror image of the transferor's total deferred gain created at the corporate level. The transferor, A, has deferred $60,000 of potential gain, and the corporation too has $60,000 potential gain. As will be noted throughout this Article, this mirror image is reflected in all section 351 exchanges. The interplay of sections 351, 358, and 362 also allows for the possibility of a section 351 exchange resulting in a doubling up of

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26. If several classes of stock and securities are received, the carryover basis is allocated among the stock and securities received by the transferor in proportion to their relative fair market values. I.R.C. § 358(b)(1); Treas. Reg. § 1.358-2(b)(2) (1955).

27. In two respects, stating that A will recognize the $60,000 realized but unrecognized gain only when he disposes of the stock is not entirely correct:

(1) It ignores the fact that on a corporate sale of the transferred assets, the corporation too will recognize gain, see notes 29 to 30 and accompanying text infra, and will normally pay a tax on the gain recognized. The corporate tax paid will, of course, reduce the value of the corporation and thus the amount that the shareholder will receive on a later disposition of his stock. This illustrates the general observation that there is never a literal double tax on the same income in a Subchapter C corporation. Rather, there is one tax on the income at the corporate level and another tax at the shareholder level on the income less corporate taxes paid. See Clark, The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform, 87 Yale L.J. 90, 102 n.41 (1977).

(2) It also ignores the fact that, prior to A's disposition of the stock, he may receive the net after-tax earnings derived by the corporation on its sale of the transferred appreciated property as a distribution out of corporate earnings and profits. In such case A will effectively recognize the deferred gain (less corporate taxes paid) on the transferred property as ordinary dividend income at the time of the distribution, rather than as capital gain at the time of his disposition of the stock. See I.R.C. §§ 301, 316.

28. Stock is a capital asset and stock dispositions are generally treated without regard to corporate-level events and attributes. See Clark, supra note 27, at 107–08.

29. Each transferred asset retains the same basis in the hands of the corporation that it had in the hands of the transferor. P.A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718, 719–20 (7th Cir. 1940); I.R.C. § 362(a).
losses at the shareholder and corporate level, if the property transferred has a total value less than its adjusted basis.\textsuperscript{30}

B. The Effect of Boot on a Section 351 Transfer

Section 351 extends nonrecognition treatment only to the extent that stock or securities are received by the transferor. If money or other property other than such stock or securities is received, gain realized is recognized to the extent of such “boot.”\textsuperscript{31} Thus, in the above example, if A transferred the $50,000 of inventory (basis=$30,000) and $50,000 capital asset (basis=$10,000) to a controlled corporation in exchange for $90,000 of its stock and $10,000 cash, A would recognize $10,000 of his $60,000 realized gain. The remaining $50,000 would be deferred via the basis carryover mechanism of section 358. Under section 358(a) a transferor’s basis in the stock and securities received is his original basis in the property exchanged, decreased by the amount of money and the value of other boot received and increased by the amount of recognized gain. A’s basis in his stock would therefore be $40,000, that is, the $40,000 basis he had in the assets transferred plus the gain recognized on the transfer ($10,000), less the cash received ($10,000). When A disposes of the stock, assuming no change in the stock’s $90,000 value, he will recognize, as capital gain, the $50,000 realized but unrecognized gain.\textsuperscript{32} The $10,000 gain recognized on the section 351 exchange, on the other hand, will be partly capital and partly ordinary since the gain is attributable to the transfer of inventory, a noncapital asset, as well as to the capital asset.\textsuperscript{33}

Under section 362(a), the corporation increases its $40,000 carryover basis in the $100,000 worth of transferred assets by the $10,000 basis of gain recognized by the transferor. In the example, the $10,000 basis increase would have to be allocated between the

\textsuperscript{30} For example, if a shareholder transfers assets with a basis of $20,000 and a value of $10,000 to his controlled corporation in exchange for the corporation’s stock, he has created a potential $10,000 loss when he sells his stock, and an additional $10,000 loss when the corporation sells the transferred assets. \textit{But cf.} National Sec. Corp. v. Commissioner, 137 F.2d 600 (3d Cir.), \textit{cert. denied}, 320 U.S. 794 (1943) (predecessor of I.R.C. § 482 applied to deny loss to corporation when the transfer of the depreciated asset by the shareholder to the corporation was for tax avoidance purposes).

\textsuperscript{31} I.R.C. § 351(b).

\textsuperscript{32} \textit{But see} note 27 \textit{supra}.

\textsuperscript{33} When a transferor exchanges more than one asset, the Service has ruled that the boot he receives must be allocated on an asset-by-asset basis in proportion to the fair market value of each asset in order to determine both the amount and the character of the gain to be recognized. Rev. Rul. 68–55, 1968–1 C.B. 140.
inventory and the capital asset. Again we see the mirror image at the corporate level. Shareholder A has deferred $50,000 of gain, and the corporation has $50,000 of potential gain when it disposes of the transferred assets.

C. The Assumption of Indebtedness by the Transferee Corporation

Long before 1947, the year the Supreme Court decided Crane v. Commissioner, it had been established doctrine that, in a taxable sales transaction, a transferee's assumption of a transferor's personal liability was part of the amount realized. Crane made clear that this rule also applied when the transferee simply accepted property subject to a liability. Until 1939, however, the Code sections dealing with the tax-free transfer of property to a controlled corporation did not specifically cover the treatment of assumed liabilities. The Code said only that a transferor who otherwise met the conditions of the predecessor of section 351 would recognize realized gain to the extent he received "cash or . . . property" other than stock or securities. Yet, despite the Code's silence regarding the treatment of liabilities, "up to 1938 both taxpayers and the Government tacitly assumed that a corporate transferee's assumption of the obligations of a transferor . . . in a [tax-free] exchange did not give rise to the receipt by the [transferor] of such money or property as would necessitate the recognition of gain." But in United States v. Hendler, the Supreme Court held to the contrary, concluding that the assumption of indebtedness in a tax-free exchange should be treated as though the transferee had paid cash to the transferor. Realized gain was thus to be recognized to the extent of the liabilities assumed.

34. Precisely how the $10,000 increase is allocated between the inventory and the capital asset is not made clear by either the Code or the Regulations, but the result that would be consistent with the treatment at the shareholder level, supra note 33, would be one that increased the carryover basis of each transferred asset by the gain recognized on the transfer of such asset. See generally Rabinovitz, Allocating Boot in Section 351 Exchanges, 24 Tax. L. Rev. 337 (1969).
35. 331 U.S. 1 (1947).
37. 331 U.S. at 13-14.
38. Revenue Act of 1928, ch. 852, § 112(c)(1), 45 Stat. 817 (current version at I.R.C. § 351(b)).
40. 303 U.S. 564 (1938).
Congress's immediate response was to enact, in the Revenue Act of 1939, the predecessor of section 357(a),\textsuperscript{41} which restored the pre-
Hendler treatment of liabilities. Under this section, "[t]he amount of the liability [was] thus to be considered in computing the amount of gain or loss realized on the exchange but [was] to be disregarded in ascertaining the amount of the realized gain which [was] to be recognized at that time."\textsuperscript{42} This general rule continues today in section 357(a).\textsuperscript{43} As an example of the operation of this section, assume that Individual A transfers Blackacre, worth $100,000 with a basis of $25,000, to his controlled corporation in exchange for $80,000 of the corporation's stock and the assumption by the corporation of a $20,000 mortgage on the property. A's realized gain is $75,000, computed as follows:

\begin{align*}
\text{Amount Realized} & \quad \$100,000 \\
(\text{Value of stock received + liability assumed}) & \\
\text{Less: Basis} & \quad 25,000 \\
\text{Gain Realized} & \quad \$75,000
\end{align*}

A, however, recognizes no gain at the time of the transfer. The consideration he receives is stock, which is protected from the immediate recognition of gain by section 351(a), and the corporation's assumption of his liability, which is protected by section 357(a).

As a concomitant to the enactment of the predecessor of section 357(a), Congress enacted the basis rule now found in section 358(d). That section states that, solely for the purpose of computing the shareholder's basis in his stock and securities, liabilities are to be treated as money received in a section 351 exchange. In other words, the assumption of liabilities, while not causing the shareholder to recognize gain, does cause him to reduce the basis in the stock and securities he receives. Section 358(d) is necessary if section 357(a) is to result only in the deferral and not the exemption of gain. In the above example, A's basis in his stock would, under section 358, be $5,000 (his $25,000 basis in the transferred Blackacre less the $20,000 liability to which Blackacre was subject at the time of transfer). An immediate sale of his stock for its $80,000 fair market value would

\textsuperscript{41} Revenue Act of 1939, ch. 247, § 213(a), 53 Stat. 870 (amending Int. Rev. Code of 1939, ch. 1, § 112, 53 Stat. 4, by adding § 112(k)).

\textsuperscript{42} Surrey, supra note 39, at 15.

\textsuperscript{43} I.R.C. § 357(a) provides the general rule that the assumption of a liability by the acquiring corporation, or the corporation taking property subject to a liability, is not boot to the transferor in a § 351 exchange.
result in A's recognizing his $75,000 deferred gain. At the corporate level the mirror image persists. The corporation's basis in Blackacre under section 362(a) is $25,000, the same basis that A had in Blackacre. The liability is not considered in determining the corporation's basis.\footnote{44} An immediate sale of Blackacre by the corporation for its $100,000 value would therefore also bring the corporation a $75,000 gain.\footnote{45}

D. Tax Consequences When Liabilities Assumed Exceed Basis of Property Transferred

Section 357(a) states the general rule that the transferee corporation's assumption of the transferor's liabilities in a section 351 exchange is not treated as boot to the transferor. This rule, however, is subject to two exceptions. Under section 357(b), if any liability transferred to a controlled corporation is transferred for the principal purpose of avoiding federal income taxes or for a purpose which is not a bona fide business purpose, then all\footnote{46} of the liabilities transferred to the corporation by that transferor are treated as boot.\footnote{47} The second exception, section 357(c), is more pertinent to the present discussion. It provides generally that liabilities will be treated as boot in a section 351 exchange to the extent that "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."

The need for section 357(c) can be seen in the following illustration. Individual A transfers Blackacre, worth $100,000, with a

\footnote{44} Liabilities assumed by the corporation have no direct effect on the corporation's basis. Indirectly, however, liabilities may have such an effect if the liabilities assumed by the corporation cause recognition of gain at the transferor level under either § 357(b) or § 357(c). See notes 46 to 51 and accompanying text infra.

\footnote{45} But see note 27 supra, which considers the relationship between the tax paid by the corporation on its sale of the transferred assets and the gain finally realized by the transferor on a disposition of his stock.

\footnote{46} If any of the liabilities were assumed by the corporation for a forbidden purpose, then all of the liabilities assumed, including those assumed for good business purposes, are treated as boot. Treas. Reg. § 1.357-2(a) (1955).

\footnote{47} I.R.C. § 357(b) is normally applied in one of two situations: first, when a transferor has his controlled corporation assume his personal expenses, and second, when the transferor borrows on business property in anticipation of the incorporation, uses the borrowed funds for personal purposes, and has the corporation assume the liability. See Burke & Chisholm, Section 357: A Hidden Trap in Tax Free Incorporations, 25 Tax. L. Rev. 211, 215–26 (1970); Greiner, Behling & Moffett, Assumption of Liabilities and the Improper Purpose — A Re-examination of Section 357(b), 32 Tax Law. 111, 117–26 (1978).
basis of $25,000, and subject to a $50,000 mortgage, to his controlled corporation in exchange for $50,000 of the corporation's stock. A's realized gain on the transfer is $75,000, but under the general rule of section 357(a), he would recognize none.

Problems occur, however, when A's stock basis is computed. To insure that A is taxed on his entire $75,000 realized gain when he sells his stock for its $50,000 value, A would have to be given a negative basis of $25,000 in his stock — his $25,000 carryover basis in Blackacre less the $50,000 liability which it was transferred subject to. This negative basis might be justified by the plain language of section 358(d), which requires a reduction of basis by the amount of liabilities assumed. Courts, however, with one notable exception, have held that the basis of property cannot be reduced below zero. 48 But if, in this example, the stock's basis is simply reduced to zero, its subsequent sale for $50,000 would result in only $50,000 recognized gain; the other $25,000 of realized gain would never be taxed. Therefore, if section 357(a) was not to lead to the exemption rather than the mere deferral of gain in certain cases, the excess $25,000 had to be taxed at the time of the section 351 exchange. This is precisely what is accomplished by section 357(c). This section causes the amount by which the liabilities assumed ($50,000) exceed the total adjusted basis of the assets transferred ($25,000) to be taxed at the time the property is transferred to the corporation. A thus recognizes $25,000 of his $75,000 realized gain on the section 351 exchange, takes a zero basis in the stock he receives, and defers the $50,000 of realized but unrecognized gain until a subsequent sale of the stock. 49

The corporation's tax treatment again reflects a mirror image of the shareholder's deferred gain. The corporation, under section 362(a), takes a $50,000 basis in Blackacre (the carryover basis of $25,000 plus the $25,000 gain recognized by A under section 357(c)), and will report $50,000 of gain if it immediately sells the property for its $100,000 fair market value.

48. For example, in its decision in Crane v. Commissioner, 3 T.C. 585, 591 (1944), rev'd, 153 F.2d 504 (2d Cir. 1945), aff'd, 331 U.S. 1 (1947), the Tax Court rejected the concept of a negative basis and held that when the basis of property reached zero, no further adjustments may be made. The notable exception referred to in the text is Easson v. Commissioner, 294 F.2d 653, 657-58 (9th Cir. 1961), in which the Ninth Circuit would have allowed the taxpayer to postpone gain by taking a negative basis in the situation now covered by I.R.C. § 357(c). Accord, Parker v. Delaney, 186 F.2d 455, 459 (1st Cir. 1950) (Magruder, C.J., concurring), cert. denied, 341 U.S. 926 (1951). See generally Cooper, Negative Basis, 75 Harv. L. Rev. 1352 (1962).

49. But see note 27 supra.
Section 357(c) does not attempt to characterize the nature of the gain realized to the transferor. It merely serves as an exception to section 351's nonrecognition treatment. Gain recognized under section 357(c) "must be reported as ordinary income, long-term capital gain, or short-term capital gain according to the nature and the holding period of the transferred property." Under section 1.357-2(b) of the Regulations it appears that if more than one type of property is transferred, the recognized gain is simply allocated among the various classes of assets in proportion to their fair market values. In other words, if capital assets worth $50,000 and ordinary assets worth $50,000 are transferred to a corporation in a transaction to which section 357(c) applies, the recognized gain is one-half ordinary and one-half capital without regard to the assets which gave rise to the gain. This leads to "the absurd result that the transfer may give rise to ordinary income even though the only ordinary income assets transferred had a basis in excess of their fair market value."

PART II. SPECIAL PROBLEMS INVOLVED IN THE MIDSTREAM INCORPORATION OF A CASH-BASIS TAXPAYER

A. The Transfer of Cash-Basis Accounts Receivable

The transfer of zero-basis trade accounts receivable by a cash-basis taxpayer to a controlled corporation in a section 351 exchange for stock and securities raises two difficult issues. The first is whether accounts receivable constitute "property" within the meaning of section 351(a). If they do not, gain must be recognized by the transferor on the exchange. Second, even if the trade accounts receivable are "property" within the terms of section 351(a), there is a question as to whether the judicial assignment of income doctrine will require the transferor to recognize income as the receivables are collected by the transferee corporation.

The United States Court of Appeals for the Third Circuit dealt with both of these issues in the 1974 case of Hempt Bros., Inc. v. United States. In that case, the taxpayer was the corporate transferee of $662,000 of cash-basis accounts receivable in a section

50. B. Bittker & J. Eustice, supra note 19, § 3.07, at 3-27.
51. Rabinovitz, supra note 34, at 360. "Furthermore, assuming that the same method of allocation would be used in determining the transferee's basis, such an allocation results in a basis step-up for assets which have, in fact, decreased in value." Id. at 360-61.
351 exchange. The taxpayer claimed that it had no income when it collected the receivables, since the income should properly have been reported by the transferor partnership. The taxpayer's initial argument was that the term "property" as used in section 351 did not include accounts receivable and that therefore the gain "realized" by the transferor partnership upon the transfer of the receivables should have been "recognized" by the partnership at that time. The Third Circuit, however, found no difficulty in concluding that accounts receivable were in fact property for purposes of section 351. The court "failed to perceive any special reason why a restrictive meaning should be applied to accounts receivable so as to exclude them from the general meaning of property," noting that "receivables possess the usual capabilities and attributes associated with jurisprudential concepts of property law."

