SECTION 357(c) AND THE CASH BASIS TAXPAYER

In a typical incorporation, an individual might transfer the assets and liabilities of a going business to a corporation in exchange for its capital stock. Since the inception of the income tax, Congress has struggled with the problem of how such a transfer should be treated for tax purposes. Prior to the enactment of the Revenue Act of 1921, if an individual transferred assets to a corporation and received stock in exchange, he was taxed to the extent that the fair market value of the stock exceeded his basis in the assets. Recognizing that such a procedure would seriously impede necessary incorporations, Congress provided in section 202 of the Revenue Act of 1921 that no gain or loss would be realized by the transferor when he conveyed assets to the corporation so long as he was in control of the corporation after the transfer.

Section 202 was reenacted without major modification in section 112(b)(5) of the 1939 Internal Revenue Code. Several important facets of this complex problem still required clarification, however. Under section 112(c)(1), if the transferor received from the corporation “property or money” other than stock or securities in the corporation, he would be taxed to the extent the fair market value of that “other property or money” exceeded his basis in the assets.

1 Revenue Act of 1921, ch. 136, 42 Stat. 227.
2 When property is exchanged for other property, the property received in exchange shall for the purposes of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange.
3 Under existing law “when property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value, if any.” 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.
4 Section 202 provided in part:
   (c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—
5 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.
6 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.

S. REP. No. 275, 67th Cong., 1st Sess. 11 (1921).

Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1060.

transferred to the corporation.6 This provision left an important question unanswered: if the corporation assumed a debt of the transferor, did such an assumption constitute “other property or money” so that the transferor would be taxed to the extent of the assumption? The Supreme Court’s opinion in United States v. Hendler7 answered this question in the affirmative:

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 treated as such.8

In a typical incorporation of an existing business, the transferor does not liquidate his liabilities before conveying his assets to the corporation. Realizing, therefore, that the Hendler result could defeat the purpose of section 112(b)(5),9 Congress added section 112(k) to the Code. The new section provided that the assumption of a liability by the corporation was not “other property or money” unless it appeared either that the transferor’s purpose in having the corporation assume the debt was tax avoidance or that the transaction was not a bona fide business deal.10 The courts interpreted section

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6 If an exchange would be within the provisions of subsection (b) . . . (5) . . . if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph . . . to be received without the recognition of gain, but also of other property or money, then the gain, if any to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

7 303 U.S. 564 (1938). Hendler arose under section 112(c)(1) of the Revenue Act of 1928, ch. 852, 45 Stat. 817. Section 112(c)(1) was reenacted without major change in section 112(c)(1) of the Internal Revenue Code of 1939. See Walter F. Haass, 37 B.T.A. 948 (1938); Brons Hotel, Inc., 34 B.T.A. 376 (1936).

8 303 U.S. at 566.

9 The recent Supreme Court case of United States v. Hendler . . . has been broadly interpreted to require that, if a taxpayer’s liabilities are assumed by another party in what is otherwise a tax-free reorganization, gain is recognized to the extent of the assumption. 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 as is indicated above will largely nullify the provisions of existing law which postpone the recognition of gain in such cases....


10 Where upon an exchange the taxpayer receives as part of the consideration property which would be permitted by subsection (b) . . . (5) . . . to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as “other property or money” received by the taxpayer within the meaning of subsection (c) . . . ;
112(k) as overruling the Hendler result, and this section was subsequently reenacted without major change in sections 357(a) and (b) of the 1954 Code. A third provision was added to section 357, however, which had no predecessor in the 1939 Code. Subsection (c) provides that if the sum of the liabilities assumed by the corporation plus the sum of the liabilities to which the transferred assets are subject, exceed the total adjusted basis of the assets transferred, then the transferor will be taxed on the difference. The committee

except that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition 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, for the purposes of this section, be considered as money received by the taxpayer upon the exchange.


11 See, e.g., Helvering v. Taylor, 128 F.2d 885 (2d Cir. 1942).

12 (a) GENERAL RULE—Except as provided in subsections (b) and (c), if—
(1) the taxpayer receives property which would be permitted to be received under section 351 . . . without the recognition of gain if it were the sole consideration, and (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money or other property . . .


For cases interpreting this subsection and its predecessor, § 112(k), see, e.g., Jewell v. United States, 330 F.2d 761 (9th Cir. 1964); Edwards Motor Transit Co., 23 CCH Tax Ct. Mem. 1968 (1964).

(b) TAX AVOIDANCE PURPOSE—
(1) IN GENERAL—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—
(A) was a purpose to avoid Federal income tax on the exchange, or
(B) if not such purpose, was not a bona fide business purpose,
then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351 . . . be considered by the taxpayer on the exchange.


