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Section 357(c): The Quest for Equality between Accrual and Cash Basis Taxpayers

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Comment

SECTION 357(c): THE QUEST FOR EQUALITY BETWEEN ACCRUAL AND CASH BASIS TAXPAYERS

I. INTRODUCTION

Incorporation of an existing business almost invariably raises the question of whether the corporation should assume the business's liabilities and whether such an assumption creates income tax problems under section 357 of the Internal Revenue Code.[1] Cash basis taxpayers in particular have encountered special problems when incorporating a partnership or sole proprietorship and often have received an unexpected tax liability in the year of incorporation.

Generally, gain or loss is not recognized when assets and liabilities are transferred to a controlled corporation solely in exchange for the stock or securities of that corporation.[2] Section 357(c) of

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1. The general rule of § 357 provides for nonrecognition where liabilities are assumed by the corporate transferee. INT. REV. CODE OF 1954, § 357(c) [hereinafter cited as CODE] provides:

   Liabilities in Excess of Basis.—

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

   (A) to which section 351 applies, or

   (B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D),

   if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

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

   (A) subsection (b)(1) of this section applies, or

   (B) section 371 or 374 applies.

2. CODE § 351 provides:

   (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 . . . of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

the Internal Revenue Code, however, requires that gain be recognized to the extent that the liabilities assumed (plus liabilities to which the property transferred is subject) exceed the aggregate adjusted basis of property transferred to the new corporation.[3] The cash basis taxpayer's unexpected tax liability results from a very literal interpretation of section 357(c). Under this interpretation, for the cash basis taxpayer, the adjusted basis of accounts receivable is zero while the accounts payable are liabilities which are valued at their face amount. Therefore, unless other property with a substantial aggregate adjusted basis is transferred, instant income is recognized under the section 357(c) formula.[4] Recently the Court of Appeals for the Second Circuit, in *Bongiovanni v. Commissioner*,[5] disagreed with the prevailing literal interpretation and held that the liabilities referred to in section 357(c) were tax liabilities and not accounting liabilities. Accordingly, the court held that, for tax purposes, a cash basis taxpayer's accounts payable should not be valued at face amount but at zero. The court justified this distinction on the grounds that, since the cash basis taxpayer had not been allowed a deduction for the accounts payable, a contrary determination would promote inequality between accrual and cash basis taxpayers.

This comment will examine the history and purpose behind section 357(c), including an analysis of the defects in pre-1954 law which section 357(c) was designed to remedy, to determine the proper application of the section when accounts receivable and

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> (b) RECEIPT OF PROPERTY.—If subsection (a) would apply to an exchange but for the fact that there is received in addition to the stock or securities permitted to be received under subsection (a), other property or money then—
> (1) gain (if any) to such recipient shall be recognized, but not in excess of—
> (A) the amount of money received, plus
> (B) the fair market value of such other property received; and
> (2) no loss to such recipient shall be recognized.
> . . . .
> (e) CROSS REFERENCES.—
> (1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357.

3. In the interest of clarity, the phrase "liabilities assumed" will hereinafter refer both to liabilities assumed by the corporate transferee as well as liabilities to which the property transferred is subject.
4. Peter Raich, 46 T.C. 604 (1966); Rev. Rul. 69-442, 1969-2 CUM. BULL. 53. It should be noted that when more than one transferor is involved in the exchange, the IRS has ruled that each must be viewed separately to determine individual tax liability. *See* Rev. Rul. 66-142, 1966-1 CUM. BULL. 66.
5. 470 F.2d 921 (2d Cir. 1972).

accounts payable are involved. In addition, the implications and inconsistencies of both the *Bongiovanni* decision and the "majority" view of section 357(c) will be explored to determine whether equality between cash basis and accrual taxpayers exists under either interpretation.

II. BACKGROUND

Section 357 applies only to tax-free exchanges meeting the requirements of section 351. The basic premise of section 351(a) is that a transfer of property to a corporation controlled[6] by the transferor in exchange for its stock or securities merely changes the form of his investment and should not be an occasion for recognition of gain.[7] As a practical matter, the taxpayer in such a situation has neither realized a gain nor closed out a losing venture. However, section 351(b) provides that if money or other property is received on the exchange in addition to the stock or securities, the tax-free status of the transaction is not affected but the transferor must recognize gain to the extent of the sum of the money and the fair market value of any property received.

Under section 112(c)(1), a predecessor of section 351(b), taxpayers and government thought an assumption of liabilities by the transferee corporation did not result in recognizable gain.[8] This notion was abruptly dispelled in *United States v. Hendler*[9] where the Supreme Court held that, in an otherwise tax-free reorganization,[10] the assumption and payment of the transferor's liability by the corporate transferee constituted income to the transferor:

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6. The word "control" is a term of art when used in the nonrecognition provisions relating to a tax free incorporation. As defined in CODE § 368(c):

   > [T]he term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

7. *See* Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940). *See also* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.01, at 3-4 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].
8. Burke & Chisholm, *Section 357: A Hidden Trap in Tax-Free Incorporations,* 25 TAX L. REV. 211, 212 (1970) [hereinafter cited as Burke & Chisholm]; Surrey, *Assumption of Indebtedness in Tax-Free Exchanges,* 50 YALE L.J. 1, 6 (1940) [hereinafter cited as Surrey].
9. 303 U.S. 564 (1938).
10. CODE § 361 currently provides for tax-free treatment of reorganizations defined in CODE § 368. *Hendler* arose under Int. Rev. Code of 1928, § 112(c)(1), a provision which embodied transactions presently covered by both CODE §§ 361 and 351.

> The transaction . . . under which the Borden Company assumed and paid the debt and obligation of the Hendler Company is to be regarded in substance as though the $534,297.40 had been paid directly to the Hendler Company. . . . Its gain was as real and substantial as if the money had been paid it and then paid over by it to its creditors. The discharge of liability by the payment of the Hendler Company's indebtedness constituted income to the Hendler Company and is to be taxed as such.[11]

The *Hendler* decision had two far-reaching consequences.[12] First, the decision severely impaired the ease with which an individual or corporation could readjust its legal form of business operation. In order to avoid recognizing income, the transferor would be required to liquidate some of his assets in order to dispose of his liabilities before transferring the remainder of his business to the corporation. This result was wholly inimical to the purpose behind the nonrecognition provisions then in effect.[13]

Secondly, the decision created the possibility of a major loss in future revenue. Because of basis provisions then in effect, prior transferors would have been entitled to a step up in the basis of stock received on earlier exchanges whether gain had previously been recognized or not.[14] Similarly, the transferee corporation also would have been entitled to increase its basis in the assets received by the amount of gain that should have been recognized by the transferor.[15]

As a result, Congress, in order to preserve the spirit of the tax free exchange provisions and prevent any loss of government revenues, passed section 112(k), which effectively overruled the *Hendler* result.[16]