The more difficult issue for the court was the assignment of income issue. The taxpayer corporation argued that even if no income was properly reportable by the transferor partnership at the time of incorporation because of section 351, the judicial assignment of income doctrine caused the collection of the accounts receivable by the corporation to result in taxable income to the transferor partnership. The taxpayer relied "on the seminal case of Lucas v. Earl ... and its progeny for support of its proposition that the application of the [assignment of income] doctrine is mandated whenever one transfers a right to receive ordinary income." The Third Circuit, like the district court in the same case, was convinced, however, that "on balance," the assignment of income doctrine "must give way ... to the broad Congressional interest in facilitating the incorporation of ongoing businesses." It therefore held that, at least when the section 351 transfer of receivables is made for non-tax-avoidance purposes, as would be the case in the

53. Id. at 1175–76. The transferee corporation took this position at a time when the statute of limitations presumably had run against the transferor partners. Id. at 1176 n.4.
54. Id. at 1175. Cf., e.g., Midland-Ross Corp. v. United States, 485 F.2d 110, 119 (6th Cir. 1973) (accounts receivable — uncompleted, long-term contracts in this case — are property for § 337 purposes).
55. 490 F.2d at 1176 (citations and footnotes omitted).
57. 490 F.2d at 1178.
58. On the other hand, "income will not be shifted to the transferee if it appears that the exchange was motivated primarily by tax avoidance rather than being made for a legitimate business purpose." 354 F. Supp. at 1177–78 n.10. The transfer of accounts receivable for tax avoidance purposes is discussed in the text accompanying notes 196 to 217 infra.
typical incorporation of a cash-basis business, the policy of section 351 overrides the policy of the assignment of income doctrine.\textsuperscript{59}

Thus, under \textit{Hempt Bros.}, the transferor of cash-basis receivables in a section 351 exchange generally does not recognize income either on the incorporation transfer or at the time the accounts receivable are collected by the corporation. Rather the transferor’s realized gain on those receivables is deferred, via the basis carryover provision of section 358, until his eventual disposition of the stock.\textsuperscript{60} Under section 358, the stock received for the receivables takes the same zero basis as the cash-basis receivables.\textsuperscript{61} Similarly, pursuant to section 362(a), the transferee corporation takes a zero basis in the accounts receivable and reports ordinary income on their collection.\textsuperscript{62}

The Service’s internal ruling policy\textsuperscript{63} has, for many years, been consistent with the judicial treatment of zero-basis accounts

\textsuperscript{59} 490 F.2d at 1178. \textit{Accord}, Kniffen v. Commissioner, 39 T.C. 553 (1962), 
\textit{acquiesced in}, 1965–2 C.B. 5; Briggs v. Commissioner, 15 T.C.M. (CCH) 440, 447, 451 (1956). In both \textit{Briggs} and \textit{Kniffen} the Internal Revenue Service took the position that the assignment of income doctrine applied to a transfer of zero-basis accounts receivable to a controlled corporation even in the absence of a tax avoidance motive of the transferor. However, in both cases the courts ruled against the Service. The Service’s acquiescence in the \textit{Kniffen} case was an indication that it would no longer assert the assignment of income doctrine when the transfer was made for legitimate business purposes. That this was, in fact, the Service’s position was confirmed in \textit{Hempt Bros.}, in which the IRS contended that assignment of income was inapplicable. \textit{See} 354 F. Supp. at 1177–80. The IRS private ruling policy specifically adopts the \textit{Hempt Bros.} treatment of zero-basis receivables transferred in a § 351 transaction. \textit{See}, e.g., IRS Letter Ruling 7830010 (Apr. 14, 1978) [hereinafter cited as LTR 7830010]; notes 62 to 66 & accompanying text \textit{infra}.

This treatment of zero-basis accounts receivable was an unstated assumption in all of the § 357(c) cases discussed in the text accompanying footnotes 152 to 183 \textit{infra}. The § 357(c) cases begin from the premise that the accounts receivable come to the corporation with a zero basis and will be taxed to the corporation when collected by it. \textit{See}, e.g., Focht v. Commissioner, 68 T.C. 223, 223, 227 (1977).

\textit{But see} note 27 \textit{supra}.

\textsuperscript{60} The basis of accounts receivable to a cash basis taxpayer is zero. Raich v. Commissioner, 46 T.C. 604, 610 (1966); Rev. Rul. 69–442, 1969–2 C.B. 53.

\textsuperscript{61} Of course, if gain is recognized to the transferor, because he has received boot, or gain is recognized by him under § 357(b) or § 357(c), there is a basis increase to the corporation pursuant to § 362(a). Part of that increase will be allocated to the zero-basis accounts receivable, and therefore less than the total amount collected by the corporation on those accounts receivable will be income to the corporation. Apparently, whether the corporation is on a cash or accrual method, it will be required to report the amounts collected on accounts receivable acquired from its cash-method predecessor on the cash method. \textit{See} Hempt Bros., Inc. v. United States, 354 F. Supp. at 1181.

\textsuperscript{62} Since October 31, 1976 all private rulings, determination letters, and technical advice memoranda issued by the IRS have been available for public inspection. I.R.C. § 6110(a). Nevertheless, an IRS written determination (i.e. a private ruling, determina-
receivable in section 351 transactions. This private ruling position of the Service was fully explained in a 1970 article by a former Chief Counsel of the Internal Revenue Service:

It would seem that the basic policy of Section 351 is to recognize that the new corporation represents a substantial

tion letter, or technical advice memorandum) may not be used or cited as precedent. I.R.C. § 6110(j)(3). A private ruling is "a written statement issued by the National Office to a taxpayer . . . that interprets and applies tax laws to a specific set of facts." Treas. Reg. § 301.6110–2(d) (1977). Private rulings (letter rulings) apply only to the taxpayer who is the subject of the ruling. If the IRS decides to publish a private ruling (after deleting all identifying information) as a Revenue Ruling in its Internal Revenue Bulletin and Cumulative Bulletin, both taxpayers and IRS personnel may then rely on such published rulings as precedent. Treas. Reg. § 601.601(d)(2) (1973).

"A 'technical advice memorandum' is a written statement issued by the National Office to, and adopted by, a district director in connection with the examination of a taxpayer's return or consideration of a taxpayer's claim for refund or credit. A technical advice memorandum generally recites the relevant facts, sets forth the applicable law, and states a legal conclusion." Treas. Reg. § 301.6110–2(f) (1977). Although a technical advice memorandum is addressed to an IRS field office, its effect is very much like a private ruling, since it involves the determination of tax questions concerning a particular taxpayer. Like a private letter ruling, a technical advice memorandum is not currently usable as precedent by the IRS or any taxpayer.

"A 'determination letter' is a written statement issued by a district director in response to a written inquiry by an individual or an organization that applies principles and precedents previously announced by the National Office to the particular facts involved." Treas. Reg. § 301.6110–2(e) (1977). Determination letters, like private rulings and technical advice memoranda, are not usable as precedent.

64. See Hempt Bros., Inc. v. United States, 490 F.2d at 1178 n.9; Worthy, IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations, 32 J. TAX. 88, 90 (1970). The following paragraph is included in private rulings, see, e.g., IRS Letter Ruling 7801008 (Sept. 30, 1977), issued to cash-basis taxpayers who had transferred zero-basis accounts receivable to a controlled corporation:

Items which, but for the transfer, would have resulted in income or deduction to Transferor in a period subsequent to the transfer will constitute items of income or deduction to Transferee when received or paid by it. Transferee will have a zero basis for the income items so transferred. The proceeds received in collection of the income items will be included as ordinary income in computing the taxable income of Transferee. If Transferee disposes of all or any portion of the income items (other than by collection in the ordinary course of business) in any manner including but not limited to (a) a sale; (b) an assignment; (c) a pledge; (d) a taxable exchange; (e) nontaxable exchange (except in a transaction to which section 381 of the Code applies); (f) a gift or donation; (g) a dividend distribution; or (h) a distribution in partial or in complete liquidation, Transferee will include the face amount of the income items so disposed of in its gross income in the taxable year of the disposition. The amount so included in gross income will thereupon become the basis for income tax purposes of the income item in the hands of Transferee at the time of disposition. Where the income item does not have a face value, the sales proceeds in the case of an arms-length sale or fair market value in all other cases will be included in income in the taxable year of disposition. The term "items" is not limited to accounts receivable but includes any item the sale, exchange or disposition of which would have resulted in ordinary income in the hands of Transferor.
continuation of the business formerly conducted by the transferor. This policy would suggest the transferor should not be taxed on the accounts receivable and the new corporation should be taxed when it collects them. It is generally the practice of the Service to issue rulings to this effect in cases of a bona fide transfer of a going business to a new corporation, which is not carried out in such a way as to cause a distortion of income. It has also been the position of the Service to issue such rulings only if accompanied by closing agreements which require, as a condition to nonrecognition by the transferor, that the transferee corporation agrees that it will recognize income upon collecting the receivables, and that such income will be ordinary in character if it would have been ordinary in the hands of the transferor. The closing agreements contain certain other stipulations, one of which ordinarily is that any accounts payable of the transferor must be put into the new corporation along with the accounts receivable.65

Although the Service did, and still does, require a closing agreement before issuing a ruling with respect to the treatment of zero-basis accounts receivable transferred in a section 351 exchange, it has been quite clear, at least since Hempt Bros., that a taxpayer can rely on not being taxed on the receivables even without obtaining a prior ruling.66

Thus, the general rule today is that the cash-basis transferor of trade accounts receivable will not be taxed on the transfer of those receivables. Only the transferee corporation will be taxed when it collects them. As the former Chief Counsel noted, however, the IRS recognizes exceptions to this general rule. Recent private rulings67 confirm that the IRS may still use the assignment of income doctrine as well as other statutory weapons available to it when the receivables are transferred for tax avoidance purposes, or the transaction is otherwise carried out in such a way as to cause a distortion of income.68 These special cases are discussed in Section D

65. Worthy, supra note 64, at 90.
67. E.g., LTR 7830010, supra note 59. An IRS written determination (a private ruling, determination letter, or technical advice memorandum) may not be used or cited as precedent. I.R.C. § 6110(j)(3). See discussion in note 63 supra.
68. More specifically, the Commissioner may use his power under § 482 to allocate income and deductions among businesses controlled by the same interests, or his power under § 446(b) to change a taxpayer’s method of accounting to reflect clearly income. For a discussion of how these sections may be used by the Commissioner in the type of transaction under discussion, see notes 196 to 217 and accompanying text infra.
below. This tax avoidance caveat should, however, pose no problem for the taxpayer who transfers his zero-basis accounts receivable along with the other assets and liabilities of his ongoing cash-basis business to a controlled corporation.

B. *The Assumption by the Corporate Transferee of Deductible Trade Payables of the Cash-Basis Transferor When Total Liabilities Do Not Exceed Basis of Assets Transferred*

When a cash-basis taxpayer incorporates his business, he will often require the new corporation to assume or take subject to a variety of the business’ liabilities. Generally, as we have seen, the assumption of liabilities by a transferee corporation causes no problems of interpretation in an otherwise nontaxable section 351 exchange. Section 357(a) provides that liabilities are not “boot,” and therefore cause no recognition of gain to the transferor; under section 358(d), however, the transferor must generally reduce the basis in the stock and securities he receives by the amount of those liabilities.

Significant problems of interpretation do arise, however, when some or all of the liabilities assumed by the transferee corporation are trade accounts payable of a cash-basis transferor. At the time of a section 351 exchange, the transferor, as a cash-basis taxpayer, would not yet have taken a deduction for these liabilities.69 It must therefore be determined whether either the transferor or the transferee is entitled to a deduction for such liabilities, and if so, when such a deduction may be claimed. Before the 1978 Revenue Act, a determination was also required as to whether such cash-basis obligations were the types of liabilities which, under section 358(d), would cause the transferor to reduce his basis in the stock and securities received.

The advice that tax advisors traditionally gave a cash-basis client incorporating his business was to retain his trade accounts payable and pay them outside of the corporation.70 It was thought, with good reason, that if the trade payables were assumed and paid by the transferee corporation, the right to a deduction would be lost.

69. Under the cash method, deductions are taken in the year that payment is made. I.R.C. § 461(a); Treas. Reg. § 1.1446-1(c)(1)(i) (1957).

70. *E.g.*, Z. Cavitch, *Tax Planning for Corporations and Shareholders* § 4.03[2][d][i], at 4-36 (1974): “The clear moral is that, unless and until the courts or the Service resolve . . . [the issue of the deductibility of assumed cash basis trade payables] favorably to taxpayers, cash-basis accounts payable should be retained by the transferor and paid by him.” Normally, it was suggested that the transferor also retain sufficient accounts receivable to provide the cash flow to pay for the payables when they become due. *Id.*
to both the transferor and the transferee. The transferee was not entitled to the deduction because the liabilities were simply regarded as part of the price it paid to acquire the transferor's assets. The cash-basis transferor, it was thought, would not be entitled to a deduction for the payables because the expense was not in fact paid by him.\textsuperscript{71} It also went unquestioned that the IRS would require the transferor, under unamended section 358(d), to reduce his basis in the stock and securities received in the section 351 transaction by the amount of the trade payables assumed by the transferee corporation.\textsuperscript{72}

The assumptions on which the earlier advice rested have been altered by a combination of the congressional amendment of section 358(d), and a more liberal IRS position concerning the deductibility by a transferee corporation of assumed cash-basis trade accounts payable.\textsuperscript{73} With respect to basis reduction, section 358(d) was amended by the Revenue Act of 1978 to follow the Tax Court's decision in \textit{Focht v. Commissioner},\textsuperscript{74} which did not require a cash-basis transferor in a section 351 transaction to reduce his stock basis by an obligation assumed by his controlled corporation if the payment of that obligation would have been deductible if made by the transferor. As to the corporate deductibility of assumed payables, a recent National Office technical advice memorandum\textsuperscript{75} (LTR 7830010)\textsuperscript{76} suggests that the IRS will normally permit the corporate transferee to claim a deduction when it pays the assumed obligations of the cash-basis transferor even in the absence of a prior closing agreement. The issue regarding the permissibility of a corporate deduction upon payment of the payables by the corporation, was, however, specifically left open by the Tax Court in \textit{Focht},\textsuperscript{77} and by Congress in the 1978 Revenue Act.\textsuperscript{78}

This section of the Article will discuss the past and present approaches to taxing the transferor and transferee corporation when deductible obligations of a cash-basis transferor are assumed by a

\textsuperscript{71} See notes 105 to 151 and accompanying text infra.

\textsuperscript{72} See notes 80 to 89 and 168 to 172 and accompanying text infra.

\textsuperscript{73} See notes 90 to 99 and 129 to 130 and accompanying text infra.

\textsuperscript{74} 68 T.C. 223 (1977).

\textsuperscript{75} Technical advice memoranda and other private rulings issued by the National Office of IRS may not be used or cited as precedent by the IRS or the taxpayer. I.R.C. §6110(j)(3). See discussion in note 63 supra.

\textsuperscript{76} See note 59 supra. The ruling is quoted at text following note 130 infra.

\textsuperscript{77} 68 T.C. at 238.

\textsuperscript{78} In its report on the amendments to §§ 357(c) and 358(d), Congress stated that the amendments were not intended to "affect the corporate-transferees' tax accounting for the excluded liabilities." S. Rep. No. 1263, 95th Cong., 2d Sess. 2, 185 (1978), reprinted in [1978] U.S. Code Cong. & Ad. News 3, 190.
controlled corporation. This part is based on the premise that the total liabilities so assumed — both the deductible obligations and other liabilities — do not exceed the basis of the assets transferred to the corporation. The author’s conclusion from the forthcoming analysis is that correct results are achieved at the shareholder and corporate levels only when the IRS approach of LTR 7830010 is combined with that of the newly amended section 358(d).