13 (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
reports dealing with the new subsection fail to specify Congress' reason for adding to the earlier provisions. Therefore, in order to understand what problem the new subsection was intended to cure, it is necessary to examine the difficulty which arose under section 112(k).

**Mortgaged Property**

The situation arising most frequently in cases involving the assumption of liabilities is the transfer of mortgaged property. In *Crane v. Commissioner*, the taxpayer was devised a parcel of land and a building with an outstanding mortgage of $255,000. Some years later she sold the building and land for $3,000 subject to the mortgage. The issue before the Supreme Court was whether the amount of the original mortgage should be included in the taxpayer's basis in the property and whether the outstanding mortgage assumed by the purchaser should be included in the amount the taxpayer realized on the sale. The taxpayer maintained that since she was not personally liable on the mortgage, her gain on the sale was limited to the cash she actually received. The Court, however, held that the amount of the original mortgage was included in her basis in the property and that the outstanding mortgage assumed by the purchaser was included in the amount she realized on the sale. Furthermore, the Court held that her basis in the property had to be reduced by the sum of the depreciation deductions she had taken on the building while she owned the property. Upon subtracting this adjusted basis from the amount realized, the Court found her taxable gain to be $24,000.

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 . . .


16 The entire property was subject to the mortgage of $255,000. However, for our purposes, only the value of the building is essential, since land is not a depreciable asset. Therefore, the discussion below pertains only to the value of the building and the figures are adjusted to exclude the value of the land. The figures below have been rounded off.

17 Since the taxpayer received the property from a decedent, the basis of the property in her hands was its fair market value at the date of her husband's death. Int. Rev. Code of 1954, § 1014(a). If the taxpayer had purchased the property, her basis in the property would have been cost. Int. Rev. Code of 1954, § 1012. See Parker v. Delaney, 186 F.2d 455, 458 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951).

18 Although the Court emphasized that the mortgage was not a personal obligation of the taxpayer, subsequent decisions have not relied on this distinction, and the rule now seems well established that depreciation deductions will reduce the taxpayer's original basis regardless of whether or not he is personally liable on the mortgage.

19 Rounding off the figures in *Crane* and disregarding the value of the land, the transaction was as follows:
Three years later, when faced with a fact situation similar to that presented in *Crane*, the First Circuit, in *Parker v. Delaney*, followed the Supreme Court’s approach in computing the taxpayer’s gain on the transfer. In a concurring opinion, Judge Magruder suggested an alternative approach which has come to be known as the negative basis doctrine. Judge Magruder argued that since the taxpayer incurred no out-of-pocket expenses in acquiring the mortgaged property, his original basis ought to be zero. A negative basis resulted when the depreciation deductions were subtracted from the zero basis in computing the adjusted basis.

Under the terms of the sale the taxpayer was relieved of the property and the obligation on the mortgage; therefore, Judge Magruder maintained, for tax purposes the amount realized on the sale was also zero. The amount realized on the sale, zero,

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale Price—Amount of mortgage</td>
<td>$201,000</td>
</tr>
<tr>
<td>Boot for Building</td>
<td>2,000</td>
</tr>
<tr>
<td>Total amount realized on sale</td>
<td>$203,000</td>
</tr>
<tr>
<td>Original basis in building</td>
<td>$207,000</td>
</tr>
<tr>
<td>Minus: Depreciation deductions</td>
<td>28,000</td>
</tr>
<tr>
<td>Minus: Adjusted basis</td>
<td>$179,000</td>
</tr>
<tr>
<td>Taxable gain</td>
<td>$24,000</td>
</tr>
</tbody>
</table>

Boot is defined as cash or non-qualifying property received by the taxpayer in addition to the qualifying property which he received without incurring a taxable gain in the section 351 exchange. BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION 470 (3d ed. 1965).

The total boot received in the sale of the property was $3000. Since we are concerned solely with the sale of the building, we have allotted $2000 of the boot to the building and the remaining $1000 to the land.

For a critique of the *Crane* case, see Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966).

The taxpayer made arrangements with two banks to take over and manage four apartment houses held by the banks after foreclosures. In each case a straw party gave the bank a note secured by a first mortgage on the property and then gave the taxpayer a second mortgage on each of the properties. The first mortgage liens totaled $273,000. During the period in which the taxpayer managed the properties, he paid $14,000 on the mortgages and deducted $45,000 for depreciation. In 1945 the mortgages were in default and the banks took the properties back. The court held that the taxpayer realized a taxable gain of $31,000 on the foreclosure. The taxpayer’s original basis in the properties, $273,000, was reduced by the amount of the depreciation deductions, $45,000, and increased by the sum of the payments on the mortgage, $14,000, to arrive at an adjusted basis of $242,000. On the foreclosure, the taxpayer realized $273,000, the amount of the mortgage of which he was relieved. The amount realized, $273,000, minus the adjusted basis, $242,000, resulted in the taxable gain of $31,000.