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11. 303 U.S. at 566.
12. For a complete discussion of the impact of the *Hendler* decision, see Surrey, *supra* note 8, at 11.
13. The Senate Report on the Revenue Act of 1921, § 202(c), the precursor of all the statutory provisions regarding tax-free exchanges, observed: "Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business readjustments."
S. REP. No. 275, 67th Cong., 1st Sess. 11 (1921).
14. Int. Rev. Code of 1934, § 113(a)(6). However, where the statute of limitations had not run, the government was still free to assert a deficiency if gain had not been recognized on the exchange. *See* Surrey, *supra* note 8, at 11-12.
15. Int. Rev. Code of 1928 § 113(a)(7)-(8). *See* Surrey, *supra* note 8, at 12-13.
16. Int. Rev. Code of 1939 § 112(k) [hereinafter cited as 1939 Code] provided:

    Assumption of Liability not Recognized.—Where upon an exchange the taxpayer receives as part of the consideration property which would be permitted by subsection (b)(4) or

Section 112(k) had a dual purpose. First, it provided that the assumption of liabilities in an otherwise tax-free exchange did not result in a taxable event. Second, it established criteria to remedy any possible abuses connected with the assumption of liabilities on the exchange. Section 357(c), the provision involved in the *Bongiovanni* decision, was added to the 1954 successor of section 112(k) and had no counterpart in prior law. To understand the reason for its enactment and the manner in which it should be interpreted, it is important to discern the abuses against which section 112(k) was directed, and its inability to provide a complete remedy.[17]

III. TAX AVOIDANCE AND BUSINESS PURPOSE

The main thrust of section 112(k) was to provide for nonrecognition where liabilities were assumed by the transferee corpora-

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> (5) of this section to be received without the recognition of gain . . . and as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires . . . property subject to a liability, such assumption or acquisition shall not be considered as "other property or money" received by the taxpayer . . .; except that if . . . it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose such assumption or acquisition (in the amount of the liability) shall . . . be treated as money received by the taxpayer on the exchange. . . .

In its technical explanation of section 112(k), the Ways and Means Committee stated:

> In typical transactions changing the form or entity of a business it is not customary to liquidate the liabilities of the business and such liabilities are almost invariably assumed by the corporation which continues the business. Your committee therefore believes that such a broad interpretation, the Hendler decision . . . will largely nullify the provisions of existing law which postpone the recognition of gain in such cases.

H.R. Rep. No. 855, 76th Cong., 1st Sess. 19 (1940).

17. Section 112(k) was reenacted in § 357(a) and (b) in the 1954 Code without substantial change. One change which was fairly significant, however, was that where the taxpayer's purpose on the exchange is one of tax avoidance, or where there is a lack of business purpose, then the *total* amount of liabilities assumed is considered as money received rather than just the specific tainted liability. Although on its face the statute purports to apply to both the tax avoidance purpose and the business purpose clauses, the Senate Committee Report on the 1954 Code explained that this provision only came into effect where a tax avoidance purpose existed:

> The language of subsection (b), relating to assumption of liability for tax avoidance purpose, has been changed in one respect from existing law. Where such a tax avoidance purpose exists, the total amount of the liabilities assumed

tion. But it also provided that with respect to the assumption or acquisition of liabilities, if the taxpayer's purpose was to avoid taxes, or if the taxpayer lacked a bona fide business purpose, the amount of the tainted liability assumed would be considered money received and therefore recognized as gain.[18] Furthermore, Congress required that the taxpayer bear the burden of proof on this issue, and that he establish his proof by a clear preponderance of evidence.[19]

Section 112(k) was intended to handle possible abuses whereby taxpayers might incur heavy liabilities just prior to incorporation and thus escape taxation on the exchange.[20] For example, since a loan is not a taxable event, the taxpayer could borrow prior to incorporation, pocket the proceeds, and then transfer the encumbered property to a controlled corporation. The taxpayer would therefore have an unrestricted right to the proceeds without paying any tax on the exchange. It also was meant to tax those individuals who borrow for personal reasons and then attempt to transfer the liabilities to a controlled corporation.[21] Since the remedial provisions of section 112(k) were intended to further only business readjustments, this seems consistent with the purpose behind its enactment.

Ascertaining why section 357(c) was needed in order to augment further the existing exceptions to the general rule of nonrecognition is difficult. There were no judicial decisions constru-

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> will be considered as money received by the taxpayer and not merely a particular liability with respect to which the tax avoidance purpose existed.

S. REP. No. 1622, 83d Cong., 2d Sess. 270 (1954). The question concerning its precise application, however, is not firmly resolved at this time. See Burke & Chisholm, *supra* note 8, at 216 n.21 and accompanying text.

18. The Commissioner has argued that there must also be a valid corporate business purpose for the assumption. In Easson v. Commissioner, 294 F.2d 653, 659 (9th Cir. 1961), the court rejected this argument and the government has since conceded the point in Jewell v. United States, 330 F.2d 761, 765 (9th Cir. 1964). *See also* Drybrough v. Commissioner, 376 F.2d 350 (6th Cir. 1967); W.H.B. Simpson, 43 T.C. 900 (1965). *But see* Treas. Reg. § 1.351-3(a)6,-(b)(7) (1955).
19. The regulations go one step further and require that "the presence of a bona fide business purpose" be "unmistakable." Treas. Reg. § 1.357-1(c) (1955).
20. *See, e.g.,* Bryan v. Commissioner, 281 F.2d 238 (4th Cir. 1960); BITTKER & EUSTICE, *supra* note 7, ¶ 3.07, at 24-25.
21. *See, e.g.,* Campbell v. Wheeler, 342 F.2d 837 (5th Cir. 1965); Eck v. United States, 25 Am. Fed. Tax R.2d 70-1227 (D.N.D. 1969); John G. Stoll, 38 T.C. 223 (1962).

ing the tax avoidance and business purpose clauses prior to 1954, and just why Congress felt section 357(c) was necessary to remedy defects in the existing statutory framework is unclear. However, an examination of some post-1954 decisions construing section 112(k) and its successor, section 357(b), illustrate their scope, and the nature of the abuses which they were equipped to handle as well as those which they could not.

The first case decided under section 112(k) was *Bryan v. Commissioner*.[22] The taxpayer had purchased four tracts of land on which he had constructed houses and made other improvements at a total cost of 1,485,701.96 dollars. During the construction phase, the taxpayer obtained loans totalling 1,692,350 dollars, which exceeded his cost by 157,798.04 dollars. He then organized four corporations and transferred the four tracts of land, each to a separate corporation, in exchange for stock and the corporations' assumption of the loans encumbering the property.