The taxation of the transferor will be taken up first. Then the question of the propriety of a deduction at the corporate level will be considered. The following factual situation (referred to as Example I) will be used for purposes of analysis: Sole proprietor A, a cash-basis taxpayer in a service business, transfers two assets with a total $100,000 value to newly formed Corporation X, in exchange for $75,000 worth of Corporation X’s stock, and X’s assumption of a $25,000 salary obligation owed by A to one of his employees. The assets transferred are:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Accounts Receivable</td>
<td>0</td>
</tr>
<tr>
<td>Undeveloped Land (a capital asset)</td>
<td>50,000</td>
</tr>
<tr>
<td>$50,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

For purposes of simplicity, it will be assumed that Corporation X has other losses that will exactly offset any net income it will realize on the collection of the receivables and payment of the payables.79

(1) The Tax Treatment of the Transferor

(a) The Pre-Focht Tax Court Approach

Before Focht and the congressional amendment to section 358(d), both the Tax Court and the IRS agreed that the tax consequences for a transferor whose controlled corporation assumed his deductible obligations as part of a section 351 incorporation were as follows: the cash-basis transferor was not entitled to a deduction at any time,80 yet was required under section 358(d) to reduce his basis in the stock and securities received by the amount of the cash-basis trade payables assumed by the corporation.81 This approach

79. See note 27 supra.
80. See text accompanying note 106 infra.
81. Until the amendment of § 358(d) by the Revenue Act of 1978, it had been the position of the IRS and the Tax Court that deductible obligations of a cash-basis transferor were liabilities for § 358(d) purposes. See, e.g., Focht v. Commissioner, 68 T.C. 223 (1977). See also Truskowski, Section 358(d) and the Cash Basis Taxpayer, 56 Taxes 555 (1978).
always resulted in overtaxing the transferor.\textsuperscript{82} Because he reduced his stock basis by the amount of the assumed liabilities, the transferor was eventually taxed on the corporate assumption of the payables, but he was never allowed an offsetting deduction for the payment of those liabilities. To illustrate, in Example I, A’s overall economic gain on the transaction is $25,000; yet, under the Pre-Focht Tax Court Approach he recognized $50,000 of gain for income tax purposes if he sold the stock immediately after the section 351 exchange.\textsuperscript{83} This unjustified dichotomy between A’s economic gain and his eventual tax gain can be easily visualized if we consider, from both a cash flow and a tax viewpoint, each step A has taken in this transaction from start to finish.

<table>
<thead>
<tr>
<th>A’s Cash Receipt (or Expenditure)</th>
<th>Amount of A’s Taxable Income (or Deduction) Per Pre-Focht Tax Court Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) A acquires a $50,000 trade account receivable by performing services.</td>
<td>None</td>
</tr>
<tr>
<td>(2) A incurs a $25,000 salary obligation to his employee.</td>
<td>None</td>
</tr>
<tr>
<td>(3) A purchases land for $50,000.</td>
<td>($50,000)</td>
</tr>
<tr>
<td>(4) A transfers the land and the trade account receivable to Corporation X for $75,000 stock, and X assumes A’s $25,000 salary obligation.</td>
<td>None</td>
</tr>
</tbody>
</table>

\textsuperscript{82} See notes 83 to 88 and accompanying text infra; Truskowski, \textit{supra} note 81.

\textsuperscript{83} Because unamended § 357(c) was inapplicable when the total liabilities (including deductible payables) assumed by a controlled corporation did not exceed the total basis of the assets transferred, see notes 46 to 51 and accompanying text supra, the overtaxation of the transferor in the non-§ 357(c) situation was not immediate. It was a deferred overtaxation, with the overtaxation occurring only when the transferor disposed of his stock. The § 357(c) situation, which resulted in the immediate overtaxation of the transferor, was clearly more dramatic. Thus, all of the decided cases and most of the commentary have dealt only with situations in which § 357(c) applied, virtually ignoring the fact that the transferor was overtaxed, even in the absence of § 357(c), every time he transferred deductible obligations to a controlled corporation. But see Truskowski, \textit{supra} note 81. While commentators traditionally warned cash-basis taxpayers that neither the transferor nor transferee would be entitled to a deduction if trade payables were transferred to a controlled corporation, see note 70 supra, they almost never completed the analysis by considering the deferred overtaxation of the transferor that resulted if he had to reduce his basis under § 358(d) by the deductible obligations. But see Truskowski, \textit{supra} note 81.

\textsuperscript{84} See I.R.C. § 1012.

\textsuperscript{85} The $50,000 basis in the property transferred less the $25,000 liability assumed by the corporation.
(5) Corporation X pays the $25,000 liability.

(6) A immediately resells the stock for $75,000.\textsuperscript{86}

\begin{tabular}{|c|c|c|}
\hline
\textbf{A's Cash Receipt (or Expenditure)} & \textbf{Amount of A's Taxable Income (or Deduction)} & \textbf{Pre-Focht Tax Court Approach} \\
\hline
None & None & \\
\hline
$75,000 & $50,000\textsuperscript{87} & \\
\hline
\$25,000 & \$50,000 & \\
\hline
Cash & Taxable Income & \\
\hline
\end{tabular}

The chart clearly shows that A's taxable income exceeds his economic income by $25,000.\textsuperscript{88}

There are two possible ways to bring A's tax consequences in line with his actual economic gain. One approach is that which was finally taken by Congress when it amended section 358(d) to codify the Focht decision. Under the Focht-Congressional Approach, discussed in detail in subsection (b) below, Individual A is not provided with a deduction for the salary obligation, but neither is he required to reduce his stock basis by that obligation. An alternative to the Focht-Congressional Approach might have been one that required Individual A to reduce his basis in the stock by the $25,000 liability assumed by the corporation, but permitted A a $25,000 deduction for the salary obligation, either when assumed or when

\textsuperscript{86} If we assume (contrary to the facts of Example I) that the corporation, in fact, paid some tax on the net income resulting from its collection of the receivables and payment of the payables, A will no longer be able to resell the stock for $75,000. Rather he will be able to resell it only for $75,000 less the corporate tax paid, which payment will reduce the value of the stock. See note 27 supra. That would, of course, in no way change the text's conclusion that A is being taxed on $25,000 more than his economic income.

\textsuperscript{87} If the stock in Example I is sold by A in less than one year, the sale will produce both short-term and long-term capital gain. "On selling stock or securities received tax-free under § 351(a), the transferor determines his holding period under § 1223(1) by including . . . the period during which he held the transferred property, provided the transferred property was either a capital asset or a § 1231(b) asset." B. Bittker & J. Eustice, supra note 19, § 3.11, at 3–42. Because, in Example I, accounts receivable, a noncapital asset, as well as a capital asset were transferred, it is "necessary to make an allocation under § 1223(1), with the result either that some of the shares or securities received will have a holding period dating from the § 351 exchange while others will have longer holding periods, or that each share or security will be divided for holding period purposes." Id.

\textsuperscript{88} The problem of overtaxation does not arise for an accrual-basis transferor of assets subject to trade payables. At the time of the incorporation in Example I, an accrual-basis taxpayer would have already included the $50,000 trade accounts receivable in income, and would have deducted the $25,000 salary obligation. See Treas. Reg. § 1.446-1(c)(1)(ii) (1957). For an accrual-basis taxpayer (not using a bad
paid by the corporation.89 This alternative approach is discussed in subsection (c) below under the heading “The Deduction Approach.”

(b) The Focht-Congressional Approach

In its 1977 decision in Focht v. Commissioner90 the majority of the Tax Court held that, to the extent a cash-basis transferor’s obligation, assumed by a controlled corporation, “would have been deductible by him upon his payment, such obligations are not to be

---

<table>
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<tr>
<th>Amount of A’s Income (or Deduction)</th>
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</tr>
</tbody>
</table>

Total +$25,000

Thus, for the accrual-basis taxpayer the economic and tax gain are the same — $25,000. Although the accrual-basis taxpayer has been required to reduce his basis by the liability assumed by the corporation, he has been given, prior to the incorporation, a tax benefit in the form of a deduction for that liability. For the treatment of the transfer of accrual-basis accounts receivable subject to a bad debt reserve in a § 351 exchange, see Rev. Rul. 78–280, 1978–2 C.B. 139.

89. The Deduction Approach would generally put the cash-basis transferor in the same position with respect to the accounts payable as the accrual-basis taxpayer. See note 88 supra. But, for the cash-basis taxpayer, if the zero-basis accounts receivable are still taxed at the corporate level, there will be a distortion of income. The deduction for the payables will be taken at the transferor level while the related income from the collection of the accounts receivable will be reported at the corporate-transferee level. This problem is discussed in the text accompanying notes 196 to 217 infra.

90. 68 T.C. 223 (1977).
treated as liabilities for purposes of sections 357 and 358.”91 As part of the Revenue Act of 1978 Congress amended both sections 357(c) and 358(d) in order to “codify the approach taken by the Tax Court in Focht.” Those sections, as amended,92 now read as follows:

[Section 357(c)]

(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.

. . . .

(3) Certain Liabilities Excluded.—

(A) In general

—If—

(i) the taxpayer’s taxable income is computed under the cash receipts and disbursements method of accounting, and

(ii) such taxpayer transfers, in an exchange to which section 351 applies, a liability which is either—

(I) an account payable payment of which would give rise to a deduction, or

91. Id. at 238. The Tax Court was not the first court to read the word “liabilities” in §§357 and 358 in a nonliteral manner. In Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972), the Second Circuit came quite close to writing the same decision as did the majority of the Tax Court in Focht. The Bongiovanni decision was somewhat ambiguous, however, and left commentators concerned about the precise kind of liabilities that were to be excluded from the §357(c) definition, and concerned also that the decision did not extend to §358(d). See, e.g., Bittker & J. Eustice, supra note 19, §3.07, at 3–27 n.38 (Supp. No. 3, 1978); Kahn & Oesterle, A Definition of “Liabilities” in Internal Revenue Code Sections 357 and 358(d), 73 Mich. L. Rev. 461, 479 (1975); Comment, Incorporating a Cash Basis Business: The Problem of Section 357(c), 34 Wash. & Lee L. Rev. 329, 337 (1977).

(II) an amount payable which is described in section 736(a),

then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject.

(B) Exception — Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

[Section 358(d)]

(d) Assumption of liability—

(1) In general — Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or

93. The Senate Finance Committee explained the reference to § 736(a) in the statute as follows:

Section 736(a) applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's active interest in the partnership. If such payments meet the requirements of section 736, they are considered either as a distributive share of partnership income to the recipient or as guaranteed payments. If the payments are considered a distributive share of partnership income, than [sic] the distributive shares of the other partners are reduced. If payments are guaranteed payments, then they are deductible under section 162 by the partnership.

In either instance, for cash basis taxpayers the obligation to make such payments is similar to the partnership's obligation with respect to its (deductible) accounts payable since both would constitute ordinary deductions or would reduce gross income to the non-retiring partners when the obligations are paid. Accordingly, under the bill, section 736(a) payments would be excluded in determining the amounts of liabilities assumed or to which the property transferred is subject for purposes of section 357(c) and 358(d).


94. The Senate Finance Committee explained section 357(c)(3)(B) as follows:

The exception for obligations which give rise to basis would apply for example, where a cash-basis taxpayer purchases small tools on credit and, prior to paying for the tools, transfers them along with the related obligation to a new corporation in a section 351 transaction. While the transferor would have been entitled to a deduction if he had paid off the obligation, pending payment he would have a basis in the tools equal to the amount of the unpaid obligation. Under the provision, that obligation would constitute a “liability” for purposes of section 357(c); but the amount of this liability would be offset by the basis in the transferred tools.

Id. at 185 n.7.
acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

(2) Exception — Paragraph (1) shall not apply to the amount of any liability excluded under section 357(c)(3).

The amendment of these sections resolves the transferor’s overtaxation problem under the Pre-Focht Tax Court Approach. While Individual A in Example I is not to be given a deduction for the $25,000 salary obligation, neither is he required, under section 358(d), to reduce the basis in his stock by the amount of the $25,000 trade payable. Therefore, A’s basis in his stock is $50,000, the unreduced carryover basis of the transferred land. His taxable gain on an immediate resale of the stock for its fair market value of $75,000 will be $25,000, which is precisely the amount of his economic gain.

The Focht-Congressional treatment of liabilities at the transferor level is entirely consistent with the existing treatment of cash-basis receivables transferred to a controlled corporation in a section 351 exchange. Under the previously discussed Hempt Bros. decision, with which the IRS agrees, zero-basis receivables generally are not taxable to the transferor either when transferred to or collected by the corporation. Rather, the potential gain on the receivables is deferred, under sections 351 and 358, until the transferor’s eventual disposition of the stock. Consistently, under the Focht-Congressional treatment of assumed deductible liabilities, neither the assumption nor the payment by the controlled corporation of the trade payables of the cash-basis transferor leads to a deduction by the transferor. Instead, the potential loss reflected in those payables will be recognized only when the stock is disposed of. In the normal case, in which both receivables and payables are transferred, this means that the gain represented by the net excess of the transferred trade receivables over the trade payables of a cash-basis taxpayer will be deferred until the transferor disposes of his corporate stock. It will then be taxed as a capital gain.

95. The transferred accounts receivable, of course, had a zero basis to the cash-basis transferor. See note 3 supra.
97. See notes 63 to 65 and accompanying text supra.
98. If the receivables are transferred for tax avoidance motives, however, assignment of income principles may be applied. See notes 197 to 206 and accompanying text infra.
99. But see note 27 supra.
(c) The Deduction Approach

An alternative approach that would have insured that Individual $A$ was taxed on no more than his economic gain would have been one that provided $A$ with a $25,000 deduction for the salary obligation at the time Corporation $X$ assumed or paid that liability. 100 In other words, under what is here called the Deduction Approach, the cash-basis transferor would have been required, under the unamended section 358(d), to reduce his basis in the stock and securities received by the amount of his trade payables assumed by the corporation, but would have been given a deduction for those payables either when they were assumed or paid by the corporate transferee. In Example I, $A$'s $50,000 gain on the sale of the stock 101 would have been offset by the $25,000 deduction for the payables, resulting in net income 102 equal to his $25,000 economic gain. 103

While, at first glance, this approach might appear to be an acceptable alternative to the Focht-Congressional solution, closer scrutiny reveals that it is not. The Deduction Approach actually results in a distortion of the transferor's income, as well as a distortion of income between the transferor and the transferee. Under the Deduction Approach, the transferor ends up deferring any realized gain on the accounts receivable transferred ($50,000 in Example I) until he disposes of his stock, and then the entire gain will be reported only as capital gain. At the same time, however, he takes an immediate deduction from ordinary income for the trade payables assumed by the corporation. 104 As between the transferor and the transferee, there is also an obvious distortion, since, under the Hempt Bros. decision, the corporate transferee will report

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100. Presumably, if the cash-basis transferor were to be given a deduction for an assumed liability, it would not be until the transferee paid the liability. The rationale is that the transferee's assumption of the debt would not satisfy the debt, and therefore the cash-basis transferor would remain liable until actual payment. See Kahn & Oesterle, supra note 91, at 469 n.40.

101. In Example I, $A$'s stock basis using the Deduction Approach would be $25,000 — the $50,000 carryover basis in the land transferred (the transferred receivables, of course, have a zero basis), less the $25,000 salary obligation assumed by the corporation. An immediate resale of the stock for its $75,000 fair market value would produce the $50,000 gain.

102. This computation ignores any differences of capital gain versus ordinary gain.

103. That Individual $A$'s economic gain in Example I is $25,000 is illustrated in the text accompanying notes 83 to 88 supra.