When a property owner incurs no out-of-pocket expenses in acquiring a mortgaged property, his original basis is zero. A negative basis resulted when the depreciation deductions were subtracted from the zero basis in computing the adjusted basis.

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22 186 F.2d at 459.

23 Since Judge Magruder had assigned a zero basis to the property, it may seem unusual that he had taken into account depreciation deductions in computing the taxpayer’s basis at the time of sale, for technically when one has no basis, he can take no depreciation deductions. Int. Rev. Code of 1954, § 167. However, the approach used by Judge Magruder is proper since in computing basis on sale, the basis of the property is reduced by the allowed or allowable depreciation deductions. Int. Rev. Code of 1954, § 1016(a) (2). In *Parker v. Delaney*, the Commissioner had allowed $28,000 of depreciation expenses over a period of years.
minus the negative adjusted basis resulted in a taxable gain. Although Judge Magruder arrived at the same figure as the majority, he sanctioned a doctrine which could potentially produce far different results in subsequent mortgaged property cases.

A potential problem created by the Crane and Parker decisions came to the forefront in Woodsam Associates, Inc. v. Commissioner. In that case the taxpayer was a corporation which had received property from a stockholder in an earlier tax-free exchange. The controversy in the case concerned the taxpayer's basis in the property, which, in turn, depended on the basis of the property in the hands of the stockholder.

The stockholder had acquired the property for $300,000. After her basis in the property had been reduced to $270,000 because of depreciation deductions, she mortgaged the property for $400,000. At this point she transferred the property to the corporation. The Commissioner maintained that the taxpayer's basis in the property was its original cost to the stockholder ($300,000) less the depreciation deductions. The taxpayer, on the other hand, argued that the amount by which the mortgage exceeded the stockholder's adjusted basis in the property ($130,000) should have been taxable gain to her at the time of the transfer, and that the resulting stepped-up basis of $400,000 carried over to the corporation.

In deciding in favor of the Commissioner, the Second Circuit held that the stockholder never "sold or otherwise dispos[ed] of" the property within the meaning of section 1001 (a), and therefore a taxable event did not occur at the time of the transfer and would only occur when the property was actually sold. The mortgage did not change her basis in the property.

Woodsam Associates is an excellent example of the fuzzy thinking which exists concerning the taxability of borrowed money. The

<table>
<thead>
<tr>
<th>Amount realized on foreclosure</th>
<th>$  0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original basis in building</td>
<td>$  0</td>
</tr>
<tr>
<td>Minus: Depreciation deductions</td>
<td>45,000</td>
</tr>
<tr>
<td>Plus: Mortgage payments</td>
<td>14,000</td>
</tr>
<tr>
<td>Minus: Total adjusted basis</td>
<td>$-31,000</td>
</tr>
<tr>
<td>Taxable gain</td>
<td>$  31,000</td>
</tr>
</tbody>
</table>

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24 See Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961).
25 198 F.2d 357 (2d Cir. 1952).
26 When the corporation received the property from the stockholder it assumed her basis in the property. Int. Rev. Code of 1939, ch. 1, § 113(a) (7), 53 Stat. 41 (now Int. Rev. Code of 1954, § 362(b)).
27 Woodsam Associates is the archetype of the negative basis problem which will be discussed at length below. The negative basis problem arises when property appreciates in value and is then mortgaged for more than the taxpayer's original basis.
28 The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain . . . . Int. Rev. Code of 1954, § 1001(a).
29 When an individual borrows money, he does not realize a taxable gain. 198 F.2d at 359; 1 MERTENS, FEDERAL INCOME TAXATION § 5.12, at 32, 34 (rev. ed. 1962); Spears, MORTGAGES IN EXCESS OF BASIS, U. So. Cal. 1959 TAX INST. 883, 885.
crucial issue is not how the taxpayer disposes of the property but whether she realizes a gain by disposing of the property and the corresponding mortgage. Under the court's holding, the stockholder in *Woodsam Associates* realized a tax-free profit of $130,000 by mortgaging the property for more than her cost and then disposing of it along with the mortgage.\(^{31}\) It is important to realize that when the taxpayer borrows money and is later relieved of the obligation to repay the loan, he has the unrestricted possession of cash which he did not have before. Therefore, at the point when the taxpayer is relieved of the obligation to repay, he realizes a gain on which he should be taxed.

