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GLENN E. COVEN*

Liabilities in Excess of Basis:

Focht, Section 357(c)(3)

And the Assignment of Income

MOST businesses are permitted by the tax laws to incorporate their operations without the immediate recognition of taxable gain.¹ The decision of the Tax Court in *Peter Raich*,² however, in effect denied this dispensation to those businesses using the cash method of accounting whose invested capital is exceeded by the sum of current and long-term liabilities.³ The seeming unfairness of this decision precipitated a series of judicial inquiries into alternative patterns of taxation that could be reconciled with the statutory provisions governing tax-free incorporations.⁴ Without exception, these inquiries have focused on reinterpreting the incorporation sections of the Internal Revenue Code.

The need to construe the Code's incorporation provisions has resulted from the Internal Revenue Service's failure to apply to most incorporation transfers those general principles of taxation that prohibit the assignment of income. As a result, the nonrecognition provisions governing incorporation exchanges have controlled the taxation of items of current income and expense, a task for which they were not designed and are ill-suited. In this respect, incorporation transfers are not taxed in harmony with the general pattern of the Code. As a result of that disharmony, the *Raich* problem has not been satisfactorily resolved. Indeed, the recently adopted congressional solution⁵ has significantly and

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¹ See I.R.C. § 351(a).

² 46 T.C. 604 (1966).

³ See text accompanying notes 19-23 *infra*.

⁴ See note 32 *infra*.

⁵ Revenue Act of 1978, Pub. L. No. 95-600, § 365 (codified at I.R.C. §§ 357(c)(3), 358(d)(2)) (codifying the result in *Focht v. Commissioner*, 68 T.C.

needlessly complicated the taxation of incorporation exchanges without achieving a rational pattern.

This Article contends that the assignment of income doctrine should be applied to incorporation transfers, and that the present patchwork of solutions should be abandoned. If the doctrine were so applied, the *Raich* problem would simply disappear, and the taxation of incorporation exchanges would conform with the general structure of the Code.

I

THE *Raich* PROBLEM

The traditional view of the *Raich* problem has been fully set forth in the literature⁶ and need be only summarized here. In its relatively early opinions in *United States v. Hendler*⁷ and *Crane v. Commissioner*,⁸ the Supreme Court established that on the sale or exchange of property, the assumption by the transferee of an obligation of the transferor constituted a further payment in consideration of the transfer in the amount of the liability assumed. Consider, for example, property that has a \$60 tax basis and a \$100 gross value, and that is subject to a \$30 note and mortgage. If such property were transferred in exchange for \$70 in cash and the transferee's agreement to assume the transferor's obligations on the note and mortgage, then the total amount realized on the exchange would be \$100,⁹ with a \$40 gain realized by the transferor.¹⁰ In effect, the transferor is treated as having received \$100 in cash and then discharging its own obligation, and the transferee is treated as having paid \$100 in cash and then refinancing the property. Furthermore, the Supreme Court has indicated that this treatment of the assumption of indebtedness is applicable not only to taxable sales and exchanges, but also to those corporate reorganizations that Congress has determined should otherwise be tax-free.¹¹

Treating the assumption of liabilities as further payment in a taxable transaction was regarded as necessary to the structure of the taxing act and did not appear to produce undesirable side effects. When

223 (1977), *appeal dismissed*, No. 78-1118 (3d Cir. Mar. 23, 1978)). See text accompanying notes 34-42 *infra*.

⁶ See, e.g., Del Cotto, *Section 357(c): Some Observations on Tax Effects to the Cash Basis Transferor*, 24 BUFFALO L. REV. 1 (1974); Kahn & Oesterle, *A Definition of "Liabilities" in Internal Revenue Code Sections 357 and 358(d)*, 73 MICH. L. REV. 461 (1975); Note, *Incorporating a Cash Basis Business: The Problem of Section 357(c)*, 34 WASH. & LEE L. REV. 329 (1977).

⁷ 303 U.S. 564 (1938).

⁸ 331 U.S. 1 (1947).

⁹ See I.R.C. § 1001(b).

¹⁰ See I.R.C. § 1001(a).

¹¹ *United States v. Hendler*, 303 U.S. at 566.

applied to reorganization exchanges, however, the results were disastrous. The law provided that upon the incorporation of a business, or in another reorganization exchange, if the transferor of property received only stock or securities in the transferee corporation, then no gain would be recognized and the entire tax would be deferred.¹² The receipt of any other property, however, would be subject to tax.¹³ Since in a reorganization exchange the assumption of indebtedness would not constitute a transfer of stock or securities, but rather a transfer of "other property," the assumption of liabilities of the transferred business would produce a tax to the transferor. Because the capital structure of many businesses contained substantial liabilities that could not be discharged prior to reorganization, without liquidation of a major portion of the business's assets, the effect of *Hendler* was to deny tax-free reorganization treatment to most taxpayers.¹⁴

Congress promptly responded by amending the reorganization provisions to extend deferral of tax on reorganization exchanges to the receipt of an assumption of indebtedness.¹⁵ Rather than taxing the amount of the assumption at the time of the exchange, Congress provided that the tax basis that the transferor would otherwise obtain in the stock or securities received in the exchange would be reduced by the amount of the assumption of indebtedness, thus ensuring that the tax deferred at the time of the exchange would be collected upon any subsequent taxable disposition of the affected stock or securities.¹⁶ In effect, Congress provided that the value received by the transferor upon the assumption of its liabilities would be treated as a return of its investment, rather than its gain.