104. The deduction will be available immediately whether $A$ is permitted to claim the deduction on the corporation's assumption of the obligation, or only later when the corporation pays the obligation, see note 100 supra, because in the normal course of events, the corporation will pay that obligation shortly after the incorporation.
ordinary income from the collection of the receivables, while, under the Deduction Approach, the shareholder transferor will deduct the related payables.

Even had the Deduction Approach produced logical tax consequences,\(^{105}\) it would not have been considered a viable alternative under pre-1978 law, since there existed no precedent for permitting the transferor a deduction for transferred payables in a section 351 exchange in which no gain was recognized.\(^{106}\) In her dissenting opinions in *Thatcher v. Commissioner*\(^ {107}\) and *Focht v. Commissioner*,\(^ {108}\) Judge Hall of the Tax Court suggested a Modified Deduction Approach which would have granted a transferor a deduction in a section 351 exchange for his deductible obligations assumed by the transferee. The deduction, however, would have been limited to the gain recognized to the transferor under section 357(c).\(^ {109}\) The Modified Deduction Approach accepted the existing

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105. If the Deduction Approach had been adopted by the courts, it seems possible that the IRS could have avoided the obvious distortion of income by using its power under § 482 to allocate the $25,000 salary deduction to the corporation in order to reflect income clearly. Treas. Reg. § 1.482-1(d)(5) (1962) expressly states that § 482 is applicable to nonrecognition provisions such as § 351, and § 482 has, in fact, been used by the Commissioner in many cases to allocate deductions from a transferor to a transferee in a § 351 exchange. *See*, e.g., *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962). *See generally* notes 208 to 217 and accompanying text *infra*. In Example I, the collateral effect of the Commissioner’s allocation of the deduction from Individual A to the corporation should be that A’s basis in his stock is no longer reduced by the $25,000 liability which the Commissioner now treats as having been incurred by the corporation. Thus, through a combination of the Deduction Approach and the Commissioner’s use of § 482, one could have reached the same results as using the *Focht*-Congressional Approach. This simply points to the correctness of the results reached by the latter approach.


107. 61 T.C. 28, 42 (1973) (Hall, J., dissenting). Hall’s approach was essentially adopted by the majority of the Ninth Circuit in *Thatcher v. Commissioner*, 533 F.2d 1114 (9th Cir. 1976).


109. Judge Hall stated in her *Thatcher* dissent that “admittedly no . . . deduction [for the transferor] is available where assets are transferred in a section 351 transaction to the extent not treated as a sale under section 357.” 61 T.C. at 42 (Hall, J., dissenting). However, she contended that in a taxable sale, in which the acquiring party as part of the purchase price of assets assumes and pays the deductible obligations of the seller, a deduction for the transferor is permitted, *id.*, and cited as authority, *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (6th Cir. 1964); *Royal Oak Apts., Inc. v. Commissioner*, 43 T.C. 243 (1964); and *Jergens v. Commissioner*, 17 T.C. 806 (1951). She therefore concluded that a deduction should be permitted the transferor in a § 351 transaction to the extent that § 357(c) causes gain to be recognized at the transferor level. 61 T.C. at 43. Judge Hall’s dissenting opinion was adopted by the Ninth Circuit in *Thatcher v. Commissioner*, 533 F.2d 1114, 1117-18 (9th Cir. 1976). Judge Hall repeated her *Thatcher* dissent in a slightly amended version in *Focht*, 68 T.C. at 243 (Hall, J., dissenting). The majority in *Focht* held that
case law which denied a transferor a deduction in a totally nontaxable 351 exchange. It would therefore not have helped Individual A in Example I, in which the total liabilities assumed by the transferee corporation did not exceed the basis of the assets transferred. More generally, Judge Hall's solution would not correct the overtaxation of the transferor resulting from unamended section 358(d)'s requirement that the transferor reduce his basis by the amount of his deductible payables assumed by the transferee corporation. Today it is clear that both deduction approaches have been preempted by the amendments to sections 357(c) and 358(d).

(2) The Tax Treatment of the Transferee Corporation

As noted earlier, tax advisors traditionally advised clients incorporating their cash-basis businesses to retain their trade payables. Clients were warned that if the controlled corporation assumed their trade payables, the corporation would not be entitled to a deduction for those payables either at the time of their assumption or at the time of their subsequent payment. This advice was based on existing case law, which was interpreted to state that the assumption and payment of the obligations by the corporation was not a deductible corporate expense, but was instead a part of the purchase price of the transferor's assets. While this traditional belief was well founded in older case law, a number of recent cases imply or state in dictum that the corporate transferee is in fact entitled to such a deduction. In addition, it has apparently been the Service's private ruling policy for many years that a corporation may deduct cash-basis payables assumed in a section 351 transaction if the corresponding zero-basis accounts receivable are also contributed to the corporation, and if the corporation agrees in a closing agreement entered into prior to the transfer to report the income on the collection of the receivables. A 1978 technical

the correct result in a taxable sale in which a buyer assumes a deductible obligation of a seller is that the assumption results in neither income nor a deduction for the seller. See id. at 229. See note 164 infra, which concludes that the correct result in such a taxable sale and purchase is both increased income and an increased deduction.

110. See, e.g., cases cited in note 106 supra.
111. See note 70 and accompanying text supra.
112. See cases cited in note 131 infra. Under § 362(a), the corporate-transferee in a § 351 transaction receives no increase in basis for liabilities assumed, except to the extent those liabilities cause the transferor to recognize gain pursuant to § 357(c) or § 357(b).
113. See notes 131 to 137 and accompanying text infra.
114. See Bongiovanni v. Commissioner, 470 F.2d 921, 925 (2d Cir. 1972) (dictum); Thatcher v. Commissioner, 61 T.C. 28, 31 (1973), rev'd, 533 F.2d 1114 (9th Cir. 1976); Raich v. Commissioner, 46 T.C. 604, 605 (1966).
115. See generally note 65 and accompanying text infra.
advice memorandum,\textsuperscript{116} LTR 7830010,\textsuperscript{117} suggests that a closing agreement is no longer necessary as long as the completed transaction meets the criteria to which the Service would look if an advance ruling were sought with respect to the transaction.

The discussion in this section will demonstrate that the Service's position permitting a corporate deduction for assumed cash-basis trade payables, when combined with the requirement that the corporation report the income from the transferred accounts receivable, produces the appropriate tax consequences at the corporate transferee level. Moreover, it will be shown that allowing a corporate deduction in a section 351 exchange for assumed cash-basis obligations is not without precedent in case law.

(a) The Logic of the Corporation Deduction

In Example I, applying the \textit{Focht}-Congressional Approach at the transferor level without also providing a deduction for the assumed $25,000 salary obligation at the corporate transferee level solves only half of the problem. Although appropriate tax consequences are produced for the transferor, the corporate transferee is still overtaxed. The transferor in Example I properly defers the $25,000 gain realized on the incorporation,\textsuperscript{118} but unless the corporate transferee is provided a $25,000 deduction for the salary obligation it assumed, the corporation's tax picture will not mirror the shareholder's deferred gain as it should.\textsuperscript{119} The corporation will, under section 362, take a zero basis in the accounts receivable and report $50,000 of ordinary income upon their collection. It is only by giving the corporation the offsetting $25,000 deduction that the corporation's net tax gain ($25,000 income) will mirror the shareholder's deferred gain.

The suggestion has been advanced, however, that providing the corporation with a deduction for the assumed obligations, when combined with the effective deferred deduction provided the transferor by the \textit{Focht}-Congressional Approach, somehow results in a double deduction not intended under section 351.\textsuperscript{120} This suggestion is without foundation. The possibility that a section 351 transaction will result in potential losses at both the shareholder

\textsuperscript{116} See discussion in note 63 supra.
\textsuperscript{117} See note 59 supra. The ruling is quoted at text following note 130 infra.
\textsuperscript{118} See notes 90 to 99 and accompanying text supra.
\textsuperscript{119} The interplay of § 358 and § 362 is designed so that there is a mirror image of the transferor's total deferred gain created at the corporate level (ignoring ordinary versus capital gain classifications). See notes 29 to 34 and accompanying text supra.
\textsuperscript{120} See Kahn & Oesterle, supra note 91, at 474.
and corporate levels is inherent in the carryover basis provisions of sections 358 and 362.121 In fact, such a double loss occurs whenever a shareholder, in a nontaxable 351 transaction, transfers to his corporation property with a lower value than its basis.122 The transfer of cash-basis payables is analogous to a transfer of such depreciated property.

That there is nothing untoward in giving the corporation a deduction, while also granting the shareholder an effective deferred deduction, becomes even clearer when one reviews the parallel treatment of the potential income from transferred zero-basis receivables.123 The income from those receivables is eventually taxed at both levels,124 just as the payables eventually reduce income at both levels.125 A result that would permit the transferred receivables to produce income at both levels, but would not permit the transferred payables to reduce income at both levels is in fact the result that is unwarranted.

Of course, just as accounts receivable might be transferred to a controlled corporation for tax avoidance purposes, so too could a cash-basis taxpayer, for tax avoidance reasons, have his controlled corporation assume his deductible expenses.126 The Service in its private rulings127 makes clear that its rule permitting the corporation a deduction for assumed cash-basis payables will be applied only when, as in the typical incorporation, the assumption is not for tax avoidance purposes, nor does it otherwise distort income. This is consistent with the Service’s rule regarding accounts receivable transferred for tax avoidance purposes.128 These issues are covered in detail in section (D) below.

(b) The IRS Position

A clear statement of the Service’s current position regarding transferred trade accounts payable can be found in LTR 7830010.129

121. See note 30 and accompanying text supra.
122. Id.
123. See notes 52 to 68 and accompanying text supra.
124. In Example 1, Individual A takes a zero basis under §358 in the stock he receives for the zero-basis receivables transferred, and the corporation takes a zero basis in those receivables under §362(a).
125. The $25,000 corporate deduction for the salary obligation will, of course, reduce the corporation’s income in Example I by $25,000. Under the Focht-Congressional Approach the transferor need not reduce his stock basis by the $25,000 salary obligation assumed by the corporation, and therefore the amount of gain deferred by A is reduced by $25,000.
126. See notes 129 to 130 and 218 to 221 and accompanying text infra.
127. See, e.g., LTR 7830010, supra note 59; text following note 130 infra.
128. See notes 196 to 217 and accompanying text infra.
129. See note 59 supra.
That technical advice memorandum involved the transfer to a controlled corporation of assets previously used by the taxpayer in a cash-basis sole proprietorship. Among the assets and liabilities transferred to the new corporation were $33,629 of zero-basis trade accounts receivable, and $18,519 of previously undeducted trade accounts payable. Both the accounts receivable and the accounts payable were incurred in the ordinary course of business of the proprietorship. Apparently the proprietorship neither accumulated its receivables nor made any extraordinary prepaid of its payables in anticipation of the proposed transfer, and the receivables and payables transferred constituted all of the receivables and payables existing at the time of the incorporation. The taxpayer did not request an advance ruling from the Service, but the accounts receivable and accounts payable transferred to the corporation were, in fact, reported as items of income and deduction upon being received or paid by the corporation.

Based on these facts, the National Office was asked for technical advice. The specific question asked of the National Office was whether the payables should be allowed as a deduction to the corporate transferee. LTR 7830010 answered this question in the affirmative. The full discussion of this issue by the National Office was as follows:

**Discussion**

The Service has long maintained that section 351 of the Code encompasses the transfer of unrealized receivables unless the transaction lacks a business purpose, artificially produces losses, or otherwise distorts the transferor's income. That position is based in large part on the early legislative history of section 351 which indicates that Congress intended by its enactment to eliminate the impediments to business readjustments involving mere changes in form. See H. Rept. No. 350, 67th Cong., 1st Sess. 10 (1921); S. Rept. No. 398, 68th Cong., 1st Sess. 17 (1924). In view of the past and current Service position with respect to unrealized receivables it has been determined that an unrestricted application of the rationale set forth in *Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323 (8th

130. The IRS would presumably apply the assignment of income doctrine, § 482, or § 446(b) to insure that income was clearly reflected in any case in which there had been an extraordinary prepayment of trade payables or an unusual accumulation of trade receivables by the transferor prior to the incorporation of his business. See notes 197 to 217 and accompanying text infra.
Cir. 1946) [which denied corporate deduction for assumed payables] is unacceptable.

The same legislative history which we considered as support for the present Service position with respect to accounts receivable also supports a conclusion that the transferee corporation should be accorded the right to deduct expenses of the business, which if not assumed by the transferee would have been deductible by the transferor, if the section 351 transaction is business motivated, does not artificially produce losses for the transferee and does not distort the income of the transferor or transferee.

An example of a distortion of income would be a transfer of the accounts receivable to the corporation but a retention by the transferor of expenses payable. Splitting the receivables and payables in this manner results in an artificial creation of losses on behalf of the transferor. The practical effect of present Service position, which considers the splitting of accounts receivable from expenses payable as a distortion of income, is to force transferors to either hold back both the receivables and payables or transfer both to the corporation. Although retaining the receivables and payables would be the safest course from a tax standpoint, from a business point of view it may be economically unsound if the corporation will require working capital.

If the transferor finds it necessary for business reasons to transfer the accounts receivable to the corporation and, in order to clearly reflect income, if he also causes the corporation to assume the expenses payable, it would be anomalous to then create a distortion of income by requiring the corporation to capitalize the assumed expenses when paid. Income is clearly reflected when the accounts receivable are matched with the expenses payable; the income and expenses are no more matched if the expenses must be capitalized than if the transferor had held back the payables and transferred only the receivables.

The transaction described herein appears to meet the criteria the Service would look to if a closing agreement and advance ruling had been sought with respect thereto. Both the unrealized accounts receivable and the accounts payable were transferred in a manner that did not distort the transferor’s income. The basis of the accounts receivable in the hands of the transferor carried over to the transferee corporation as required by section 362 of the Code. Corp. x included the receivables in income when paid and the income so recognized retained the same character as it would have had if included by the transferor. The basis of the stock received by * * * * is a substituted basis decreased by the liabilities assumed by Corp. x as required by section 358(a) of the Code.
CONCLUSION

If the transaction described herein does satisfy the requirements of section 351 and the criteria heretofore set forth, Corp. x may deduct the transferred accounts payable, provided that such payables would have been deductible upon payment by the transferor.

(c) Judicial Precedent for a Corporate Deduction

A number of cases, both old and recent, specifically reject a corporate transferee's right to a deduction when it assumes and pays the deductible obligations of its predecessor in a section 351 transaction. In the most frequently cited case in this area, Holdcroft Transportation Co. v. Commissioner, a corporate taxpayer argued that because it acquired assets and assumed liabilities in a tax-free exchange under the predecessor of section 351, it should be considered to be in the same position with respect to expense and loss deductions as its predecessor would have been had there been no transfer. The United States Court of Appeals for the Eighth Circuit rejected this contention, stating that the predecessor of section 362 served only to determine the basis to the corporate transferee for gain and loss purposes of assets transferred to it, and did not deal with or imply that assumed liabilities incurred in the predecessor’s business could be deducted by the transferee.