In *Jack L. Easson*,\(^{32}\) the Tax Court, when faced with an indistinguishable factual situation,\(^{33}\) recognized the problem posed by the decision in *Woodsam Associates*:

> It is clear that there will not be a mere postponement of taxation, but possibly a complete tax exemption, if gain on the exchange in question is not presently recognized to the extent that the mortgage to which the transferred property was subject exceeded the petitioner's adjusted basis.\(^{34}\)

Although *Easson* was decided in 1960, the events involved occurred before 1954 so that section 357(c) was not applicable. Since the court specifically found no evidence of tax avoidance or a sham exchange, the clear language of section 112(k) (now section 357(a)) would seem to indicate that there was no taxable gain. The Tax Court, however, was perplexed by the negative basis problem. If the taxpayer's original basis in the property were $87,000 and the property were mortgaged for $247,000, the taxpayer's basis in the stock received in exchange for the property would be $-159,000.\(^{35}\) Citing the ancient tax maxim that property cannot have a negative basis,\(^{36}\) the court concluded that the taxpayer must have realized a taxable gain of $159,000 on the exchange so that his basis in the stock upon transfer would be zero. The court looked to 357(c) as proof that the Code authorized its position. Subsection (c) was not in existence

\(^{31}\) Some writers maintain that the *Woodsam* result will lead to tax postponement, not tax avoidance. Cooper, *Negative Basis*, 75 Harv. L. Rev. 1352, 1355 (1962); Spears, *supra* note 30, at 886. However, if the stockholder in *Woodsam* never sells the stock she received in exchange for the property, she will never pay tax on the $130,000. See note 44 *infra*.

\(^{32}\) 33 T.C. 963 (1960).

\(^{33}\) In 1929 the taxpayer built an apartment house. In 1952 he mortgaged the property for $250,000. Later that year he incorporated his business and transferred the property and the mortgage to the corporation. On the day of transfer his basis in the property was $87,000 and the outstanding mortgage was $247,000. The taxpayer claimed he realized no gain on the transfer. See note 27 *infra*.

\(^{34}\) 33 T.C. at 969.

\(^{35}\) Not only would the taxpayer's basis in the stock received in exchange for the property be negative, but the corporation's basis in the property would also be minus $159,000. See note 27 *infra*.

\(^{36}\) 33 T.C. at 970 & n.3. See Cooper, *supra* note 31, at 1353 & authorities cited n.6.
when the events of this case took place, but the court avoided that problem by saying that subsection (c) merely clarified existing law.

The Ninth Circuit reversed, holding that the language of sections 112(b)(5) and 112(k) clearly indicated that there was no taxable gain on the exchange. As for the negative basis problem, the court looked to Judge Magruder's concurring opinion in *Parker* as evidence that a negative basis was a possibility. The court concluded, therefore, that the taxpayer did not realize a taxable gain on the exchange under 112(k) and that the stock he received had a basis of —$159,000. Furthermore, the legislative history of 357(c) emphasized that the subsection had no predecessor in the 1939 Code, so that the principles of that subsection were inapplicable to the facts of this case. To date the Ninth Circuit is the only court which has allowed a negative basis.

The Tax Court in *Easson* was correct in realizing that 357(c) was adopted to resolve the negative basis problem which first arose in *Woodsam Associates* and later in *Easson*. Admittedly, nowhere in the legislative history of subsection (c) is this purpose clearly enunciated. Nevertheless, the examples cited in the Treasury Regulations to illustrate the application of sections 357(c) and 358 indicate that negative basis was the crux of the problem that subsection (c) was intended to cure. Section 358 states, in effect, that the basis of any stock or securities received in a 351 exchange is the same as that of the property transferred. In example two in the regulations, an individual owned property with an adjusted basis of $25,000 and a mortgage of $50,000. He transferred the property to a cor-

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38 In a case arising in the Third Circuit, the Commissioner was successful in convincing the court that the taxpayer should be taxed on the difference between his adjusted basis in the property and the amount of the mortgage assumed by the corporation upon transfer. *Simon v. Commissioner*, 285 F.2d 422 (3d. Cir. 1960). The crucial fact in that case was that the taxpayer mortgaged the property only three months before transferring it to the corporation, and the court held that, in effect, there was a sale of the property to the corporation with the corporation obtaining the necessary funds for the purchase by mortgaging the property. *Id.* at 425.


41 In the case of an exchange to which section 351 ... applies—

(1) 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—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer ...  

(B) increased by—

(ii) the amount of gain to the taxpayer which was recognized on such exchange . . . .