The taxpayer argued that since there was no provision comparable to section 357(c) in the 1939 Code, the fact that his liabilities exceeded basis was immaterial.[23] The court rejected this argument and held that the critical issue was the taxpayer's purpose in arranging for the assumption by the corporation on the exchange. The court relied on two factors in ascertaining the taxpayer's purpose: first, the loans did exceed his adjusted basis in the property; and, second, the loans were incurred just prior to incorporation. It found, in view of the circumstances and nature of the liabilities, that his principal purpose was tax avoidance. Therefore, the court required him to pay tax on the total amount of liabilities assumed.[24]

In *Drybrough v. Commissioner*,[25] decided under the 1954 code,[26] the taxpayer had mortgaged four properties which he owned for a

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22. 281 F.2d 238 (4th Cir. 1960). Although this case was decided after 1954, the events which gave rise to tax consequences occurred prior to that date. Therefore, the 1939 Code, § 112(k) was controlling.
23. What the taxpayer failed to realize was that a tax avoidance purpose as defined by § 112(k) could exist whether liabilities exceeded basis or not. The drafters of § 357(c) expressly recognized this possibility and provided that in the event both apply, § 357(b) is controlling.
24. Although it seems unfair that he was taxed on the total amount of the liabilities, the basis provisions do allow the taxpayer to increase his basis in the stock received by the amount recognized on the exchange. But he must also decrease his basis in the stock received by the amount of the liabilities assumed by the corporate transferee. CODE § 358.
25. 376 F.2d 350 (6th Cir. 1967).
26. Even though *Drybrough* was decided under the 1954 CODE, its main

total of 600,000 dollars. These properties were encumbered in 1953. In 1957, shortly before he formed five corporations, he mortgaged a fifth piece of property for 150,000 dollars. Four of the new corporations assumed the 1953 mortgage and the fifth assumed the 1957 mortgage. The properties and their adjusted bases are set forth in the following table:

PROPERTY TRANSFERRED	ADJUSTED BASIS	LIABILITY ASSUMED
1. 800 South Fourth Street	$ 83,682.17	$100,000
2. 720 South Fifth Street	$ 83,293.29	$ 75,000
3. 725 South Fourth Street	$ 79,955.94	$175,000
4. 655 South Fifth Street	$161,076.16	$250,000
5. 620 South Fifth Street	$103,840.12	$149,000

On his tax return for 1957, Drybrough reported 223,806.12 dollars as long term capital gain arising from the transfer of the properties and the corporations' assumption of the liabilities since the liabilities exceeded his aggregate adjusted basis under section 357(c).[27] The Commissioner argued that the tax avoidance and business purpose clauses[28] should prevail, and that the *total* liabilities should be taken into income rather than merely the amount that exceeded basis.

The Court of Appeals for the Sixth Circuit agreed in part with the taxpayer and in part with the Commissioner. The court observed: "[T]he purpose to avoid income tax is precisely narrowed to a purpose '*with respect to the assumption*' and to a purpose to avoid income tax '*on the exchange.*' "[29]

Although the proceeds of the 1953 mortgage were used to pay off existing mortgages and to purchase tax exempt securities, the court held:

> We cannot find or infer, however, that the purposes thus served revealed as a matter of fact or law a purpose to avoid income tax "on the exchange" made *four years later* when in 1957 Drybrough's business as an investor in real estate was converted as a proprietorship to corporate enterprises.[30]

The court also found that the taxpayer's desire to remain liquid

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concern was the interpretation of CODE § 357(b) (1), which was substantially the same as the 1939 Code, § 112(k).

27. This argument was essentially the same as that used by the taxpayer in Bryan v. Commissioner, 281 F.2d 238 (4th Cir. 1960). As previously discussed both §§ 357(b) (1) and (c) theoretically can apply to the same transaction, but § 357(b) (1) always controls.
28. CODE § 357(b).
29. 376 F.2d at 356.
30. *Id.*

as an investor was a sufficient business purpose for not paying off the 1953 mortgage before effecting its transfer.[31]

The court took a different view of the 1957 mortgage. The court agreed with the Tax Court's finding that the debt was created solely in anticipation of the exchange[32] and held that the taxpayer's primary purpose was tax avoidance. In addition, since the proceeds were not used to carry on the purposes of the business enterprise, but were instead used for purely personal reasons, the court found that the taxpayer in *Drybrough* lacked a valid business purpose.

In *Easson v. Commissioner*,[33] a decision under the 1939 code, the taxpayer mortgaged his apartment house for 250,000 dollars. Later in the same year, he formed a corporation and transferred the property subject to the mortgage to a controlled corporation in exchange for all of its capital stock. He did, however, remain personally liable on the notes.

The Tax Court specifically found that the taxpayer had a legitimate business purpose for the assumption and that his principal purpose was not tax avoidance. However, at the time the property was transferred, the unpaid mortgage exceeded the adjusted basis of the property by 159,849.15 dollars. The basis provisions at that time required the transferor to reduce his substituted basis in the stock received by the face amount of the liabilities assumed.[34] The application of this provision would have reduced the transferor's basis in the stock to a minus 159,000 dollars.[35]

31. This court took a liberal view of the phrase "bona fide business purpose." For other articulations of the same view, see Jewell v. United States, 330 F.2d 761 (9th Cir. 1964) and Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961). *But see* Campbell v. Wheeler, 342 F.2d 837 (5th Cir. 1965). For a collection of authorities construing the "business purpose" clause, see 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.158 (1972); Burke & Chisholm, *supra* note 8, at 217.

32. The court relied primarily on a letter written by Drybrough shortly before the exchange wherein he stated he was eager to mortgage the property to the limit before incorporation. 376 F.2d at 358.

33. 294 F.2d 653 (9th Cir. 1961).

34. 1939 Code, § 113 (a) (6).

35. At the time of the transfer, the taxpayer's basis in the property was $87,214.86 and its fair market value was $320,000. The principal balance of the mortgage was $247,064.01. Since the 1939 Code, § 113 (a) (6) required that any liability assumed must be treated as money received, the taxpayer's substituted basis of $87,214.86 would have to be reduced by the amount of the mortgage viz:

$ 87,214.86	- adjusted basis in property transferred
- 247,064.01	- amount of mortgage
-$159,849.15	- taxpayer's basis in stock received

The Tax Court specifically found that property cannot have a negative basis. Therefore, the court held that unless the taxpayer were taxed on the exchange, the proceeds would permanently avoid taxation.

On appeal, the Ninth Circuit rejected the Tax Court's holding and found that property can have a negative basis. In addition, the court agreed with the lower court's finding that no tax avoidance motive existed and that the taxpayer had a valid business purpose. Therefore, the total amount of the liabilities went unrecognized until such time as the taxpayer sold his stock, even though the liabilities assumed exceeded the adjusted basis.

In all three decisions, *Bryan*, *Drybrough* and *Easson*, the statutory language existing prior to enactment of section 357(c) could solve the problem of liabilities in excess of basis only in certain situations. The fact that liabilities exceeded basis was not in itself evidence of tax avoidance; the purpose to avoid taxes or a lack of a bona fide business purpose must be *with respect to the assumption on the exchange*. Since these motives are not always present where liabilities exceed basis under the existing law, that amount would have gone unrecognized. But, irrespective of a purpose to avoid taxes, the individual taxpayer, when relieved of property and the liability, still is given an unrestricted right to proceeds which exceed his original cost. No argument can be made that the transaction would still be open because the taxpayer has transferred the property as well as the mortgage upon incorporation.