In the more recent case of M. Buten & Sons, Inc. v. Commissioner, the taxpayer again argued that if the assumed trade payables had been deductible to the transferor partnership, they should be deductible to the transferee corporation as the partnership’s successor in interest. The Tax Court rejected this argument, stating:

It is well settled that an expenditure of a preceding owner of property which has accrued but which is paid by one acquiring that property is a part of the cost of acquiring the property, irrespective of what would be the tax character of the expenditure to the prior owner. Such payment becomes part of the basis

131. See, e.g., W.P. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948); Holdcroft Trans. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946); Rodney, Inc. v. Commissioner, 145 F.2d 692 (2d Cir. 1944); M. Buten & Sons, Inc. v. Commissioner, 31 T.C.M. (CCH) 178 (1972); Leavitt v. Commissioner, 31 T.C.M. (CCH) 453 (1972).
132. 153 F.2d 323 (8th Cir. 1946).
133. Id. at 324–25.
134. Id. at 325.
135. 31 T.C.M. (CCH) 178 (1972).
136. Id. at 181.
of the property acquired and may not be deducted when paid by the acquirer of that property.\textsuperscript{137}

The final sentence of the above quotation is erroneous when applied to a tax-free section 351 transaction. In a 351 transaction, the transferee corporation, unlike the purchaser in a taxable purchase, does not include assumed liabilities in the basis of the acquired assets. There is one further difference in tax treatment between a corporate transferee in a section 351 transaction and a purchase in a taxable purchase that militates in favor of the corporate deduction. When a taxable sale of a cash-basis business is involved, the transferor rather than the transferee reports the ordinary income from the transferred accounts receivable, whereas in a section 351 incorporation of a cash-basis business, the transferee corporation reports such income.\textsuperscript{138} Therefore, in order to avoid a distortion of income in a section 351 transaction, it is necessary to permit the acquiring corporation also to take a deduction for the payables accrued but not deducted by its cash-basis predecessor. These considerations presumably explain the fact that, despite the clear line of cases denying a deduction to the corporate transferee, other cases imply or actually state, at least in dictum, that the corporate transferee in a section 351 transaction is entitled to a deduction when it pays the otherwise deductible obligations of its predecessor.\textsuperscript{139}

Moreover, a number of older cases, normally cited as authority for denying a deduction to the cash-basis transferor of trade payables in a section 351 exchange,\textsuperscript{140} also imply that the corporate transferee may be entitled to the deduction. For example in the 1941 case of \textit{Citizens National Trust and Savings Bank v. Welch},\textsuperscript{141} the Ninth Circuit conceded that the obligations assumed by the transferee corporation "were deductible — by someone in some year — under [the predecessor of section 162]."\textsuperscript{142} It then rejected the transferor's claim to the deduction, noting that the deductions were "allowed in computing [the transferee's] net income."\textsuperscript{143} In \textit{Doggett v.}

\textsuperscript{137} Id. at 181 (emphasis added).
\textsuperscript{138} See notes 52 to 68 and accompanying text supra.
\textsuperscript{139} See, e.g., Bongiovanni v. Commissioner, 470 F.2d 921, 925 (2d Cir. 1972); Doggett v. Commissioner, 275 F.2d 823, 827 (4th Cir. 1960); Citizens Nat'l Trust & Sav. Bank v. Welch, 119 F.2d 717, 719 (9th Cir. 1941); Thatcher v. Commissioner, 61 T.C. 28 (1973), rev'd, 533 F.2d 1114 (9th Cir. 1976); Raich v. Commissioner, 46 T.C. 604, 605 (1966).
\textsuperscript{140} See cases cited in note 106 supra.
\textsuperscript{141} 119 F.2d 717 (9th Cir. 1941).
\textsuperscript{142} Id. at 719.
\textsuperscript{143} Id. at 720.
Commissioner, the taxpayer's sole proprietorship taxicab business was taken over by a new corporation. The taxpayer contended that the transfer of accounts payable to the corporation constituted payment of the accounts by him as an individual or, in the alternative, that payment was made by the corporation as his agent. Citing Citizens National Trust, the Fourth Circuit rejected the transferor taxpayer's claim to a deduction. Like the Ninth Circuit, however, the court acknowledged that "to the extent these payables arose out of the business they should be deductible by someone," and subsequently in the opinion restated "that one or the other should be allowed to claim the deduction."

This constituted the confusing case law regarding the deductibility to the corporate transferee of assumed cash-basis payables at the time the Focht case was decided in 1977. In Focht, the Tax Court, ignoring its apparent acquiescence in a corporate deduction in Raich v. Commissioner and Thatcher v. Commissioner, specifically declined to decide whether the transferee corporation was entitled to a deduction when it assumed and paid the transferor's cash-basis payables. Congress took no action with respect to this issue in the Revenue Act of 1978. In fact, the Senate Finance Committee's report on the amendments to sections 357(c) and 358(d) specifically stated that the amendments were "not intended to affect the corporate-transferee's tax accounting for the excluded liabilities." Significantly, however, as has been previously noted, the Service now seems generally amenable to allowing the corporate transferee a deduction in this situation. Considering the logic of that result and the conflicting judicial precedent described above, the IRS seems entirely justified in its private ruling posture. A published ruling or regulation, however, would seem to be in order at this time.

144. 275 F.2d 823 (4th Cir. 1960).
145. Id. at 827.
146. Id.
147. 46 T.C. 604 (1966).
148. 61 T.C. 28 (1973), rev'd, 533 F.2d 1114 (9th Cir. 1976).
149. 68 T.C. at 238. However, the Tax Court's footnote in Focht, 68 T.C. at 238 n.31, citing Magruder v. Supplee, 316 U.S. 394 (1942), on this point, implied that it thought a corporate deduction improper. Magruder stands for the proposition that a purchaser who, in a taxable sales transaction, assumes a deductible liability of the seller as a part of the purchase price for property cannot deduct that liability. The Supreme Court reasoned that, for the purchaser, the liability was simply part of the purchase price of the property. Id. at 398. This seems clearly correct in the context of a taxable sale and purchase, but not properly applicable to a tax-free §351 transaction.
151. See, e.g., LTR 7830010, supra note 59; quoted at text following note 130 supra.
C. The Section 357(c) Problem: The Assumption by the Corporate Transferee of Deductible Trade Payables of the Cash-Basis Transferor When Total Liabilities Assumed Exceed Basis of Assets Transferred

As was explained in section (B) above, a cash-basis transferor of trade payables in a section 351 transaction was always overtaxed under the Pre-Focht Tax Court Approach. Yet the non-section 357(c) aspect of the problem was rarely discussed in the literature, since the overtaxation of the transferor was not immediate. That is, if the total liabilities assumed did not exceed the total basis of the assets transferred, the overtaxation of the transferor was deferred until that indeterminate later date when he disposed of his stock, and then his entire deferred gain would be taxed only as a capital gain. Moreover, that deferred gain might never be realized by anyone if the stock was held until the transferor's death. 152 It was for these reasons that the major focus of attention of the cases and commentators was on the situation in which the transferred trade accounts payable alone or in combination with other liabilities exceeded the total basis of the assets transferred, thereby subjecting the transferor to an immediate tax under section 357(c).153

For example, in the 1966 Raich case, a cash-basis taxpayer transferred assets previously used by him in a sole proprietorship to a corporation in exchange for all of the corporation's issued stock and the corporation's assumption of the liabilities of the proprietorship. The basis of the assets transferred was $11,000. The assets included $77,000 of zero-basis accounts receivable. As part of the consideration for the assets, the corporation assumed $46,000 of liabilities of the taxpayer, including $38,000 of cash-basis trade accounts payable, which had not yet been paid — and therefore not yet deducted — by the cash-basis transferor. The Tax Court held

152. Prior to the Tax Reform Act of 1976, the basis of property acquired by inheritance became, under §1014, its fair market value at the date of the decedent's death or the alternate valuation date. Because the decedent had recognized no gain or loss, all appreciation or depreciation in value was wiped out by death. In 1976 Congress enacted §1023 which provides, as the general rule, that property acquired by inheritance takes the same basis in the hands of the heir that it had in the hands of the decedent. The main exception to this treatment is found in §1023(h), which provides that the basis of property owned by the decedent on December 31, 1976 is increased (for purposes of determining gain but not loss) by the excess of its value over its basis on that date.

Sections 515 and 702(c)(1) of the Revenue Act of 1978 postponed for three years the effective date of the carryover basis rules for inherited property added by the Tax Reform Act of 1976. Thus, the carryover basis provision will apply only to property acquired from a decedent dying after December 31, 1979.

153. But see Kahn & Oesterle, supra note 91; Truskowski, supra note 81.
that, under section 357(c) of the Code, the taxpayer recognized $35,000 of income on the incorporation.\textsuperscript{154} This represented the amount by which the liabilities assumed by the corporation ($46,000) exceeded the total basis of the assets transferred ($11,000).

Although the taxpayer in \textit{Raich} was required to report the corporation’s assumption of his trade payables as income, he was not permitted to take a deduction for those payables either at the time they were assumed by the corporation or later when they were paid by the corporation.\textsuperscript{155} The resulting overtaxation of the cash-basis transferor in this situation was clear.\textsuperscript{156} Nevertheless, for the next eleven years,\textsuperscript{157} despite an unprecedented barrage of adverse comments to its \textit{Raich} decision in legal and tax journals,\textsuperscript{158} dissonance within the Tax Court,\textsuperscript{159} and the disavowal of the \textit{Raich} result by the United States Courts of Appeal for both the Second\textsuperscript{160}

\textsuperscript{154} The court did not discuss the § 358(d) problem. See notes 70 to 110 and accompanying text supra. However, in \textit{Raich}, not only was the taxpayer overtaxed by $35,000 under § 357(c), but he was also overtaxed by the additional $3,000 that was used to reduce his basis pursuant to unamended § 358(d).

\textsuperscript{155} The \textit{Raich} court noted, without further comment, that the transferee-corporation deducted the trade accounts payable in its initial tax period. 46 T.C. at 605. See notes 111 to 149 and accompanying text supra.

\textsuperscript{156} See notes 168 to 172 and accompanying text infra.

\textsuperscript{157} Prior to \textit{Raich}, there were a few reported cases in which cash-basis accounts receivable and payable were involved. Testor v. Commissioner, 327 F.2d 788 (7th Cir. 1964); DeFelice v. Commissioner, 25 T.C.M. (CCH) 835 (1966); Kniffen v. Commissioner, 39 T.C. 553 (1962). Strangely, in each of these cases the IRS and the courts, without comment, appeared to assume that, for purposes of § 357(c), the accounts receivable of a cash-basis taxpayer could be considered to have a basis equal to their book value, rather than a zero basis. \textit{Raich} was the first case in which either the IRS or a court actually analyzed the particular problem § 357(c) posed for cash-basis transferors.

\textsuperscript{158} See, e.g., Burke & Chisolm, supra note 47; Del Cotto, Section 357(c): Some Observations of Tax Effects to the Cash Basis Transferor, 24 BUFFALO L. REV. 1 (1974); Kahn & Oesterle, supra note 91; Phelan, Conflicting Definitions of “Liabilities” Threatens Some Tax-Free Reorganizations, 40 J. TAX. 356 (1974); Roha, 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); Wellen, New Solutions to the Section 357(c) Problem, 52 TAXES 361 (1974); Comment, Section 357(c) and the Cash Basis Taxpayer, 115 U. PA. L. REV. 1154 (1967); Comment, Incorporating a Cash Basis Business: The Problem of Section 357(c), 24 WASH. & LEE L. REV. 329 (1977). For commentary after the Tax Court’s decision in Focht v. Commissioner, 68 T.C. 223 (1977), but prior to the Revenue Act of 1978, see, e.g., Note, Donald D. Focht, 68 T.C. 223 (1977) — Section 357 Liabilities Do Not Include Deductible Liabilities of Cash Method Taxpayers, 31 TAX LAW. 243 (1977).

\textsuperscript{159} In \textit{Focht}, 68 T.C. at 225, the Tax Court commented that “our steadfast position has divided this court.”

\textsuperscript{160} Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972), rev’g 30 T.C.M. (CCH) 1124 (1971).
and Ninth Circuits, the Tax Court majority doggedly held to its Raich decision. Then, in 1977, the Tax Court decided the case of Focht v. Commissioner.

Focht, like Raich, involved the transfer to a controlled corporation of assets previously used by the taxpayer in a cash-basis sole proprietorship. The adjusted basis of the assets transferred, including $42,000 of zero-basis accounts receivable, was approximately $35,000, and the total liabilities assumed by the corporation was about $89,000. Of these liabilities, about $75,000 would have been deductible had they been paid by the transferor. The Commissioner determined that, under section 357(c), the taxpayer recognized approximately $54,000 of income on the incorporation, such amount representing the excess of the liabilities assumed over the adjusted basis of the assets transferred. The majority of the Tax Court held, however, that no gain was recognized on the incorporation, concluding that cash-basis accounts payable and other obligations are not liabilities for purposes of sections 357 and 358 if the payment of such obligations by the transferor would have resulted in a deduction for him.

Our steadfast position has divided this Court and produced reams of commentary from the tax bar. As previously stated two appellate circuit courts disagreed with our harsh result and in differing manners have prevented taxation of something that was not in fact economic gain to a cash basis taxpayer. It is time for us to reconsider. We now hold that it is inappropriate to treat an assumed liability of a cash method taxpayer as income to him and simultaneously to deny him a tax benefit, if the obligation would have been deductible upon his payment, for the satisfaction of that debt. Congressional intent, under sections 357 and 358(d), was to affect only those liabilities that, if assumed by a transferee corporation in a tax-free exchange,


162. The Tax Court's most recent pre-Focht decision upholding the Raich doctrine was Rosen v. Commissioner, 62 T.C. 11 (1974), aff'd mem., 515 F.2d 507 (3d Cir. 1975). Since the appeal from the Tax Court in Focht would have been to the Third Circuit, which had affirmed the use of the Raich rule in Rosen, the Tax Court had to clear a procedural hurdle — its Golsen rule, Golsen v. Commissioner, 54 T.C. 742 (1970), before reaching the substantive issue. Golsen stands for the proposition that the Tax Court will follow a controlling decision of a Court of Appeals to which an appeal would lie even if the decision is contrary to the views of the Tax Court. The court cleared this procedural hurdle by noting that the taxpayer in Rosen used the accrual basis while the taxpayer in Focht used the cash basis, and concluding that this difference made Golsen inapplicable. Focht, 68 T.C. at 230.

163. 68 T.C. 223 (1977).
would cause gain recognition. An obligation should not be
treated as a liability, under sections 357 and 358, to the extent
that its payment would have been deductible if made by the
transferor. To the extent that this position is inconsistent with
our prior case law (Raich v. Commissioner, et al) we will no
longer follow those decisions.\textsuperscript{164}

164. \textit{Id.} at 229. While the results reached by the Tax Court in \textit{Focht} (and now
incorporated in §§357(c) and 358(d)) are clearly correct in the §351 context, the
reasoning the court used to reach those results seems faulty. At the foundation of
the Tax Court's argument, 68 T.C. at 234, is a footnote from the Supreme Court's decision
in \textit{Crane v. Commissioner}, 331 U.S. 1 (1947). \textit{Crane} involved a transfer of real
property subject to a debt on which interest was overdue. The Supreme Court held
that the principal amount of the mortgage debt was part of the amount realized by the
transferor. Nothing, however, was mentioned in the text of the decision about the
interest payable on the mortgage that was assumed by the transferee. The only
reference to the interest was in a footnote that stated, "[t]he Commissioner explains
that only the principal amount, rather than the total present debt secured by the
mortgage, was deemed to be a measure of the amount realized, because the difference
was attributable to interest due, a deductible item." \textit{Id.} at 4 n.6. From this footnote,
and with the help of the analysis of Kahn & Oesterle, \textit{supra} note 91, the Tax Court
constructed the following legislative history to justify the noliteral meaning it gave
to the word "liabilities" in §§357 and 358:

\textbf{Step 1} — The Supreme Court in \textit{United States v. Hendler}, 303 U.S. 564 (1938),
in holding that assumed liabilities constituted boot in an otherwise tax-free exchange,
implicated that such would be the case only if the obligations assumed were of the
nondeductible variety.

\textbf{Step 2} — In enacting the predecessors of §§357 and 358 in 1939, Congress
Intended to affect only those liabilities that, if assumed by a transferee corporation in
a tax-free exchange, would cause gain recognition under \textit{Hendler}. Thus, Congress
enacted these sections with the belief that they did not encompass deductible
obligations.

\textbf{Step 3} — In 1947, the Supreme Court in a footnote in \textit{Crane} adopted the
position stated by the Commissioner in his brief that, in a taxable sale and purchase of
property, the assumption and payment by the purchaser of a deductible obligation
of the seller constitutes neither an amount realized nor a deduction to the seller. The
\textit{Focht} court believed that the \textit{Crane} footnote justified its conclusion as to the state of
the law existing at the time of \textit{Hendler}. According to the \textit{Focht} court, this doctrine
remains the law today and was embodied in unamended §§357 and 358 regarding tax-
free exchanges. As is illustrated in the discussion below, the reasoning implicit in
these steps is clearly incorrect.