INT. REV. CODE OF 1954, § 358(a).
poration in exchange for all of its stock. The individual realized a taxable gain of $25,000 on the exchange under 357(c), thus increasing his basis in the stock received to zero.42 This is exactly the result the Tax Court reached in Easson; in effect, then, subsection (c) rejects the theory of both Woodsam Associates and the Court of Appeals in Easson.43

As indicated in the discussion of Woodsam Associates, subsection (c) is necessary to prevent tax avoidance, not merely tax postponement. In Woodsam Associates, the stockholder cleared a tax-free profit of $130,000 on the exchange. Whenever an individual is able to mortgage property for more than its basis and then dispose of the property along with the mortgage, he must be taxed on the difference between his basis and the amount of the mortgage at the time of the exchange. Otherwise, he may escape taxation altogether.44 What is essential to remember is that it is the transferor, not the corporation, who has received the benefit of the mortgage; therefore, it is the transferor and not the corporation who should be taxed on the difference between the transferor’s original basis and the amount of the mortgage assumed.

Since 357(c) was adopted in a milieu composed largely of mortgaged property cases, the thinking regarding such cases may have a critical bearing on how the subsection will be applied in other areas. Unfortunately, some of the conclusions resulting from this discussion may mislead courts attempting to apply subsection (c) to non-mortgage cases. First, the mortgaged property doctrine of Crane applies both to cash and accrual basis taxpayers. With mortgaged property there is no need to distinguish between cash and accrual basis taxpayers. With mortgaged property there is no need to distinguish between cash and accrual basis taxpayers since they will both treat the mortgage identically for tax purposes.45

42 Int. Rev. Code of 1954, § 358(a) (1) (B) (ii).
43 This was the position argued by the taxpayer in Woodsam. The taxpayer maintained that the stockholder should have realized the tax on the difference between her original basis and the amount of the mortgage assumed. Had this been the case, the corporation would have assumed her stepped-up basis of $400,000 in the property under Int. Rev. Code of 1939, ch. 1, § 113(a) (7), 53 Stat. 41 (now Int. Rev. Code of 1954, § 362(b)). See Commissioner v. Corpus Christi Terminal Co., 126 F.2d 898 (5th Cir. 1942).

The attorney for the taxpayer has written an article on mortgaging property for more than cost. Lurie, Mortgagor’s Gain on Mortgaging Property for More Than Cost Without Personal Liability, 6 Tax L. Rev. 319 (1951).

44 Assuming that the taxpayer in Woodsam Associates received stock in exchange for the property, she will never pay tax on the $130,000 profit on the exchange if the value of the property depreciates below the amount of the outstanding mortgage and is subsequently forfeited. The taxpayer in this case has the unrestricted use of money with no obligation to repay. She, in effect, has received a windfall unless she is taxed on the amount of the debt at the time when she is relieved of the obligation to repay the loan. See text accompanying note 31 supra. In addition, even if the value of the property is always sufficient to satisfy the encumbrance, the taxpayer will pay no tax if she retains the stock until her death, for the basis in the stock to her devisee would be its fair market value. Int. Rev. Code of 1954, § 1014(a).

45 The acquisition of a building is a capital expenditure for which no deduction is allowed for either cash or accrual basis taxpayers. Int. Rev. Code of 1954, § 263(a) (1) and Treas. Reg. § 1.263(a)-2(a) (1958).
However, other types of liabilities computed under 357(c) might require different treatment by the two types of taxpayers. Second, the discussion of negative basis causes one to wonder whether practitioners have arrived at a clear understanding of the tax consequences which should follow when money is borrowed and the debt thereby incurred is transferred to another taxpayer. For these reasons, it is not surprising that there has been little thought about the proper application of subsection (c) to cash basis taxpayers in non-mortgage cases.

PETER RAICH

A recent opinion in the Tax Court should generate some thought concerning the proper application of subsection (c) to cash basis taxpayers. In Raich, a cash basis taxpayer incorporated his sole proprietorship. On the day of incorporation his balance sheet showed assets of $88,613.39, including $77,361.66 of trade accounts receivable. His liabilities totaled $45,992.66, $37,719.78 of which were trade accounts payable. The taxpayer personally guaranteed payment of the accounts receivable. In exchange for these assets, the taxpayer received stock valued at $25,000 on the corporation’s books and a promissory note for $16,280.58. Thus the corporation’s balance sheet on the day of incorporation showed that the value of the assets transferred exceeded total liabilities and capital stock by $1,340. Nevertheless, the Tax Court held that the transferor realized a gain of $34,741.08, reasoning as follows: since the taxpayer was on the cash basis, the trade accounts receivable had an adjusted basis of zero. Therefore, the assets transferred were assigned a value which was $77,361.66 less than the taxpayer’s evaluation, or $11,251.73. The liabilities assumed, $45,992.81, exceeded the adjusted basis of the assets by $34,741.08, thus bringing subsection (c) into play.