Furthermore, the basis provisions then in effect (as well as those now in effect under section 358) would dictate a negative basis in the stock or securities received by the taxpayer unless gain is recognized. Although one commentator has argued that a negative basis results in tax avoidance,[36] others have observed that it results only in tax postponement.[37] Regardless of which view is "correct", it does substantially impair the collectibility of federal income tax. The greater the negative basis allowed, the less likely the holder is to dispose of the stock. In addition, by deferral of tax liability, the transferor receives a windfall over and above what

36. Note, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154, 1160 n.31 (1967). The writer maintains that if the stock is never sold the transferor will never be required to pay tax on the proceeds. But this is always true when a liability is transferred to a controlled corporation, whether it exceeds adjusted basis or not. The real question is not whether gain is realized, but when should it be recognized.

37. Cooper, *Negative Basis*, 75 HARV. L. REV. 1352, 1355 (1962); Spears, *Mortgages in Excess of Basis*, U. SO. CAL. 1959 TAX INST. 883, 886.

he has actually invested in the property. The negative basis problem, as well as the possibility of allowing a windfall where liabilities exceed basis, were two good reasons for Congress to enact section 357 (c) in order to remedy defects in the existing statutes.

IV. MORTGAGE IN EXCESS OF ADJUSTED BASIS

Although the precise results of the above decisions were not known to Congress when section 357(c) was enacted, they do demonstrate the inadequacy of the pre-1954 law. There were, furthermore, decisions prior to 1954 which predicted the possibility of revenue impairment unless statutory changes were enacted.[38] These decisions concerned the acquisition and disposition of property encumbered with mortgages.

The leading case, *Crane v. Commissioner*,[39] established two broad legal propositions. First, a purchaser's cost of acquiring property includes the amount of any mortgage which the purchaser takes the property subject to or personally assumes.[40] Second, the seller must include, as part of the proceeds received upon the sale, the amount of the mortgage on the property. These rules applied whether the seller was personally liable or not. Their purpose was to insure that the parties to the transaction did not receive a windfall by way of converting the proceeds to personal use, or by taking advantage of depreciation deductions without having to pay tax consequences.[41]

Since the mere acquisition of mortgage proceeds in excess of basis is not in itself a taxable event, it does create a problem where the property is transferred to a controlled corporation. *Woodsam Associates Inc. v. Commissioner*[42] considered such a factual situation. The legal issue was the corporation's basis in the property, which in turn depended upon the transferor's basis. The taxpayer argued that, when the mortgage was obtained, the amount of the

38. One commentator has suggested that these decisions were the primary reason § 357(c) was enacted, a view which seems substantially correct. See Note, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154, 1161 (1967).
39. 331 U.S. 1 (1947).
40. An alternative to this approach has been suggested. *See* Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950) (Magruder, J., concurring).
41. *See* Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), where the court held that even though the taxpayer was not personally liable on the mortgage and received no money when it was disposed of, he nonetheless realized gain on a disposition where depreciation deductions had decreased the adjusted basis below the principal amount of the mortgage.
42. 198 F.2d 357 (2d Cir. 1952).

proceeds which exceeded the shareholder's adjusted basis was a gain taxable to her at that time. This was based on the fact that she was not personally liable on the debt. Accordingly, she argued that the shareholder's adjusted basis should have been increased by the amount of gain. The court rejected this argument, reasoning that whether the mortgagor is personally liable or not is immaterial. The transaction was considered open, and the court held that realization should be postponed until there was final disposition of the property by the corporation.

The *Woodsam* court did not specifically consider whether the shareholder would have been taxed at the time of the exchange, but it seems clear from the opinion that gain would not have been recognized. This follows from the court's reasoning that the transfer to the corporation did not involve a final disposition. Thus, after the taxpayer's adjustment of basis in the stock received, she would have had a negative basis.[43]

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43. Rounding off the numbers, the computations would be as follows:

Shareholder's original basis in the property transferred	$300,000
Depreciation deductions	- 30,000
Adjusted basis at time of transfer	270,000
Amount of mortgage assumed	-400,000
Adjusted basis in stock received	$(130,000)

The computations would be the same under current code provisions, except that § 357(c) would require recognition of the $130,000, which would increase the taxpayer's basis to zero. The present basis provision, CODE § 358, provides in part:

> (a) GENERAL RULE.—In the case of an exchange to which section 351 . . . applies—
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> (1) NONRECOGNITION PROPERTY.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—
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> (A) decreased by—
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> (i) the fair market value of any other property (except money) received by the taxpayer,
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> (ii) the amount of any money received by the taxpayer, and
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> (iii) the amount of loss to the taxpayer which was recognized on such exchange, and
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> (B) increased by—
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> (i) the amount which was treated as a dividend, and
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> (ii) the amount of gain to the taxpayer which was recognized on such exchange. . . .
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> . . . .
>
> (d) ASSUMPTION OF LIABILITY.—Where, as part of the consideration to the taxpayer, another party to the exchange

The *Woodsam* decision was a clear indication of the potential for tax avoidance where property mortgaged in excess of its adjusted basis is transferred to a controlled corporation. It is conceded that section 357(c) does not contain any specific limitation that the liabilities must encumber specific property nor does the legislative history clearly state any specific limitations. However, the examples illustrating the principle behind section 357(c) in both the Senate and House explanations of the act suggest that this was the evil sought to be avoided.[44]

V. OTHER LIABILITIES

Undoubtedly, Congress did not intend to limit the application of section 357(c) to those situations where property is specifically encumbered.[45] To do so would not have cured the negative basis problem. The taxpayer would still have been able to incur liabilities far in excess of the cost of his assets without encumbering specific property. Unless he were taxed on the exchange, he would receive a windfall gain in the same manner as where property is specifically encumbered. Therefore, the broad Congressional language must have been intended to include these types of liabilities.

This does not necessarily mean that Congress meant to include all items commonly referred to as liabilities. More likely, Congress was simply unaware of the problems that might result if section 357(c) were applied to certain types of liabilities such as the liabilities of a cash basis taxpayer.[46] Indeed, in several in-

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> assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

44. The example cited by the Senate and House Committee reports is the same:

> Thus, if an individual transfers, under section 351, property having a basis in his hands of $20,000, but subject to a mortgage of $50,000, to a corporation controlled by him, such individual will be subject to tax with respect to $30,000, the excess of the amount of liability over the adjusted basis of the property in the hands of the transferor.

S. Rep. No. 1622, 83d Cong., 2d Sess. 270 (1954); H. Rep. No. 1337, 83d Cong., 2d Sess. A129 (1954).

45. *See* Testor v. Commissioner, 327 F.2d 788, 790 (7th Cir. 1964).