\textit{The Supreme Court never adopted as its position, in the Crane footnote or
elsewhere, the rule that in a taxable sale and purchase of property, the assumption
and payment by the purchaser of a deductible obligation of the seller constitutes
neither an amount realized nor a deduction to the seller.} In fact, the Supreme Court
ever gave any hint that it approved of such treatment. All that the Court did in the
\textit{Crane} footnote was note, without comment, that the Commissioner had not included
the part of the liability attributable to interest in Mrs. Crane's amount realized
because "the difference was attributable to interest due, a deductible item." The
Supreme Court thus simply acknowledged a concession of the government attorney
trying the case.

Further support for the argument that very little significance should be
attributed to the \textit{Crane} footnote is the fact that the footnote had no effect whatever on
Mrs. Crane's tax liability. In the case, it made no difference to Mrs. Crane whether
she had an additional amount realized and an additional interest deduction or simply
With the Tax Court’s turnabout in Focht, the Internal Revenue Service was left without a judicial ally. Moreover, the IRS could not

no additional amount realized and no interest deduction. Mrs. Crane conceded on appeal that the real estate she sold was not a capital asset. Therefore, the additional amount realized by her would have been ordinary gain which would have been offset by an ordinary deduction under § 163. 331 U.S. at 5. It is, therefore, not surprising that the taxpayer in Crane did not contest in the Supreme Court the Commissioner’s exclusionary treatment of the deductible interest obligation. It is clear that the Supreme Court did not make any determination of the correctness of such treatment.

The tax results set forth in the Crane footnote (no income and no deduction) seem logically incorrect in the context of a taxable sale. The correct result should be that a seller who requires a buyer to assume his deductible obligation has both an increased amount of recognized gain on the transfer of property and an increased deduction, rather than having neither income nor a deduction. The most significant difference between the two approaches as applied to a taxable sale and purchase transaction is that the additional amount realized by the seller would often result in capital gain to him, while the offsetting deduction would be ordinary. As previously noted, the capital gain-ordinary deduction issue was not relevant in Crane, since Mrs. Crane had conceded on appeal that the building sold by her was not a capital asset.

The tax results set forth in the Crane footnote are logically incorrect in analogous tax contexts. The Focht decision gives further impetus to the current illogical treatment of interest-free loans. The erroneous assumption of the Focht court that an exclusionary approach was the same as an approach that caused both income and deduction to be increased was similarly made by the Tax Court in Dean v. Commissioner, 35 T.C. 1063 (1961), a case involving the tax consequences of interest-free loans received by taxpayers as dividends or compensation. In Dean the Tax Court held that a stockholder realizes no income from his interest-free use of a corporation’s money. The Commissioner argued that the shareholders “realized income to the extent of the economic benefit derived from the free use of borrowed funds from [the corporation].” Id. at 1087. Judge Raum, speaking for the majority of the Tax Court, held that there was no need to recognize income, since the recipient of the interest-free loan would have been able to take an offsetting deduction for any interest paid under § 163. Id. at 1090. The many problems with the use of the exclusionary approach in Dean have been pointed out by the commentators. See, e.g., Keller, The Tax Consequences of Interest-Free Loans From Corporations to Shareholders and From Employers to Employees, 19 B.C.L. Rev. 231 (1978). For example, the Dean court’s conclusion that interest will always be deductible under § 163 and will therefore completely offset any gain recognized is incorrect. A person who does not itemize his deductions could not deduct the interest paid unless the borrowed funds were used for business purposes. Similarly, even the person taking itemized deductions would not be entitled to the interest deduction if the debt were incurred to purchase tax-exempt municipal bonds. I.R.C. § 265(2). Thus, the appropriate result in the interest-free loan situation, paralleling the proper result in the taxable sale situation, is to require the borrower to treat the loan as a two-step process: he should report additional income and then claim a deduction to the extent such deduction is otherwise permissible under the Code. See Keller, supra, at 233-44.

One might also question how the Crane footnote’s exclusionary rule would be applied, for example, to a sale of assets pursuant to a § 337 liquidation. Assume, for example, that a corporation transfers land for cash plus the buyer’s assumption of the seller’s deductible obligation. Because the sale of the land would not be taxable in any event under § 337, the exclusionary rule would overtax the transferor corporation. If the transferor had instead received only cash for the land and then used this cash to pay its deductible obligation, it would have had no additional income, but would have
have failed to recognize that "its mechanical application of section 357(c), while defensible literally, produce[d] a harsh result . . . not in conformity with the overall purposes of sections 351 and 357(a)."\textsuperscript{165} Therefore, rather than carry its untoward, though literally defensible, position forward, the IRS dropped its appeal in the \textit{Focht} case, and presumably requested a congressional solution to the problem. That solution came quickly as Congress, in the Revenue Act of 1978, amended both sections 357(c) and 358(d) to "codify the approach

had an additional deduction for the payment of its liability. The exclusionary rule would presumably give it neither income nor a deduction.

\textit{The Exclusionary Rule was not the law at the time of Crane or Hendler}. The discussion above shows that the footnote in \textit{Crane} was never approved by the Supreme Court, and that it also leads to incorrect results in most taxable sales and other analogous transactions. For these reasons, it is not surprising to find that no record exists of a so-called exclusionary approach being applied to taxable sale and purchase transactions prior to \textit{Crane}. In fact, in the one clear holding on the issue during the \textit{Hendler-Crane} years (1938-1947), the Board of Tax Appeals held that the assumption by a purchaser of a seller's deductible obligation resulted in both an additional amount realized and an offsetting deduction by a taxpayer-seller, and the IRS acquiesced in the decision. See \textit{Cooledge v. Commissioner}, 40 B.T.A. 1325 (1939), \textit{acquiesced in}, 1940-1 C.B. 2. In \textit{Cooledge}, a taxpayer sold real estate subject to taxes and interest that had accrued prior to the sale. The court held that the transferee's assumption and payment of the taxes should have been included in the transferor's purchase price and then deducted by the transferor.

Given this background of the \textit{Crane} footnote, it seems nonsensical to state, as the Tax Court did in \textit{Focht}, that "\textit{Hendler foreshadowed Crane}'s exclusionary treatment of assumed deductible liabilities," 68 T.C. at 234. This foreshadowing apparently consisted of the Supreme Court's statement in \textit{Hendler} that the taxpayer's "'gain [caused by the transferor's assumption of its liabilities] was as real and substantial as if the money had been paid to it and then paid over by it to its creditors.' " \textit{Id.} at 234 n.29 (quoting \textit{United States v. Hendler}, 303 U.S. 564, 566 (1938)). To an impartial observer not intent on creating a legislative history, this statement appears to justify not an exclusionary rule, but rather a rule that an assumption of deductible obligations constitutes both a realization of income and an offsetting deduction for the transferor. In fact, the Tax Court actually supported this view when it commented in \textit{Focht} that "it seems highly probable that had Hendler [which was taxed on the assumption of liabilities] pressed its claim for the deductions (with respect to its obligation assumed by the transferee) and if such items were properly deductible if paid by Hendler, the Supreme Court would have sustained this part of the claim." 68 T.C. at 234. Yet the Tax Court apparently thought that its statement, as well as the statement from \textit{Hendler} quoted above, justified the exclusionary approach of the \textit{Crane} footnote. The Tax Court seemed simply to ignore the difference between the exclusionary approach and the approach that would provide the selling taxpayer with both additional income and an additional deduction. Yet as demonstrated in the discussion above, there are some major differences between the two approaches.

It was obviously folly of the Tax Court, then, to assume that Congress, when enacting the predecessors of §§ 357 and 358, attempted to follow a so-called exclusionary rule that was incorrect, and was not, in fact, a rule of law prior to, at the time of, or subsequent to the enactment of those sections. See \textit{James M. Pierce Corp. v. Commissioner}, 326 F.2d 67 (8th Cir. 1964); \textit{Royal Oak Apts., Inc. v. Commissioner}, 43 T.C. 243 (1964); \textit{Jergens v. Commissioner}, 17 T.C. 806 (1951).

\textsuperscript{165} 68 T.C. at 227.
taken by the Tax Court in the *Focht* case." 166 As was noted earlier, under the congressional amendment the term "liability," for purposes of both sections 357(c) and 358(d), does not include any "account payable" transferred in a section 351 exchange by a cash-basis taxpayer, if payment of that account payable "would give rise to a deduction" if paid by the transferor.

This section of the Article first reviews the section 357(c) trap that existed for a transferor under the Pre-*Focht* Tax Court Approach when his cash-basis business was incorporated and then considers how the *Focht*-Congressional Approach eliminates this trap. Next, the *Focht*-Congressional Approach is contrasted with a Modified Deduction Approach used by the Ninth Circuit in *Thatcher v. Commissioner*, and advanced by Judge Hall in her dissenting opinions in *Thatcher* and *Focht*. A brief discussion of the issue of the deductibility by the transferee corporation of the assumed trade payables in section 357(c) cases concludes this section.

The following example (Example II) will be used throughout this section to illustrate the section 357(c) problem and its appropriate solution. Sole proprietor A, a cash-basis taxpayer in a service business, transfers assets, worth $100,000, with a total basis of $50,000, to Corporation X, in exchange for (i) $25,000 worth of Corporation X's stock, (ii) X's assumption of A's unsecured obligation to repay a $40,000 business loan made to him by a bank, and (iii) X's assumption of a $35,000 salary obligation owed by A to one of his employees. The assets transferred are:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Accounts Receivable</td>
<td>0 ( $50,000)</td>
</tr>
<tr>
<td>Undeveloped Land (a capital asset)</td>
<td>$50,000 ( 50,000)</td>
</tr>
</tbody>
</table>

\[\begin{array}{ll}
\text{Basis} & \text{Value} \\
\text{Trade Accounts Receivable} & 0 \ 50,000 \\
\text{Undeveloped Land (a capital asset)} & 50,000 \ 50,000 \\
\hline
\text{Total} & $50,000 \ 100,000 \\
\end{array}\]

For purposes of simplicity, it will be assumed that Corporation X has other losses that will exactly offset any net income it will realize on the collection of the receivables and payments of the payables. 167

(1) *The Tax Treatment of the Transferor*

(a) *The Pre-*Focht* Tax Court Approach*

Under the Pre-*Focht* Tax Court Approach, cash-basis trade payables were considered liabilities for purposes of both sections 357 and 358, even though the transferor was not entitled to a deduction

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166. See notes 90 to 98 and accompanying text supra.
167. See note 27 supra.
with respect to those payables. This meant that the transferor in a section 351 exchange would, under section 358(d), have to reduce his carryover stock basis by the total liabilities assumed by the corporation, including assumed cash-basis trade payables. To the extent the total liabilities exceeded the total basis of the assets transferred, section 357(c) stepped in to tax the excess to the transferor immediately. Because the Pre-Focht Tax Court Approach did not permit the transferor to take a deduction for the transferred cash-basis trade payables, the transferor was always overtaxed.

Applying the Pre-Focht Tax Court Approach to the facts of Example II, Individual A would, under unamended section 357(c), report a gain on incorporation of $25,000 — the excess of the $75,000 of liabilities assumed by the corporation over the total $50,000 basis of the assets transferred. Under the irrational allocation of gain procedure provided by section 1.357-2(b) of the Regulations,\(^{168}\) this gain would be half capital and half ordinary even though only the ordinary asset, accounts receivable, had a value in excess of basis.\(^{169}\) A's basis in his $25,000 worth of Corporation X stock would be reduced to zero;\(^{170}\) zero is always the stock basis for a transferor who has been taxed under section 357(c). An immediate sale by the transferor of his stock for its $25,000 fair market value would thus produce an additional $25,000 of gain. The total $50,000 gain recognized by the transferor would not be offset by any deduction for the salary obligation. Thus, A would eventually report $50,000 taxable income even though his economic gain on the entire transaction was only $15,000. The difference between his $15,000 economic gain and his $50,000 tax gain can easily be seen by considering from a cash flow and tax viewpoint each step individual A has taken in this transaction from start to finish.

<table>
<thead>
<tr>
<th>A's Cash Receipt (or Expenditure)</th>
<th>Amount of A's Taxable Income (or Deduction) Per Pre-Focht Tax Court Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) A acquires a $50,000 trade account receivable by performing services.</td>
<td>None</td>
</tr>
<tr>
<td>(2) A incurs a $35,000 salary obligation to his employee.</td>
<td>None</td>
</tr>
</tbody>
</table>

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169. See notes 50 to 51 and accompanying text supra.
170. The $50,000 carryover basis plus the $25,000 gain recognized by transferor A, less the $75,000 of liabilities assumed by the transferee corporation.
A’s Cash Receipt (or Expenditure) | Amount of A’s Taxable Income (or Deduction) Per Pre-Focht Tax Court Approach
---|---
(3) A purchases land for $50,000. ($50,000) | None (Basis in Land = $50,000)\(^\text{171}\)
(4) A borrows $40,000 from bank. $40,000 | None
(5) A transfers the land and the account receivable to Corporation X for $25,000 stock, and X assumes A’s $35,000 trade payable and A’s $40,000 obligation to bank. None | $25,000 (Stock Basis = Zero)\(^\text{172}\)
(6) Corporation X pays assumed liabilities. None | None
(7) A immediately resells stock for $25,000.\(^\text{173}\) $25,000 | $25,000
\(+$15,000\) | \(+$50,000\)
Cash | Taxable Income

The chart clearly shows that A’s taxable income exceeds his economic income by $35,000.

Congress resolved this overtaxation problem by following Focht and amending sections 357(c) and 358(d) so that the deductible obligations were no longer considered liabilities. How that approach corrects A’s overtaxation in Example II is considered next.

(b) The Focht-Congressional Approach

The Focht-Congressional Approach insures that the transferor shareholder in Example II will be taxed only on his $15,000 economic income. Under the Focht-Congressional Approach, the $35,000 transferred salary obligation would not be considered a liability for purposes of either sections 357(c) or 358(d). Therefore, in the example, Individual A would report no tax on incorporation

\(^{171}\) I.R.C. § 1012.
\(^{172}\) See note 170 supra.
\(^{173}\) If we assume (contrary to the facts of Example II) that the corporation, in fact, paid some tax on the net income resulting from its collection of the receivables and payment of the payables, A will no longer be able to sell the stock for $25,000. Rather, he will only be able to resell it for $25,000 less the corporate tax paid; this payment will, of course, reduce the value of the stock. See note 27 supra. That would, of course, in no way change the text’s conclusion that A is being taxed on $35,000 more than his economic income.
under section 357(c), since the only other liability assumed by the corporation under section 357(c)(3)'s definition of liabilities (the $40,000 bank loan), did not exceed the transferor's $50,000 basis in the assets transferred. Moreover, the transferor's section 358 carryover basis of $50,000 in the stock received would be reduced only by the $40,000 bank liability, not by the $35,000 salary obligation assumed by the corporation.

A's basis in the stock would, therefore, be $10,000 and an immediate resale of that stock for its $25,000 fair market value would produce a $15,000 gain to the shareholder. This is the appropriate result in a section 351 exchange. The taxpayer defers both the $50,000 potential gain on the cash-basis accounts receivable transferred and the $35,000 potential loss on the trade accounts payable until the final disposition of the stock.