A handful of cases had arisen before in which accounts receivable and payable had been involved. Admittedly, in each of the cases the issue did not involve the adjusted basis of the receivables. Never-
theless, the Commissioner seemed content to assume that if the market value of the assets transferred was greater than the market value of the liabilities assumed, then the exchange was tax-free under 357(a). Apparently the Commissioner has reversed his position in Raich and will now go beyond a comparison of market values and consider whether the transferor is on the cash or accrual basis. Since the Commissioner's stand in Raich appears inconsistent with his earlier position, the time has come to consider the question more fully.

Before examining the technical tax aspects involved in this question, one might consider whether Raich is the type of individual who should be taxed. It is difficult to understand how he realized a "gain" by incorporating for he did not "cash out" by holding assets and transferring the corresponding obligations to another party. Since Raich personally guaranteed the accounts receivable if they proved uncollectible, he certainly transferred assets sufficient to pay the liabilities assumed by the corporation. Furthermore, this is not a case where the taxpayer incurred a debt, took a deduction for the debt, and then transferred the debt to a corporation, for, since Raich was on the cash basis, by definition he could not deduct the accounts payable until he paid them. This case is also far different from Woodsam Associates where the stockholder enjoyed a clear cash profit of $130,000 on the exchange. The court itself admits that its decision might not produce the best policy result:

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

As indicated above, the legislative history of subsection (c) is not very helpful in interpreting the purpose behind the section. Therefore, we must inquire whether the section itself is so clear that the decision in Raich was dictated by the language of the statute despite the poor policy result. Is the section as clear as the court implied or is this a case where the court has not considered carefully the tax consequences which should follow when a cash basis taxpayer transfers accounts receivable and payable?

the assumption of a debt owed to the corporation by the transferor was a taxable event in itself. In DeFelice, the court taxed the transferor on the difference between the market value of the liabilities assumed and the market value of the assets transferred.

61 Treas. Reg. § 1.446-1(c)(1)(i) (1961). An accrual basis taxpayer, on the other hand, may deduct the accounts payable in the year in which they accrue. Treas. Reg. § 1.446-1(c)(1)(ii).

62 See note 44 supra.

63 46 T.C. at 611.

64 See note 14 supra and accompanying text.
The court begins by stating that since the taxpayer was on the cash basis, the accounts receivable had a basis of zero. It is important to realize that basis is a tax concept. Therefore, although the accounts receivable might have a market value of $77,361.66, for tax purposes they do have a basis of zero in the hands of a cash basis taxpayer since he has received no money for them and, more importantly, has not reported them as income. The taxpayer in Raich, however, chose to base a major part of his attack on this issue. First, he attempted to distinguish the cases the Commissioner cited for the zero basis proposition in an effort to prove that the receivables should be valued at market cost. In the alternative he maintained that even if the receivables were not valued at market, they should still offset the payables. To support this contention the taxpayer tried to prove that the accounts receivable were encumbered by liens so that as soon as they were collected, the proceeds would be used to liquidate the payables. This was the stronger of his two arguments, and the court never rejected it in theory but merely held that the taxpayer had failed to prove that the receivables were actually so encumbered.

To simplify the issues in Raich, imagine the following hypothetical case. An individual on the cash basis owns a proprietorship with $100,000 in accounts receivable as the sole asset and $50,000 in accounts payable as the only liability. If the individual decides to incorporate his proprietorship, he could conceivably do one of three things with his receivables and payables. First, he could collect the receivables, liquidate the payables, pay all income taxes and transfer the balance in cash to the corporation. As Congress noted when enacting section 112(k) of the 1939 Code to overrule the Hendler result, requiring such a practice would make incorporations cumbersome and difficult. Therefore, the individual would probably transfer all or part of his assets and liabilities to the newly-formed corporation. In our hypothetical he might transfer either all the receivables or both...

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55 P. A. Birren & Son v. Commissioner, 116 F.2d 718, 720 (7th Cir. 1940); Ezo Products Co., 37 T.C. 385, 393 (1961).
57 Id. at 22-24.
58 46 T.C. at 610. The theory that if the assets are specifically encumbered by liabilities, then the transfer will be tax-free provided the liabilities are not greater in amount than the basis of the assets, is probably another holdover from the mortgaged property area. In reality, however, should it make any difference whether the assets are specifically encumbered by the liabilities transferred in the exchange? Even though the payables do not specifically encumber the receivables, the payables still are a cost of producing the receivables and therefore should be set off against them as if they specifically encumbered the receivables. This is especially true in this case since the taxpayer guaranteed payment of the receivables if they proved uncollectible. If the Tax Court in Raich had merely set off the payables against the receivables, it could have avoided the difficult task of deciding whether the payables were actually "liabilities" within the meaning of the statute.
59 See note 9 supra.
the receivables and the payables. In enacting section 112(k) to counteract Hendler, Congress recognized that if the purpose of the Internal Revenue Code is to encourage legitimate incorporations, the tax consequences of transferring all the assets and liabilities of a going business to a corporation should be no more onerous than the consequences of liquidating all the liabilities before transferring the remaining assets.