46. A cash basis taxpayer's liability as used in this comment means any expense or indebtedness incurred during the ordinary course of business which would be allowable as a deduction, but which has not previously been deducted from the individual's income because the individual is not allowed a deduction until it is paid.

stances it appears as though the Commissioner himself was unaware of its ramifications for the cash basis taxpayer.[47]

When section 357(c) is applied to a mortgage in excess of adjusted basis, it provides equal treatment no matter what method of accounting is used by the transferor. However, when applied to a cash basis taxpayer transferring accounts receivable and accounts payable, it has a tendency to frustrate the purpose behind the nonrecognition provisions of section 351[48] as well as legislation enacted to remedy the *Hendler* result.[49]

A. *Peter Raich*—THE LITERAL INTERPRETATION

In *Peter Raich*[50] the Tax Court for the first time squarely faced the issue of whether a cash basis taxpayer transferring an existing business should be required to recognize income on the exchange under section 357(c), even though the book value of the assets is far in excess of liabilities. Prior to incorporation Raich conducted a contracting business using the calendar year cash basis method of accounting. Early in 1961 he transferred to a controlled corporation all of the assets of the proprietorship totalling 88,613.39 dollars, including 77,361.66 dollars of trade accounts receivables. He also transferred 45,992.81 dollars of liabilities of which 37,719.78 dollars were accounts payable. In exchange he received all of the issued stock of the corporation plus a short term promissory note in the face amount of 16,280.58 dollars.[51] Because the business was on the cash basis method of accounting, none of the receiv-

47. There were two decisions involving the transfer of accounts receivable and accounts payable prior to the Peter Raich decision. Testor v. Commissioner, 327 F.2d 788 (7th Cir. 1964); Arthur L. Kniffen, 39 T.C. 553 (1962). Both of these decisions involved cash basis taxpayers and in each case the accounts receivable were valued at face rather than zero for purposes of § 357(c). Although their adjusted basis was not in issue in either case, the IRS did not disallow the taxpayers' original determination of adjusted basis. This position was exactly the opposite as that taken in *Raich* where accounts receivable were given an adjusted basis of zero.
48. *See* Committee Report, *supra* note 13 and accompanying text.
49. If the term "liabilities" as used in § 357(c) includes the accounts payable of a cash basis taxpayer, it is tantamount to requiring him to liquidate his assets and liabilities before changing his form of business. This result conflicts with the congressional purpose behind the enactment of the nonrecognition provisions. *See* Committee Report, *supra* note 16.
50. 46 T.C. 604 (1966).
51. The taxpayer had guaranteed the collection of the receivables prior to incorporation, but since $3,525.08 proved uncollectible, the face amount was reduced $12,755.50 which was paid off in full in less than 2 years. The short term note was treated by the Commissioner

ables[52] had been taken into income nor had the accounts payable been deducted.[53]

The Tax Court held that a literal interpretation of section 357(c) required its application to the above facts even though the market value of the receivables exceeded the payables. The court emphasized that the statute speaks solely in terms of the aggregate adjusted basis of the property transferred and not market value. The court then found that the taxpayer had an adjusted basis of zero in the accounts receivable. As a result of this finding, Raich's aggregate adjusted basis was only 11,251.73 dollars. Subtracting this amount from the liabilities assumed, the court found that liabilities exceeded basis by 34,741.08 dollars and held that this was recognizable gain.[54]

The taxpayer advanced three arguments. First, Congress did not intend section 357(c) to apply where the transferor received no economic benefit or gain. Second, section 357(c) was meant to apply only where liabilities exceeded book value as well as adjusted basis. And, third, even if adjusted basis is the only stand-

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as "boot" within the meaning of CODE § 351(b). For a complete discussion of short term notes and their relation to the term "stock or securities" as used in CODE § 351(a), see BITTKER & EUSTICE, *supra* note 7, ¶ 3.04, at 3-14.

52. The transferor's balance sheet contained both "receivables," which were valued at $1,833.97, and "trade accounts receivable." Although the exact nature of the "receivables" and their distinction from the "trade accounts receivable" is not known, the Commissioner did allow the taxpayer to include them in his adjusted basis to the full extent of their book value.

53. In a similar situation, the transferor in Arthur L. Kniffen, 39 T.C. 553, 566-67 (1962), contended that he was entitled to a deduction when the corporation assumed his payables since it was an expense of his business and he furnished the consideration for the transferee to make the payments. The Tax Court, with a complete disregard of the equities, rejected this contention as "obviously lacking in merit and does not require "further discussion." *Id.* at 567.

54. The taxpayer's assets and liabilities prior to incorporation and his aggregate adjusted basis were as follows:

Assets	Amount or Value	Adjusted Basis
Cash	$ 1,045.40	$ 1,045.40
Trade Accounts Receivables	77,361.66	0
Receivables	1,833.97	1,833.97
Prepaid Rent	125.00	125.00
Equipment	13,621.30	8,247.36
Aggregate Adjusted Basis	-	$11,251.73
Liabilities		
Trade Accounts Payable	$37,719.78	
Note Payable	8,273.03	
Total Liabilities Assumed	$45,992.81	

ard recognized, he at least should be able to offset his receivables by the amount of his payables.

In regard to his first contention, as proof of Congressional intent, he offered examples cited in the House and Senate Committee reports illustrating the application of section 357(c).[55] The court dismissed this argument by replying that, if Congress meant to so limit the application of this section to these examples, neither the plain meaning of the statute nor its legislative history indicates it.[56]

Although there are no specific words in the statute indicating an intent to limit its application, the examples cited by the regulations[57] and the committee reports[58] at least provide some evidence of that intent. Despite such a harsh result, however, the court refused to look behind the statute and its legislative history to ascertain the problem that Congress sought to remedy.

The taxpayer's second argument, limiting application of section 357(c) to situations where liabilities exceed book value as well as adjusted basis, was closely tied to his first contention. In effect, he argued that Congress did not intend section 357(c) to apply where book value exceeds the liabilities transferred, because the transferor receives neither a benefit nor an economic gain. The court observed that the statute speaks solely in terms of adjusted basis and not book value. It therefore dismissed this contention, mainly relying on prior decisions holding that receivables have a zero basis.[59] This phase of the court's decision is proper since the taxpayer had not taken these items into income.

Finally, in order to show a cost basis in his receivables, the taxpayer attempted to demonstrate that the receivables were specifically encumbered by his payables, contending that the payables were liens under state law. The court observed that the argument was novel and, rather than specifically rejecting the theory, found that the receivables were not in fact encumbered by liens. The court, however, did recognize that the application of section 357(c) in this situation conflicted with Congressional policy concerning tax deferral in connection with business readjustments:

> [W]e are not unmindful that the result reached may conflict with

55. *See* Committee Reports, *supra* note 44.
56. 46 T.C. at 609.
57. Treas. Reg. § 1.357-2(a) (1955).
58. *See* Committee Reports, *supra* note 44.
59. Helvering v. Cement Investors, 316 U.S. 527 (1942); P.A. Birren & Son v. Commissioner, 116 F.2d 718 (7th Cir. 1940); Ezo Products Co., 37 T.C. 385 (1961).