(c) The Modified Deduction Approach

One final approach to resolving the section 357(c) trap will be referred to as the Modified Deduction Approach. It was first proposed by Judge Hall in her dissenting opinion in the case of Thatcher v. Commissioner,174 and was adopted by the Ninth Circuit in the same case.175 The Modified Deduction Approach is, as the name implies, a modified version of the Deduction Approach discussed in section (B) above. Whereas the Deduction Approach provides the cash-basis transferor with a deduction for all of his trade accounts payable assumed by the transferee corporation, the Modified Deduction Approach would limit the deduction to the gain recognized by the transferor under section 357(c). Judge Hall's dissent in Thatcher, as well as the Ninth Circuit's decision in the same case, seemed to further limit the transferor's deduction to the amount of cash-basis accounts receivable transferred by him.176 But in Focht, in which Judge Hall again dissented and reaffirmed her

175. 533 F.2d 1114 (9th Cir. 1977).
176. See, e.g., Kahn & Oesterle, supra note 91, which explains Judge Hall's dissent in Thatcher as follows:

Judge Hall, ... dissenting in Thatcher, advanced an alternative theory. Although acknowledging that typically no deductions are available in section 351 exchanges, she contends that section 357(c) turns the transaction into an ordinary exchange for the purpose of recognizing gain. Since Judge Hall maintained that a transferor receives an immediate deduction for the assumption of his deductible obligation in an ordinary sale, she concluded that the transferor should receive a deduction for his trade accounts payable.
own approach as the correct one,\textsuperscript{177} she indicated that this second limitation was not intended. One of her illustrations clearly demonstrated that, even if no receivables were transferred, the transferor would be entitled to a deduction for the transferred cash-basis trade payables to the extent of the gain recognized under section 357(c).\textsuperscript{178} Judge Hall's reference in \textit{Thatcher} to an offset of payables against receivables\textsuperscript{179} seemed restricted after \textit{Focht} to an assertion that if receivables were transferred, the section 357(c) gain should first be allocated to those receivables, with any additional gain being allocated to the other assets pursuant to section 1.357–2(b) of the Regulations.\textsuperscript{180} Taking her two dissenting opinions together, Judge Hall's approach seemed to be as follows: (1) she rejected the Tax Court majority's nonliteral definition of liabilities which excluded trade payables; (2) she rejected a deduction for the cash-basis transferor of trade payables in a section 351 exchange if no gain were recognized by the transferor; (3) she accepted a

\begin{center}
to the extent of the accounts receivable or the gain recognized under section 357(c), whichever is less.
\end{center}

\textit{Id.} at 481. This reading of Hall's \textit{Thatcher} dissent clearly results from her statement in that case that,

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).

61 T.C. at 43. The Ninth Circuit's opinion in \textit{Thatcher} also calls for the same double limitation on the transferor's deduction. 533 F.2d at 1117–18.

177. 68 T.C. at 243 (Hall, J., dissenting).

178. \textit{Id.} at 246. Judge Hall, in her dissenting opinion in \textit{Focht}, gave an example of a cash-basis taxpayer who transfers long-term securities (and no accounts receivable) in exchange for stock of a controlled corporation plus that corporation's assumption of the transferor's trade payables in an amount in excess of the basis of the securities. \textit{Id.} at 245–46. Judge Hall concluded that the transferor is entitled to a deduction for the trade payables in an amount equal to the gain recognized by the transferor under § 357(c). The deduction is clearly not limited to the amount of accounts receivable transferred, as there were none in the example.

179. \textit{See note 176 supra}.

180. As noted earlier, \textit{see} notes 50 & 51 and accompanying text \textit{supra}, Treas. Reg. § 1.357–2(b) (1955) treats any gain recognized by the transferor under § 357(c) as allocable to the various classes of assets transferred in proportion to their fair market value. This can result in gain being allocated to property that has not increased, or has even decreased, in value. Under Judge Hall's approach, this problem is avoided in any case in which the transferred accounts receivable exceed in value the amount of the transferred trade payables. In that event the gain recognized under § 357(c) is treated as gain from the sale of the receivables, \textit{i.e.}, ordinary income which is then offset by the ordinary deduction. Judge Hall stated in her dissenting opinion in \textit{Focht} that "[a]s a matter of appropriate allocation, the taxable part of the payables . . . should be netted first against receivables . . . and then any balance against other assets (except cash) in proportion to their respective fair market values under the principles of section 1.357–2, Income TaxRegs." 68 T.C. at 248. Where Judge Hall finds the exception to Treas. Reg. § 1.357–2(b) is unclear.
deduction for the cash-basis transferor of trade payables in a section 351 exchange only to the extent the transferor recognized gain under section 357(c); and (4) she believed that any gain recognized under section 357(c) to a cash-basis taxpayer should be allocated first to the cash-basis receivables, and only then to other assets under section 1.357-2(b) of the Regulations.

The Modified Deduction Approach applied to the facts of Example II brings about tax results that are more correct than those of the Pre-Focht Tax Court Approach, but far inferior to those reached by the Focht-Congressional Approach. Under the Modified Deduction Approach, transferor A in Example II would, as in the Pre-Focht Tax Court Approach, realize $25,000 gain on incorporation under unamended section 357(c). This gain would all be allocated to the accounts receivable and would therefore be ordinary income. This immediate ordinary income would be offset by an equal $25,000 ordinary deduction for A when the corporation paid the assumed trade payables. If A immediately resold the stock for its $25,000 value, he would have an additional gain of $25,000 since his stock basis would be zero. This $25,000 tax gain would be reduced to the correct $15,000 economic gain only if the transferor A was entitled to an additional $10,000 deduction. Under the Modified Deduction Approach, however, the extra $10,000 deduction would not be permitted. Thus, although the transferee corporation assumed $35,000 of the transferor’s deductible obligations, the transferor’s deduction is limited under this approach to the $25,000 gain he recognized under section 357(c). In effect, Judge Hall’s solution resolves the immediate overtaxation caused by section 357(c), but not the deferred overtaxation caused by unamended section 358(d)’s required basis reduction for the assumed deductible obligations.181

(2) The Tax Treatment of the Transferee Corporation

Once the Focht-Congressional Approach is accepted as correct at the transferor level, appropriate tax consequences are produced at the corporate transferee level only if the transferee is given a deduction when it pays the assumed trade payables of the cash-basis transferor. The necessity of this corporate deduction is fully explained in section B(2) above. As previously noted, the IRS now

181. See notes 106 to 110 and accompanying text supra. Judge Hall’s approach, unlike the Focht-Congressional Approach, can result in the transferor’s allowable $25,000 deduction being placed in a year subsequent to the year in which gain is recognized by the transferor under § 357(c) — the year of incorporation. This would be the result any time the corporate transferee did not discharge the assumed deductible obligation in the taxable year in which the incorporation took place.
seems willing to permit the corporate transferee a deduction when it assumes and pays the deductible obligations of its cash-basis transferor. 182

The only additional factor that might be noted here is that, under the Pre-focht Tax Court Approach, a corporate deduction for the assumed payables made little sense, since it resulted in undertaxing the corporation. The reason for this was that the corporation already received an increase in its basis in the transferred assets equal to the gain recognized to the transferor under section 357(c). In Example II, the corporation, under the Pre-Focht Tax Court Approach, would have (i) taken a total basis in the land and accounts receivable of $75,000 — their $50,000 carryover basis plus the $25,000 increase for the gain recognized to the transferor under section 357(c) — and (ii) reported $25,000 net income on the disposition of the assets. This $25,000 income would then have been more than offset by the $35,000 deduction, if such a deduction were given the corporate transferee upon the assumption or payment of the trade payables. The result would be a net loss at the corporate level. 183

(D) Consideration of Remaining Tax Planning Options for Cash-Basis Transferors

Given the legislative changes in sections 357(c) and 358(d) and the Service’s apparent acquiescence in a corporate deduction for assumed trade payables of a cash-basis transferor, owners of unincorporated cash-basis businesses can now be relatively184 certain that if they transfer their trade accounts receivable and their trade accounts payable to a controlled corporation there will be no adverse tax results. The controlled corporation will simply step into the shoes of the cash-basis transferor with respect to the receivables and payables. It will report ordinary income when it collects the receivables and take ordinary deductions when it satisfies the payables. At the transferor shareholder level, the transfer of the accounts receivable subject to accounts payable will result in neither immediate income nor deduction. Rather, the net amount by which the receivables exceed the payables will be deferred until such time

182. See LTR 7830010, supra note 59; quoted at text following note 130 infra.
183. The mirror image is entirely lost, since under the Pre-Focht IRS-Tax Court Approach the transferor would defer $25,000 of gain, while the transferee would recognize none.
184. The word “relatively” is used since the IRS has not yet officially published a ruling dealing with the transferee’s deduction.
as the transferor disposes of the stock received in the section 351 exchange, and then the gain will be capital.\(^{185}\)

One question that does remain is whether there is still room for tax planning on the incorporation of a cash-basis taxpayer. For example, might it sometimes be advantageous for the transferor to retain his cash-basis payables while transferring his receivables to the controlled corporation? If it would be to his tax advantage to do so, would he, under existing judicial decisions or the Service's ruling policy, be able to accomplish the tax goal he is seeking — an ordinary deduction at the transferor level and ordinary income at the corporate transferee level? This alternative, as well as other alternatives to transferring all cash-basis receivables and payables to a controlled corporation, will be explored in this section. The weapons available to the IRS to combat any transfer of receivables or payables that results in a distortion of income at either the transferor or transferee level will also be explored.

In considering the various alternatives to a transfer of all accounts receivable and payable, the following facts will be used.\(^{186}\) Individual A, a cash-basis taxpayer, owns a proprietorship consisting of trade accounts receivable with a value of $50,000 and a basis of zero, and a capital asset with a value and basis of $50,000. The proprietorship also has $25,000 of unpaid trade payables. The tax consequences to individual A, and his controlled corporation (Corporation X), if he transferred all of the proprietorship’s assets subject to the trade payables were previously seen\(^{187}\) to be the following:

1. No immediate income or deduction to Individual A;
2. A capital gain of $25,000 to A when the stock was finally disposed of; and
3. $25,000 net ordinary income at the corporate transferee level.

In lieu of transferring all of the receivables and payables and obtaining the above tax consequences, Individual A might have taken one of the following actions:

1. He might have retained the $25,000 of trade payables and $25,000 of the accounts receivable, and transferred the

\(^{185}\) But see note 27 supra.
\(^{186}\) These facts are basically those of Example I, see text accompanying note 79 supra, with one modification. In Example I, it was assumed, for the sake of simplicity, that the $25,000 deductible obligation assumed by the corporation constituted a single salary obligation owed to an employee by the transferor. In this Part, in order to make the discussion more meaningful, it is assumed that the $25,000 deductible obligation consists of a variety of trade payables.
\(^{187}\) See text accompanying notes 90 to 99 & 111 to 151 supra.
remaining $25,000 of receivables and the capital asset to the corporation.

2. He might have retained all of the receivables and the trade payables, and transferred only the capital asset to the corporation.

3. He might have retained or prepaid the trade payables, but transferred all of the receivables and the capital asset to the corporation.

4. He might have retained all of the receivables but transferred the trade payables and the capital asset to the corporation.

The strategy involved in each of these alternatives is discussed below.

(1) Retaining the $25,000 Trade Payables and $25,000 of Accounts Receivable

Traditionally, tax advisors advised a client incorporating his business to retain his cash-basis payables outside the corporation.\(^ {188} \) This was advised at a time when the a deduction of the accounts payable by the transferee corporation was not believed to be permissible. Thus, the only way to assure their deductibility was to provide for their payment by the transferor, rather than the transferee. Often this meant that the transferor would have to retain a sufficient amount of the receivables to provide the cash flow necessary to discharge the retained payables. The IRS apparently accepted this procedure as legitimate and never argued that it resulted in a distortion of income.\(^ {189} \) If this procedure were followed in Example I, the corporation would have $25,000 of ordinary income upon collection of the $25,000 of transferred receivables and no offsetting deduction. Individual A would have no net income, since the $25,000 ordinary income on his collection of the retained $25,000 of accounts receivable would be exactly offset by the $25,000 ordinary deduction on his payment of the retained $25,000 trade payables. Individual A's basis in the stock received would be $50,000 (the basis of the capital asset transferred), and he would recognize $25,000 capital gain when he disposed of the stock for its $75,000 fair market value. In other words, Individual A and Corporation X would obtain the same tax results they would have had they transferred all of the receivables and the payables to the corpora-

\(^{188}\) See note 70 and accompanying text supra.

\(^{189}\) See, e.g., IRS Letter Ruling 7801008 (Sept. 30, 1977).
tion, and the corporation was allowed a deduction for the payables. Because there are administrative difficulties involved in withholding part of the receivables and the payables, and there no longer seem to be any tax advantages in doing so, this alternative appears to serve no purpose. Nevertheless, cautious tax advisors may continue to have their clients follow this approach until the IRS issues a published ruling setting forth its position as to the deductibility by a corporate transferee of the assumed trade payables of a cash-basis transferor.

(2) Retaining All Receivables and All Payables

Under certain circumstances it might appear advantageous from a tax viewpoint for the incorporator to retain all cash-basis trade payables and receivables outside the corporation. This would be most obviously beneficial when the transferor has losses available from other activities that offset the immediate net income from the retention of the payables and receivables. Even if there are no such losses to be offset, when the marginal tax rates of the transferor and the corporation are approximately equal, this solution would appear to be advantageous since it eliminates the possibility of a double tax burden at both the corporate and shareholder levels.

If, in the examples, Individual A retains all of the receivables and payables outside the corporation, there will, of course, be a tax only for Individual A and not at the corporate level. If, however, the receivables and payables are transferred by A to the corporation, there will be a tax on ordinary income at the corporate level as well as either an additional ordinary tax at the shareholder level (when the after-tax earnings resulting from the corporation’s collection of the receivables and payment of the payables are distributed to A),\(^{190}\) or an additional capital gain at the shareholder level (when A realizes the after-tax corporate earnings on a disposition of his stock).\(^{191}\)

It should be noted that often the advantages to the shareholder of retaining all receivables and payables will be more illusory than real. First, there are obvious administrative difficulties in keeping the preincorporation receivables and payables separate from those earned or incurred after the incorporation. Second, trade accounts receivable will often form a substantial portion of the working

\(^{190}\) See I.R.C. §§ 301, 316.

\(^{191}\) The value of the corporation will be reduced by the corporate tax paid on the net excess of receivables over payables, and the shareholder's additional capital gain on a later disposition will therefore be limited to the net excess of the receivables over the payables less the corporate tax paid on this excess. See note 27 supra.
capital needs of the continuing business, and their transfer and subsequent collection by the corporation will be required to provide the funds necessary to carry on the business. This latter problem could, however, be resolved by having the shareholder lend money to the corporation for its working capital needs, or simply by having the shareholder collect the receivables outside the corporation and then contribute the after-tax proceeds to the capital of the corporation. Third, in many cases the advantages of eliminating the deferred capital gain at the transferor level will be minimal. This will be so whenever a sale of the stock is not expected for many years and will be even less important when the transferor expects eventually to transfer this stock to his children by bequest.\textsuperscript{192} Finally, it may be quite possible for the shareholder-employee, particularly in a service business, to recoup the additional earnings and profits from the corporation by having the corporation pay such earnings back to the shareholder-employee in the form of deductible salary,\textsuperscript{193} rather than in the form of a nondeductible dividend. In fact, some part of the additional corporate earnings might be used by the corporation to make a contribution on behalf of the shareholder-employee to a qualified pension or profit-sharing plan.\textsuperscript{194} To the extent that this is done, the income will not be currently taxed to either the transferor or the transferee.\textsuperscript{195}

(3) \textit{Retaining or Prepaying the Trade Payables, Transferring All Receivables}

If the transferor otherwise has the funds available to pay off the trade payables when they became due, he might consider retaining the $25,000 of payables or prepaying them and transferring all $50,000 of accounts receivable to the corporation. The hoped-for tax consequences would be as follows: (i) $50,000 ordinary income to the corporation upon collection of the receivables, (ii) an immediate $25,000 ordinary deduction to Individual A, and (iii) a potential

\textsuperscript{192} Prior to January 1, 1980, the unrealized appreciation on property transferred at death will not be taxed to the decedent or to the beneficiary. \textit{See note 152 supra.}
\textsuperscript{193} Salaries, of course, must meet the test of reasonableness before they are deductible. \textit{See I.R.C. § 162(a)(1).}
\textsuperscript{194} Sections 401 through 415 of the Code govern the so-called “qualified” pension, profit sharing, stock bonus, and bond purchase plans. Assuming a plan meets the requirements of the relevant sections (in particular that the plan not discriminate in favor of employees who are stockholders or officers who are highly compensated, \textit{I.R.C. § 401(a)(4)}), employer contributions to the plan are deductible by the employer, \textit{I.R.C. § 404}, but are not reportable as income by the employee until he begins to receive payments, \textit{I.R.C. § 402(a)(1)}.\textsuperscript{195} \textit{See note 194 supra.}
$50,000 capital gain for Individual A on disposition of his stock.\footnote{196} These results appear advantageous any time the transferor is in a tax bracket higher than that of the transferee corporation. The deduction for the payables would reduce high bracket income of the transferor while the related income from the receivables would be taxed at the lower corporate rates. However, the Service seems well equipped to prevent this scheme from working by applying the assignment of income doctrine, or by using its authority under section 482 or 446(b) to allocate income and deductions between related entities, or change a taxpayer's method of accounting in order clearly to reflect income.