In our hypothetical, if the taxpayer collects the receivables he will have $100,000 in taxable income. If he then proceeds to pay the payables, he can deduct $50,000 from his income for a net taxable gain of $50,000. Assuming that his tax rate is 50 per cent, he will have $25,000 in cash remaining after paying his tax for the year. If instead of liquidating the payables with the proceeds from the receivables, he transfers both to a corporation; under the Tax Court's reasoning in Raich, he will realize a taxable gain of $50,000 on the exchange since the receivables have a basis of zero and the amount of the payables is $50,000. When the taxpayer transfers the receivables and payables to a corporation, he is disadvantaged in two respects. First, after the transfer he has no money left to pay the tax which we will again assume is 50 per cent, or $25,000. Second, after he pays the tax he will obviously have no money left, whereas if he had liquidated the liabilities after collecting the receivables, he would have had $25,000 left after paying his income tax. Under the Tax Court's analysis, then, the taxpayer loses $50,000 if he transfers the assets and liabilities of his proprietorship to the corporation.

This hypothetical should cause one to wonder whether subsection (c) is as clear as the court implied. The court is correct in holding that the receivables have a basis of zero, but, as the hypothetical should indicate, the court stumbles when it considers the other side of the balance sheet. The court held that the payables in the hands of the cash basis taxpayer should be valued at their face amount of $37,719.78. It seems incongruous that the receivables had a basis of zero while the payables were valued at market. Either both might be valued at market or both might be valued at zero, but to combine the two results makes neither tax nor accounting good sense.

If the court is correct in holding that the receivables have a basis of zero, then the payables must also be accounted for at zero for tax

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60 A fourth possibility would be to transfer only the payables to the corporation. However, since such a transfer would probably be construed as tax avoidance, the Commissioner would most likely tax the entire transaction under Section 357(b). See note 12 supra.

61 See note 9 supra.

62 It is maintained below that the payables and receivables of a cash basis taxpayer should not be valued at market but should be valued at zero. In one sense, however, it is possible to value the receivables at market. If one considers the payables as a cost of producing the receivables, then it is proper to value the receivables at market to the extent of the payables. See note 58 supra.
purposes. Perhaps the court's thinking became snarled over the word "liabilities" in subsection (c). "Liability" has both an accounting and a tax definition. Certainly, in Raich the taxpayer would include an accounts payable liability of $37,719.78 on his business balance sheet. The business balance sheet, however, is not necessarily synonymous with the tax balance sheet. For tax purposes, a cash basis taxpayer has no "liabilities" until he has actually paid them and been allowed a deduction for them. Thus, although it may seem artificial to say that in Raich the taxpayer's payables are not a liability to him, nevertheless, for tax purposes they are not until he actually pays them and receives a deduction. The situation is analogous to the receivables. The receivables do not appear on the tax balance sheet until the money is actually received and reported as income. Likewise, the payables do not appear on the tax balance sheet until they are paid and deducted.

Consider once again the hypothetical, but this time assume that the payables are valued at zero. When the taxpayer transfers the payables and receivables to the corporation, he recognizes no taxable gain. It is true that by transferring the receivables and the payables to the corporation he has temporarily avoided paying $25,000 in federal income tax. At the same time, however, after paying the tax he does not have the $25,000 in cash remaining that he would have incurred had he kept the receivables and liquidated the payables.

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

Consider once more the hypothetical and follow it one more step to its natural conclusion. Under section 362(b), the corporation

63 Neither the Internal Revenue Code nor the Treasury Regulations are as precise on this point as they should be. Nevertheless, both the Code and the Regulation lend support to this conclusion. Section 1012 of the Code states that "the basis of property shall be the cost of such property . . . ." The Regulations are slightly more specific: "In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property." Treas. Reg. §1.1012-1(a) (1966). The Regulations also state: "Generally, under the cash receipts and disbursements method in the computation of taxable income . . . expenditures are to be deducted for the taxable year in which actually made." Treas. Reg. §1.446-1(c) (1) (1961). Since a cash basis taxpayer has paid nothing in cash for his accounts payable and cannot deduct them until he does so, they should be valued at zero until such time as he actually does pay them.