> the well established intent of Congress to foster tax-free business reorganizations. However, in the absence of a clearly expressed congressional intent we decline to adopt a construction of section 357(c) which is supported neither by its language nor its legislative history.[60]

Thus, in spite of the poor result and the conflict with long-standing Congressional policies, the court opted to follow the "unambiguous language" of the statute. Furthermore, the Tax Court's decision encourages exactly what the remedial legislation nullifying *Hendler* sought to prevent: the necessity of liquidating assets and liabilities before incorporation in order to avoid being taxed.[61] The *Raich* decision severely impedes a cash basis taxpayer from readjusting his form of doing business without being subject to federal income taxes.[62]

B. *Bongiovanni v. Commissioner*—THE STRAINED INTERPRETATION

Although for several years this "unambiguous language" went unassailed, the court in *Bongiovanni v. Commissioner*,[63] on indistinguishable facts reached a completely opposite result. The taxpayer in *Bongiovanni* operated a masonry contracting business as a sole proprietorship prior to incorporating the business on April 15, 1966. The business used the cash basis method of accounting until 1965 when it attempted to change to the accrual method undoubtedly to avoid the tax trap established by *Raich*. In exchange for assets totalling 97,490 dollars, the taxpayer received all the issued stock of the corporation; a promissory note with a face amount of 51,253 dollars plus the corporation's assumption of accounts payable in the amount of 17,237 dollars. Included in the assets were the following items:

	AMOUNT OR VALUE	ADJUSTED BASIS
Cash	$ 223	$ 223
Trade Receivables	57,741	0
Office Equipment	1,160	1,160
Work-in-Process	22,762	0
Raw Materials	8,029	0
Tools & Supplies	4,575	0
	$94,490	$1,383

60. 46 T.C. at 611.
61. *See* Committee Reports, *supra* note 16.
62. Admittedly, the harsh result of the *Raich* decision can be avoided by prior tax planning. For example, the transferor could have retained cash and receivables sufficient to pay the payables and transferred the remainder of the receivables to the corporation.
63. 470 F.2d 921 (2d Cir. 1972).

The Commissioner disallowed the taxpayer's attempt to change to the accrual method of accounting[64] and assessed a deficiency[65] in the amount of 5,778.49 dollars due to the inclusion of 15,854 dollars in the taxpayer's income based on the *Peter Raich* decision.[66] The Commissioner contended that the accounts receivable, work in process and the raw materials had an adjusted basis of zero. Therefore, the liabilities assumed which consisted of accounts payable (for which a deduction was denied) exceeded the taxpayer's adjusted basis. The Tax Court upheld the Commissioner's determinations.

The issue, as framed by the Second Circuit, was whether section 357(c) applies to a cash basis taxpayer's liabilities in the form of trade accounts payable. The court distinguished accounting liabilities from those recognized for tax purposes. It reasoned that the accounts payable were accounting liabilities, but held that they should not be recognized for tax purposes until they are paid. The court determined that the word "liabilities" as used in section 357(c) refers only to tax liabilities and not mere accounting liabilities. Although it is difficult to ascertain from the opinion precisely what the term "tax liability" encompasses, the court did give the example of "liens" in excess of tax costs, particularly mortgages encumbering property transferred in a section 351 transaction.[67] Since the accounts payable were not considered liabilities for purposes of applying section 357(c), the taxpayer's aggregate adjusted basis of the property transferred exceeded the liabilities assumed by the corporate transferee. As a result, he was not required to recognize gain under 357(c). The court argued that its decision avoided inequality between taxpayers based solely upon differences

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64. The court below focused primarily on this aspect of the decision and concluded that the Commissioner had not abused his discretion in disallowing the taxpayer's request for a change in accounting methods. It therefore held that the decision was controlled by *Raich*. John P. Bongiovanni, 40 P-H Tax Ct. Mem. ¶ 71,262 (1972).
65. The Commissioner asserted a further deficiency of $12,080.44 based upon the disallowance of the deduction the taxpayer took for the accounts payable. In addition, it was determined that he had realized taxable gain in the amount of $51,253 because the promissory note was treated as "other property" within the meaning of § 351(b). This deficiency was upheld by the Tax Court and not appealed.
66. The income required to be included was the excess of the payables over the aggregate adjusted basis of the assets transferred:

$17,237	- Accounts payable
1,383	- Aggregate adjusted basis of property transferred
$15,854	- Gain realized

67. 370 F.2d at 924.

in methods of accounting and prevented taxation where there was no possibility that tax avoidance could result.

> There is no justification for making an accounting method inadvertently chosen by the taxpayer determinative of the tax benefits and disadvantages of that taxpayer. . . . The application of a combination of Section 351 and 357(c) to trap an individual merely because he is a cash basis taxpayer rather than an accrual basis taxpayer is unacceptable.[68]

Theoretically, there is no room for argument that a taxpayer should be discriminated against solely on the basis of his method of accounting. The only difference that should be "countenanced by the income tax law is the year of the deduction."[69] As a practical matter, this discrimination does exist.[70] But there should not be inequality based on one's method of reporting income where the same rule of law is applied to both taxpayers and the *Bongiovanni* decision does achieve this result.

VI. THE ALTERNATIVES*

The tax consequences of section 357(c) as applied to a cash basis taxpayer depends on whether the reasoning of *Bongiovanni* or *Raich* is followed. The *Bongiovanni* interpretation ignores the express statutory language and introduces a distinction of questionable validity between tax liabilities and accounting liabilities in order to reach a more "just" result in terms of equality between taxpayers. Although this construction eliminates the harsh result of *Raich*, whether the court was justified in ignoring the express language of the statute is somewhat questionable. But most important, does the statute, assuming it is subject to the *Bongiovanni* interpretation, promote equality between accrual and cash basis taxpayers?

Assume[71] T, an accrual basis taxpayer, transfers all of the assets of his sole proprietorship, worth 20,000 dollars consisting solely of accounts receivables, to XYZ corporation. In exchange T receives

68. *Id.*
69. Charles R. Stuart, 38 B.T.A. 1147, 1151 (1938).
70. *See, e.g.,* United States v. Catto, 384 U.S. 102, 113-17 (1966); Willging v. United States, 31 Am. Fed. Tax R.2d 73-785 (9th Cir. 1973).

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71. For purposes of discussion, assume in each hypothetical presented that during the year in which the exchange was made the transferor and transferee have no other assets, liabilities or income from any other source except the receivables and payables.

all of XYZ's capital stock plus the corporation's assumption of 15,000 dollars in accounts payable. Assume further that T reports his income on a calendar basis and that the transfer is made on January 15. Since T is on the accrual method of accounting, his taxable income (without regard to the exchange) for the year in which the transfer was made would be 5,000 dollars. T's adjusted basis in his receivables would be 20,000 dollars because these items were previously taken into income.[72] Therefore, since his adjusted basis exceeds the liabilities transferred, section 357(c) is not applicable and T would not be taxed on the exchange.[73]

Following the example to its conclusion, T's adjusted basis in the stock of XYZ would be 20,000 dollars (the same as the property exchanged) minus 15,000 dollars (the amount of liabilities assumed), or a net amount of 5,000 dollars.[74] At this point, if T were to sell his stock in XYZ corporation for 5,000 dollars, he would realize no gain on the sale.[75] It is readily apparent that T's economic position is the same as if the exchange had never taken place.

The XYZ corporation would have a substituted basis of 20,000 dollars in the receivables[76] and would not realize gain upon their receipt. However, XYZ would not be allowed a deduction for the payables.[77] Therefore, where the transferor utilizes the accrual method of accounting under section 357(c), the transfer is a complete wash. This construction is totally in keeping with the Congressional purpose of facilitating business readjustments with a minimum amount of disruption.