(a) **Applying the Assignment of Income Doctrine**

Under the assignment of income doctrine, the collection of the transferred accounts receivable by the corporation would result in taxable income to the shareholder transferor. The IRS clearly believes that it has the authority to apply the assignment of income doctrine to transfers of accounts receivable in a section 351 exchange any time the transfer results in a distortion of income for the transferor.\footnote{197} In LTR 7830010 the National Office gave as an example of such a distortion of income, "a transfer of the accounts receivable to the corporation but a retention by the transferor of expenses payable." The courts, in general, appear to support the Service position.

In *Hempt Bros., Inc. v. United States*\footnote{198} the Third Circuit held that a corporate transferee, rather than the transferor, was properly taxed upon its collection of accounts receivable that were transferred to it in conjunction with the section 351 incorporation of a going business by a cash-method partnership for a legitimate business purpose.\footnote{199} The court said, however, that it was not promulgating "a hard and fast rule" that the assignment of income doctrine could never be applied in a section 351 exchange. It stated:

> We believe that the problems posed by the clash of conflicting internal revenue doctrines are more properly determined by the circumstances of each case. Here we are influenced by the fact that the subject of the assignment was accounts receivable for

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\footnote{196} Individual A's basis in his stock would be $50,000 (the basis of the transferred capital asset). The stock he receives will be worth $100,000. Hence, on a sale of the stock at its fair market value, there would be a $50,000 gain. But see note 27 supra.
\footnote{197} See, e.g., LTR 7830010, supra note 59; quoted at text following note 130 supra.
\footnote{198} 490 F.2d 1172 (3d Cir.), cert. denied, 419 U.S. 826 (1974).
\footnote{199} See notes 52 to 62 and accompanying text supra.
partnership's goods and services sold in the regular course of business, that the change of business form from partnership to corporation had a basic business purpose and was not designed for the purpose of deliberate tax avoidance, and by the conviction that the totality of circumstances here presented fit the mold of the Congressional intent to give nonrecognition to a transfer of a total business from a non-corporate to a corporate form. 200

There are also a number of older cases that illustrate the principle that income will not be shifted to the corporate transferee if it appears that the exchange was motivated primarily by tax avoidance rather than being part of an overall incorporation for a legitimate business purpose. 201 None of these cases, however, deals with the specific type of situation referred to by the IRS in LTR 7830010; that is, they do not consider the situation in which all of the assets of an existing cash-basis business, including unrealized receivables, are transferred to a new corporation for legitimate business purposes, but the transfer results in a distortion of income because the related deductible payables are retained (or were previously paid and deducted) outside of the corporation. Rather, these older section 351 assignment of income cases deal with ad hoc transfers of accounts receivable to corporations for pure tax avoidance purposes unrelated to the incorporation of a going business.

An example of such a case is Brown v. Commissioner, 202 in which the taxpayer was the surviving member of a partnership. He instituted a suit in the partnership's name to recover a fee earned by it for legal services rendered. While the suit was pending, he assigned his one-half interest in the claim to a corporation organized by him in exchange for all of its stock. The claim was the corporation's only asset. The Second Circuit held, applying classic assignment of income principles, that the fee was taxable to Brown when his wholly-owned corporation collected it. 203 Likewise, in Weinberg v. Commissioner, 204 a cash-basis transferor directed his obligors to deposit certain proceeds due him from the sale of crops into fourteen newly formed corporations. The sales proceeds were

200. 490 F.2d at 1178.
201. E.g., Brown v. Commissioner, 115 F.2d 337, 339 (2d Cir. 1940); Weinberg v. Commissioner, 44 T.C. 233, 245 (1965), aff'd per curiam sub nom. Commissioner v. Sugar Daddy, Inc., 386 F.2d 836 (9th Cir. 1967), cert. denied, 392 U.S. 929 (1968); Davidson v. Commissioner, 43 B.T.A. 576, 584-86 (1941), acquiesced in, 1941-1 C.B. 3.
202. 115 F.2d 337 (2d Cir. 1940).
203. Id. at 339.
taxed to the transferor under assignment of income principles. The court found that no plausible business purpose could be shown for the existence of the corporations except as shells or conduits for the sales proceeds.205

While the decided cases have generally applied assignment of income principles in section 351 exchanges only to sham transfers, there is no reason to believe courts would not uphold the IRS in applying the same principles in distortion of income cases like those described in LTR 7830010. The issue may be moot, however, since the goal of clearly reflecting income in such cases can be and has been achieved by the Commissioner in similar section 351 distortion of income cases by his use of his powers under sections 482 and 446(b).206

(b) Clear Reflection of Income — Commissioner’s Use of Sections 482 and 446(b)

Under section 482 of the Code, in order to prevent tax evasion or clearly to reflect income, the Commissioner may allocate items of “income, deductions, credits, or allowances” between “two or more organizations, trades, or businesses (whether or not incorporated . . .) owned or controlled directly or indirectly by the same interests.”207 The Regulations make clear that section 482 may be applied to nonrecognition transactions such as section 351.208 In fact, decided cases have permitted the Commissioner to use section 482 in order clearly to reflect income when as part of a section 351 exchange, unrealized income items were transferred to a new corporation, but the related payables had previously been deducted by the transferor.209

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205. Id. at 245.
207. For a discussion of the enactment, purposes and operation of § 482, see Bittker & J. Eustice, supra note 19, § 15.06.

Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for nonrecognition of gain or loss. See, for example, National Securities Corporation v. Commissioner of Internal Revenue, 137 F.2d 600 (3d Cir. 1943), cert. denied 320 U.S. 794 (1943).
209. See Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir.), cert. denied, 344 U.S. 874 (1952).
For example, in *Rooney v. United States*, a farmer incorporated his cash-basis business on July 31, 1954. On that date, he transferred all of the assets of the unincorporated business, subject to all of its liabilities, to a controlled corporation in exchange for all of the corporation’s stock. Included in the transferred assets were certain crops that had previously been sold under contract. The crops were harvested in August and September 1954, and the proceeds from the sale were reported by the corporation. The individual transferor had, however, prior to the incorporation, deducted all of the expenses of preparing, planting, and cultivating the crop. The Ninth Circuit upheld the Commissioner’s section 482 reallocation of the expense of producing the growing crop from the transferor to the corporation. Similarly, in *Central Cuba Sugar Co. v. Commissioner*, a New York corporation incurred the cost of planting a sugar crop, which expense the New York corporation deducted. Prior to realizing any income with respect to the crop, however, the New York corporation transferred the crop along with its other assets to a Cuban corporation. Although the transferor New York corporation was granted a ruling under the predecessor of section 367 that the exchange was not pursuant to a plan having as one of its principal purposes the avoidance of taxes, section 482 was applied clearly to reflect the income of the two corporations. As in *Rooney*, the transferor’s expenses of planting the crop were allocated to the corporation that sold the crop and realized the income therefrom.

In both *Central Sugar Co.* and *Rooney* a clear reflection of income was achieved by allowing a section 482 allocation of the deductions from the transferor to the transferee. However, section 482 is by no means a statutory “carte blanche” limitation on section 351. The regulations and case authority permit section 482 to override section 351 only in appropriate “abuse” situations. In the absence of deliberate attempt at evasion of taxes or a material distortion of tax consequences, application of section 482 would in fact be an unauthorized abuse of discretion by the Commissioner.

... The “evasion” element is basically a “sham” issue. “Distortion” is at best a line-drawing process since there is invariably some amount of distortion in every instance. The question is how much distortion will be allowed and resolution appears to be heavily influenced by viewing all the facts as a whole.

Knobbe & Ridenour, *supra* note 206, at 866-67 & n.16. Particular note should be taken of the fact that in both *Rooney* and *Central Cuba Sugar Co.*, the timing of the transfer of crops was such that the deduction of the crop expense by the transferor produced an artificial loss in the year of the transfer that the transferor tried to carry back to offset against income earned in previous years. But suppose that a farmer

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210. 305 F.2d 681 (9th Cir. 1962).
211. 198 F.2d 214 (2d Cir.), cert. denied, 344 U.S. 874 (1952).
212. *Id.* at 216.
213. However, section 482 is by no means a statutory “carte blanche” limitation on section 351. The regulations and case authority permit section 482 to override section 351 only in appropriate “abuse” situations. In the absence of deliberate attempt at evasion of taxes or a material distortion of tax consequences, application of section 482 would in fact be an unauthorized abuse of discretion by the Commissioner.
of income could also have been achieved by those courts by allocating the income from the transferee to the transferor. The latter method of clearly reflecting income could have been accomplished under section 482, or, as was previously discussed, under the assignment of income doctrine.214

In our current example, when $50,000 of receivables are transferred, but $25,000 of payables are retained outside the corporation, the Service has an additional weapon to achieve a clear reflection of income. That weapon is section 446(b), which permits the Commissioner to change a taxpayer’s method of accounting if the method the taxpayer is using does not clearly reflect income.215

Using section 446(b), the Commissioner might change the transferor’s method of accounting in our example from cash to accrual, thereby requiring the transferor to claim the deduction as well as to report the income prior to the incorporation. Section 446(b) has, in fact, been applied to section 351 transfers. The most significant case to do this was Palmer v. Commissioner,216 in which a taxpayer in the construction business had reported income on the completed-contract method of accounting. Shortly before a major payment fell due for the work, the taxpayer transferred the contract to a controlled corporation. The court upheld the Commissioner’s use of section 446(b) to place the transferor on a percentage of completion accounting method in order to reflect his share of the net income earned prior to the transfer. A close analysis of the facts of Palmer,

214. But cf. Rubin v. Commissioner, 429 F.2d 650, 653 (2d Cir. 1970) (indication by court that resort to common law doctrines such as assignment of income may not be permissible when a statutory provision such as § 482 is available to deal with the problem presented).

215. In the § 351 context there appears to be no significant difference between the results the IRS can reach under §§ 482 and 446(b). See Berger, Gilman & Stapleton, supra note 206, at 527 n.17.; Knobbe & Ridenour, supra note 206, at 869 n.21.

216. 267 F.2d 434 (9th Cir. 1959).
however, make it seem more akin to the tax avoidance cases like Brown and Weinberg, which applied the assignment of income doctrine, than to such pure distortion cases as Rooney and Central Cuba Sugar Co., which applied section 482. In Palmer there was no question of income being reported by one party (the transferee) and the deduction by the other (the transferor). The problem was simply that the controlled corporation which tried to report all of the income and deductions was being utilized for tax avoidance purposes. The purpose of the section 351 transaction was to get the realized but unrecognized net income from the transferred contract into the controlled corporation, where the income would eventually offset corporate losses from another enterprise of the transferor.217

In conclusion, it would seem that when a cash-basis transferor in an otherwise business-motivated section 351 incorporation retains substantial payables but transfers receivables to a newly formed corporation, the IRS can take one of the following actions: (a) move the income from the corporate transferee to the transferor by using assignment of income principles, section 446(b), or section 482; or (b) allocate the deduction for the payables from the transferor to the transferee corporation under section 482.

(4) Transferring the Trade Payables, Retaining the Receivables

In cases in which the transferor has losses and the corporation has income it would seem advantageous from a tax viewpoint for a transferor to retain the receivables but have the corporation assume the salary obligation. Any advantages, however, are entirely illusory. First, the administrative and practical problems of withholding receivables that were discussed above, when all receivables and payables were retained, would be more severe here. Second, it seems clear that neither a court nor the IRS would allow the corporation a deduction for the assumed payables in this case, while, at the same time, permitting the transferor to report the income from the collection of the related receivables.218 The Service would presumably do one of three things in this situation: (i) simply deny the deduction for the trade payables to both the transferor and

217. Id. at 436.
218. See, e.g., the quotation from LTR 7830010, supra note 59, in the text following note 130 supra, wherein the Service made clear that the only reason it permitted the transferee corporation to deduct the assumed payables was to insure that there was a clear reflection of income at the corporate level. That is, the corporation that reports ordinary income from the collections of accounts receivable should claim the deduction when it pays the related payables.
transferee; (ii) use its power under either section 446(b) or 482 to allocate the income from the collection of the receivables to the corporate transferee while at the same time permitting the transferee a deduction for the trade payables; or (iii) use its power under either section 446(b) or 482 to allocate the deduction for the trade payables to the transferor who is reporting the income from the collection of the related receivables.

Because the mechanics of 446(b) and 482 were discussed in the prior subsection, the two last mentioned solutions will not be discussed here. Although these two solutions seem fairer than the first, it appears that the first solution is the more likely result. The IRS in LTR 7830010 clearly indicates that it will only permit the corporate transferee a deduction for assumed trade payables of a cash-basis transferor if the assumption is for a legitimate business purpose and does not distort income of either the transferor or the transferee. In other cases it apparently will revert to the rule of Holdcroft and deny the deduction to the transferee corporation. In such a case, the transferor will probably not be entitled to the deduction for the payables, for, as was previously discussed, there is no precedent in the case law for allowing the deduction to the transferor.219 Thus the deduction will be lost to both the transferor and the transferee.

Finally, in these circumstances it might be possible for the Service to argue that the deductible liability was transferred to avoid federal income tax, and therefore results in “boot” in the section 351 exchange under section 357(b).220 It is arguable, however, that section 357(b) should be restricted to cases in which the liability assumed by the transferee is unrelated to the business being transferred to it and should not be applied in the distortion of income situation described here. In any event, if section 357(b) were to be applied to make the assumption of the deductible payable “boot,” Judge Hall’s Modified Deduction Approach should also be applied to grant the transferor a deduction for the obligation.221

**Summary**

Since alternatives to the transfer of all receivables and payables that will not distort the transferor’s or transferee’s income will normally be of no tax or nontax advantage to a taxpayer, and alternatives that might give the taxpayer a tax advantage can easily

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219. See cases cited in note 106 supra.
220. See notes 46 to 47 and accompanying text supra. Section 357(b) was not amended by the Revenue Act of 1978 to exclude deductible obligations.
221. See notes 174 to 181 and accompanying text supra.
be thwarted by the Commissioner, effective tax planning in this area seems to be extremely limited.

CONCLUSION

For many years, the taxpayer incorporating his cash-basis business in midstream was faced with unresolved tax issues. Those problems have been resolved by a combination of legislative action, judicial decision, and IRS ruling policy, as follows:

First, the cash-basis transferor of zero-basis accounts receivable to a controlled corporation in exchange for stock or securities will not be taxed on the gain inherent in those receivables either on their transfer to or collection by the transferee corporation. Instead, the corporation will be taxed when it collects such receivables.

Second, under existing IRS practice a transferee corporation that assumes and pays the deductible obligations of a cash-basis transferor will be able to deduct those payables. Cautious tax advisors may still be unwilling to rely on this result without an advance ruling, however, until the IRS issues a published ruling specifically allowing the deduction to the corporate transferee.

Third, under the 1978 amendments to sections 357(c) and 358(d), deductible obligations of a cash-basis transferor are no longer considered “liabilities.” This means that the transferor is not required to reduce the basis of the stock and securities received in the exchange by the amount of those transferred trade payables and will not be required to recognize immediate gain under section 357(c) if those liabilities exceed the basis in the assets transferred.

Fourth, none of the tax results described in the three preceding paragraphs will necessarily follow if the transfers of the payables and receivables are made at such a time or in such a manner as to result in a distortion of income for either the transferor or the transferee.