64 If the taxpayer in Raich had not incorporated and had claimed a deduction for the payables without actually paying them, the Commissioner would have disallowed the deduction because the taxpayer was on the cash basis. Treas. Reg. §1.1012-1(a) (1966); 2 MERTENS, FEDERAL INCOME TAXATION §12.53, at 147 & n.29 (rev. ed. 1961).

assumes the transferor's basis in the property transferred.\textsuperscript{66} Under the interpretation advanced above, the basis would be zero since both the receivables and the payables are valued at zero when they are transferred. The corporation will get the benefit of the $50,000 deduction for the payables, but will also have to pay tax on the $100,000 of receivables.\textsuperscript{67}

Upon transferring the assets and liabilities to the corporation, the taxpayer received stock in the corporation. The basis of the stock in the transferor's hands is the adjusted basis of the assets transferred, or, in the hypothetical, zero.\textsuperscript{68} Presumably, on the day of transfer the transferor could sell the stock for $50,000, the net worth of the corporation, and incur a taxable gain of $50,000. The taxpayer's taxable gain on the entire transaction is the same as if he kept the payables and used the receipts from the receivables to liquidate them, but by transferring the assets and liabilities to the corporation, he has postponed the time when he would realize that taxable gain. A transfer of accounts receivable and payable by a cash basis taxpayer to a corporation is thus a complete wash, as it should be, and the taxable gain, if any, is postponed until the taxpayer disposes of the stock he receives in exchange for the assets.

Applying the Tax Court's holding in \textit{Raich} to this hypothetical, one can see that the taxpayer in \textit{Raich} will eventually pay a double tax if he disposes of the stock he received in exchange for the assets of his business. The Tax Court would hold in this hypothetical that the taxpayer realized a taxable gain of $50,000 upon transferring the assets and liabilities of his business to a corporation, since the receivables have a basis of zero and the payables are valued at $50,000. Since the assets he transferred are valued at zero, the stock he receives in exchange for the assets is also valued at zero under section 358(a). The taxpayer, however, is allowed to increase his basis in the stock by the amount of the taxable gain he realized on the transfer, or $50,000 in the hypothetical. Under section 358(d),\textsuperscript{69} however, he is required to reduce his basis in the stock by the amount of the liabilities assumed by the corporation, or $50,000. This provision, in effect, offsets the credit allowed for the tax paid so that the taxpayer's basis in the stock is again reduced to zero. Consequently, when the tax-

\textsuperscript{66} If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. . .

\textsuperscript{67} See, e.g., P. A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718 (7th Cir. 1940); Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir.), cert. denied, 310 U.S. 650 (1940).

\textsuperscript{68} See note 41 \textit{supra}.

\textsuperscript{69} (d) ASSUMPTION OF LIABILITY—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 acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.
payer sells the stock he will realize another taxable gain of $50,000, or a total taxable gain of $100,000. The inequity in the Tax Court's holding is that the taxpayer is taxed twice when his debts are assumed by another party. First, he must pay a tax on the amount of the liabilities assumed when the debt is transferred. Second, he loses the credit for this tax since he must reduce his basis in the stock by the amount of the debt assumed.

At this juncture the question arises whether or not 357(c) would ever apply to accounts receivable and payable. If a cash basis taxpayer transfers only receivables and payables to a corporation, subsection (c) should not apply. Consider the accrual basis taxpayer, however. Clearly, if he transfers $100,000 in accounts receivable and $50,000 in accounts payable to a corporation, he has not recognized a taxable gain. This result follows naturally from the discussion above. The taxpayer has transferred sufficient assets to liquidate the liabilities assumed. Although he has been allowed a deduction for the payables since he is on the accrual method, he nevertheless also has paid tax on the receivables. In this case, the taxpayer has not realized a gain by transferring the receivables and payables to the corporation.

If the figures are reversed, however, the result is different. If an accrual basis taxpayer conveys $50,000 in receivables and $100,000 in payables, he realizes a taxable gain of $50,000 under 357(c) in order to prevent the stock received in exchange from having a negative basis. The taxpayer has, in effect, dumped a liability of $50,000 on the corporation which he will not have to pay. At the same time, he has gained a tax benefit of $50,000 since his deduction for the payables exceeded his tax on the receivables by $50,000. In such a case, it is only just that he be taxed on the transfer.

In conclusion, then, if only accounts receivable and payable are transferred to a corporation, a taxable event should not occur under 357(c) unless the taxpayer is on the accrual method and the corporation assumes liabilities greater in amount than the basis of the assets transferred.

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This, of course, assumes that the Commissioner does not conclude that the purpose behind the transfer was tax avoidance or that the transfer was not a legitimate business deal. Int. Rev. Code of 1954, § 357(b).

This statement assumes that the receivables do not appreciate in value while in the hands of the taxpayer. If the taxpayer's original basis in the receivables and his basis at the time of transfer are the same, this statement is correct.