Now assume the same set of facts, except that T is a cash basis taxpayer.

Under the interpretation given section 357(c) in *Raich*, T's adjusted basis in his receivables will be zero, but his payables will be valued at face. Since his liabilities exceed his adjusted basis in the assets transferred, section 357(c) applies and T must recognize 15,000 dollars on the exchange. T's basis in the stock received will

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72. *See* Rev. Rul. 69-442, 1969-2 CUM. BULL. 53.
73. The conclusion that the taxpayer is not taxed on the exchange assumes that CODE § 357(b)(1) is not applicable.
74. CODE § 358.
75. CODE § 1001.
76. CODE § 362 governs the corporation's basis in the assets transferred. It provides for the same basis the assets had in the hands of the transferor, increased by the amount of gain recognized by the transferor on the exchange. In this hypothetical, since T had a $20,000 basis in the receivables and recognized no gain on the exchange, XYZ's basis would also be $20,000.
77. *See* note 83 *infra* and the authorities cited therein.

be zero since the adjusted basis of the assets transferred have a zero basis, and the gain recognized on the exchange equals the amount of liabilities assumed.[78] If T now sells his stock in the XYZ corporation for 5,000 dollars, he would realize a gain in that amount on the sale. The corporation, on the other hand, will have a 15,000 dollars adjusted basis in the receivables.[79] As a result, when XYZ accrues or receives the 20,000 dollars in receivables, it will be taxed on 5,000 dollars.

Under the *Bongiovanni* interpretation of section 357(c), T still must take a zero basis in his receivables; but since accounts payable were held not to be liabilities for tax purposes, they are also valued at zero. Therefore, because liabilities do not exceed the adjusted basis of the assets transferred, no gain is recognized on the exchange. In addition, T's adjusted basis in the stock received would be zero.[80]

The corporation's adjusted basis in the receivables would also be zero.[81] Therefore, it would recognize income of 20,000 dollars when the receivables are accrued or received. Under both *Bongi-*

78. CODE § 358. From the substituted basis of zero, § 358 requires that the transferor decrease his basis by the amount of liabilities assumed and increase it by the amount of gain recognized on the exchange. Therefore, since T is required to recognize $15,000 on the exchange and the XYZ corporation assumed $15,000 in liabilities, his adjusted basis in the stock received would be zero.
79. CODE § 362. Since T recognized $15,000 on the exchange, the corporate transferee is allowed to increase its substituted basis in the assets transferred by that amount.
80. Although the basis of the transferor's stock was not an issue in *Bongiovanni*, the word "liabilities" should be given the same construction in both §§ 357(c) and 358(d). Thus, in *Bongiovanni* since no liabilities were assumed under § 357(c), his basis under § 358(d) should be the same as the aggregate adjusted basis of the assets transferred. As applied to the hypothetical in the text, T's adjusted basis in the stock would be zero, the same as his basis in his receivables. It has recently been suggested in CCH 1973 STAND. FED. TAX REP. ¶ 8216 that the term "liabilities" in § 358 should not be construed consistently with the same term in § 357(c). As a result, the author argues that the transferor may be required to take a negative basis in his stock received in order to prevent complete escape from taxation rather than mere deferral. It is true that the potential gain on the stock received should equal the potential gain on the assets transferred. But with the cash basis taxpayer transferring accounts receivable and payable, the taxpayer's potential *taxable* gain on assets transferred should be taken into account because he has not previously been allowed a deduction for the payables. Therefore, in the text hypothetical T's potential *taxable* gain on the assets transferred is $5,000 the same as his potential *taxable* gain if he later sells his stock.
81. CODE § 362. *See also* P.A. Birren & Son v. Commissioner, 116 F.2d 718, 720 (7th Cir. 1940); EZO Products Co., 37 T.C. 385, 392-93 (1961).

ovanni and *Raich* the question arises whether the corporation should be allowed a deduction when it pays or accrues the payables. The authorities are in conflict on this point. Under *Raich* the amount of the payables, having been taxed to the transferor, enters into the basis of the corporation's assets, therefore, it is difficult to see how they could be consistently held to be deductible by the corporation. On the other hand, the court in *Bongiovanni* by way of dictum recited that the corporation should be allowed a deduction whether the cash basis transferor is taxed on the exchange or not.[82] The courts as well as most commentators have generally agreed that the corporation should not be allowed a deduction with respect to this issue in section 351 transfers.[83] The rationale given for denial of a corporate deduction in these instances is that assumed liabilities are part of the corporation's acquisition costs for the assets. If this is correct, then the corporation's basis in the assets transferred should be adjusted upward to reflect this, regardless of whether gain is recognized or not. A firmer basis on which to deny the deduction would seem to be that, since it was not incurred by the corporation, it is simply not its liability.[84] This view at least is more consistent with the present basis provisions in effect. It has been reported that provided the parties are willing to enter a closing agreement assuring that the corporation will report the receivables as income when collected, the service will not only tax the corporation rather than the individual on the assigned gross income but will also allow the corporation to deduct the payables.[85] Since *Bongiovanni* does not specifically resolve this issue, there appears to be a significant future problem if other courts follow the rationale of *Bongiovanni.* Assuming the corporation is not allowed a deduction for the payables under *Raich* but would be under *Bongiovanni*, a summary of the preceding hypotheticals is as follows:

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82. 370 F.2d at 925. The regulation the court cites in support of its dictum, however, is inapposite.

83. Birmingham Business College v. Commissioner, 276 F.2d 476, 481 (5th Cir. 1960); Holdcroft Trans. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946); Burke & Chisholm, *supra* note 8, at 230; Tritt & Spencer, *Current Tax Problems in Incorporation of a Going Business,* U. So. CAL. 1958 TAX INST. 71, 98, 99; Surrey, *supra* note 9, at 21 n.69. *But cf.* Note, *supra* 38, at 1168 where the author suggests that if payables are not treated as liabilities for purposes of § 357(c), the corporate transferee would be allowed a deduction.

84. *See* Tritt & Spencer, *supra* note 83, at 98-99.

85. *See Points to Remember,* 18 A.B.A. TAX SECT. BULL. No. 3 at 114 (1965); Hewitt, *How to Avoid the Common Tax Problems in Forming or Dissolving a Partnership,* 24 J. TAX. 294, 298 (1966). *But cf.* Tax Management Memo 66-16 (Aug. 1, 1966).

INDIVIDUAL TAX	ACCRUAL	CASH-BONGIOVANNI	CASH-RAICH
CURRENT			
As earned	5,000	0	0
On transfer	0	0	15,000
TOTAL CURRENT	5,000	0	15,000
DEFERRED			
On sale of stock or on dividend	0	5,000	5,000
TOTAL CURRENT & DEFERRED	5,000	5,000	20,000
CORPORATE TAX			
CURRENT	0	5,000	5,000
TOTAL INDIVIDUAL & CORPORATE	5,000	10,000	25,000

Before the tax treatment of accrual and cash basis taxpayers can be compared under either interpretation, one must be cognizant of the effect of assignment of income principles. The results of the above summary reveal that the cash basis taxpayer under either view of section 357(c) has effectively shifted all of his taxable income to the transferee corporation. Therefore, even though T may successfully convince a court that the *Bongiovanni* reasoning is correct, the IRS may counter with an assignment of income argument. Simply because section 351 provides for nonrecognition of gain, it does not mean that the assignment of income doctrine is necessarily inapplicable.[86] There does, however, seem to be substantial authority which would dictate an opposite conclusion. In *Thomas W. Briggs*,[87] the Tax Court held that a cash basis transferor was not taxable on accounts received that were ultimately collected by the corporation. The same result was reached in *Arthur L. Kniffen*[88] where the taxpayer transferred accrued interest on notes and deeds of trust. However, in both *Briggs* and *Kniffen* the Tax Court did not specifically discuss assignment of income principles. In fact, once it was determined that section 351 applied, the court made no further inquiry as to whether gain would be recognized under any other theory. Both courts *sub silentio* seemed to imply that the purpose behind the nonrecognition provisions outweighed any assignment income principles. In *H. B. Zachary Co.*,[89] the Tax Court sanctioned the transfer of a carved-out oil payment as "property" within the meaning of section 351 and held that the transferor did not recognize income upon receipt of the stock. The IRS did not even try to tax

86. *See* BITTKER & EUSTICE, *supra* note 7, ¶ 3.17 at 3-59; Biblin, *Assignments of Income in Connection With Incorporating and Liquidating Corporations*, U. So. CAL. 1969 TAX INST. 383.
87. 25 P-H Tax Ct. Mem. ¶ 56.086 (1956).
88. 39 T.C. 553 (1962).
89. 49 T.C. 73 (1967).

the assignor on income from the "property" that was realized by the assignee, which is the proper time under the assignment theory.[90] Furthermore in note 5 of the opinion, the court stated that it was not considering whether the assignor might be taxed under the assignment of income theory.[91]

There is some authority that assignment of income principles do apply to section 351 transfers, but each decision applying that doctrine can be distinguished.[92] Nevertheless, if the *Bongiovanni* reasoning is accepted, the IRS may press harder for the application of assignment of income principles.

Therefore, if the *Briggs-Kniffen* premise is accepted that it is within the purpose of section 351 to permit the taxability of current income to be shifted from the earner to his corporation, then the above summary indicates that *Bongiovanni* does reach a sound result with respect to current tax liabilities. Both the accrual and cash basis taxpayer are treated equally on the exchange; the only difference being that the accrual is currently taxed on 5,000 dollars as an individual whereas the cash basis taxpayer is allowed to shift his current tax liability to the corporation. Admittedly, this does promote some inequality, but with respect to section 357(c) both are treated equally by allowing each to transfer receivables and payables at the same tax cost. In contrast to *Bongiovanni*, the *Raich* interpretation does not promote equality, but instead currently taxes both the individual and the corporation.

It is true that under *Bongiovanni* and *Raich* an additional 5,000 dollars will be taxed if the cash basis taxpayer sells his stock or withdraws dividends in excess of what the corporation later earns from its own operations. But this "double tax" effect is the inevitable result of our dual tax system, whereby, barring death, any income taxed to the corporation will ultimately be taxed to the shareholder.

The price of shifting taxability of earned but uncollected income to the corporation is inflation of the amount ultimately sub-

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90. Anthony's Estate v. Commissioner, 155 F.2d 980 (10th Cir. 1946); Sol C. Siegel Productions, 46 T.C. 15 (1966); Treas. Reg. § 1.421-6(d)(4); Rev. Rul 69-102, 1969-1 CUM. BULL. 32.

91. The service's reluctance to apply assignment of income principles in § 351 transfers is illustrated by the fact that in Jack Amman Photogrammetric Eng'rs v. Commissioner, 341 F.2d 466, 468-69 (5th Cir. 1965) the court criticized the service for not attempting to apply the assignment rule in this area yet the commissioner dismissed his appeal to the same court in *Zachary*.

92. *See* Commissioner v. Montgomery, 144 F.2d 313 (5th Cir. 1944); Brown v. Commissioner, 115 F.2d 337 (2d Cir. 1940); Adolph Weinberg, 44 T.C. 233 (1965); Clinton Davidson, 43 B.T.A. 576 (1941). *See also* Biblin, *supra* note 86, at 390.

ject to this second tax. But the price paid by the taxpayer under the *Bongiovanni* interpretation does not promote total equality between the accrual and cash basis taxpayers. It will not close the gap unless the cash basis taxpayer sells his stock within six months after the exchange. Only then will he also be required to include the 5,000 dollars in ordinary income. Considering the reasons most sole proprietorships incorporate, it is highly unlikely that the stock will be sold at all. It is possible, for example, that the stockholder will hold the stock until death, in which case it will receive a stepped-up basis.[93] At the very least, it will be held longer than six months, in which case the taxpayer will receive capital gain treatment. Admittedly, if the corporation is not allowed a deduction for the payables, this also will tend to compensate somewhat for the disparity in treatment, but this question is not resolved by *Bongiovanni*. Another partial remedy at the corporate level is that the cash basis taxpayer's controlled corporation will be required to recognize income upon collection of the receivables, but this also may be more beneficial to the cash basis transferor where his marginal rate of tax is at a higher level than the corporation.

Even though this inequality does exist under *Bongiovanni*, it does not result from the court's interpretation of section 357(c), but from a rule entirely independent which allows the individual to shift his potential income to a controlled corporation. Since the *Bongiovanni* interpretation does treat both accrual and cash basis taxpayers equally with respect to the exchange, its reasoning should be adopted.

VII. CONCLUSION

Since the overall policy reasons behind section 351 favor nonrecognition upon incorporation, any doubtful construction of section 357(c) should be resolved to further that purpose. It is extremely doubtful that Congress intended to include the cash basis taxpayer's accounting liabilities within the meaning of the term "liabilities" as it is used in the statute. To do so would frustrate the policy reasons behind the nonrecognition provisions.

One point, however, should be made clear. No matter what construction is given to section 357(c), where receivables and payables are involved complete equality between accrual and cash basis taxpayers cannot be achieved. As the court in *Bongiovanni* observed: "We see no reason why different consequences under section 357(c) should arise from identical circumstances because of the wholly unrelated section of an accounting method."[94] Ad-

93. CODE § 1014(a).
94. 370 F.2d at 925.

mittedly, the *Bongiovanni* reasoning does provide for nonrecognition under section 357(c) in both the accrual and the cash basis taxpayer's transfer to a controlled corporation. But the transaction viewed as a whole does not produce equality. The *Raich* decision, on the other hand, totally frustrates the purpose of the tax-free exchange provisions and is totally unacceptable to the cash basis taxpayer.

Although *Bongiovanni* is preferable, the only reasonable solution is the enactment of legislation to remedy the existing disparities. One approach may be to require the cash basis taxpayer to accrue all receivables and payables prior to incorporation.[95] Whatever steps are taken, to allow a taxpayer's method of accounting to result in unequal tax treatment under identical circumstances is unacceptable.

Stephen C. Johnson '74

95. *See* Burke & Chisholm, *supra* note 8, at 232.