In the original legislation, Congress failed to provide for the possibility that the amount of the liabilities assumed would exceed the tax basis of the properties transferred. A period of confusion resulted during which it was uncertain whether in such a situation the transferor should be assigned a negative basis for its stock or, notwithstanding the general deferral of tax, recognize a gain to the extent that the liabilities assumed exceeded the basis of the properties transferred.¹⁷ Since the policy of nonrecognition could not reasonably be extended to defer

¹² Int. Rev. Code of 1939, ch. 1, § 112(b) (3), (5), 53 Stat. 37 (now I.R.C. §§ 354(a) (1), 351(a)).

¹³ Int. Rev. Code of 1939, ch. 1, § 112(c) (1), 53 Stat. 39 (now I.R.C. §§ 351(b), 356(a) (1)).

¹⁴ H.R. REP. No. 855, 76th Cong., 1st Sess. 19 (1939), *reprinted in* 1939-2 C.B. 518-19.

¹⁵ Revenue Act of 1939, § 213(a), 53 Stat. 870 (adding § 112(k) to Int. Rev. Code of 1939) (now I.R.C. § 357(a)).

¹⁶ Revenue Act of 1939, § 213(d), 53 Stat. 871 (adding § 113(a) (6) to Int. Rev. Code of 1939) (now I.R.C. § 358).

¹⁷ See *Easson v. Commissioner*, 294 F.2d 653 (9th Cir. 1961).

taxation when an amount exceeding the tax basis has been withdrawn from an investment, Congress again amended the reorganization provisions to require taxation of the excess.¹⁸

Soon after the adoption of this rule in section 357(c) of the Code,¹⁹ it became apparent that many businesses employing the cash method of accounting²⁰ would have liabilities substantially exceeding the tax basis of the business properties to be transferred, since the accounts receivable, not having been subject to tax, would have a basis of zero. Imposition of tax in these circumstances was said to be unfair: while accounts receivable were effectively ignored, accounts payable were fully treated as liabilities.²¹ This disparate treatment was first attacked in *Raich*, a case involving incorporation of a cash method sole proprietorship under section 351. The liabilities assumed in the exchange consisted primarily of accounts payable and substantially exceeded the tax basis of the properties transferred, although the dollar amount of receivables transferred exceeded the amount of the assumed liabilities.²² Since the taxpayer was unable to develop a persuasive theory to relieve himself from taxation, the Tax Court applied section 357(c) literally and taxed the transferor on the full amount by which the liabilities exceeded basis. In so doing, the court reached a result that is now uniformly recognized as erroneous.²³

The facts of *Raich* and the effect of the Tax Court's initial solution

¹⁸ Int. Rev. Code of 1954, ch. 1, § 357(c), 68A Stat. 117. For an analysis of the conflicting considerations and a criticism of § 357(c)'s resolution, see Cooper, *Negative Basis*, 75 HARV. L. REV. 1352 (1962).

¹⁹ Unless otherwise indicated, all references herein to sections and subsections are to the Internal Revenue Code of 1954, as amended.

²⁰ Under the cash method of accounting, which is specifically authorized by I.R.C. § 446(c) (1), a taxpayer is generally required to report items of income and expense for the year in which the income is actually or constructively received in cash or its equivalent, or the expense is paid. See Treas. Reg. § 1.446-1(c) (1) (i) (1957). The other principal method of accounting is the accrual method, which is authorized by I.R.C. § 446(c) (2). Pursuant to the accrual method, items are reported for the year in which all the events have occurred that establish either the right to payment or the fact of liability, provided the amount thereof can be ascertained with reasonable accuracy. See Treas. Reg. § 1.466-1(c) (1) (ii) (1957). Thus, an accrual method taxpayer would report the income represented by an account receivable at the time of sale, but a cash method taxpayer would report the income only upon collection of the receivable. Similarly, an accrual method taxpayer would report an expense at the time of purchase, but a cash method taxpayer would report the expense only upon payment.

²¹ See *Bongiovanni v. Commissioner*, 470 F.2d 921, 924-25 (2d Cir. 1972) (taxpayer's argument); *Peter Raich*, 46 T.C. 604, 607-10 (1966).

²² 46 T.C. at 605.

²³ See, e.g., *Bongiovanni v. Commissioner*, 470 F.2d 921, 924 (2d Cir. 1972); Kahn & Oesterle, *supra* note 6, at 464-67; Comment, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154, 1163-69 (1967).

can best be illustrated by a simplified example. The following illustration assumes that an individual cash method transferor exchanges the enumerated properties for stock and the agreement of the transferee corporation to assume all of the liabilities of the contributed business. The balance sheet of the unincorporated business immediately prior to the exchange is as follows:

<i>Assets</i>		<i>Liabilities</i>	
Accounts Receivable	\$20	Accounts Payable	\$40
Equipment	\$35	<i>Net Worth</i>	
		Capital	\$15

For simplicity, the equipment is assumed to have a tax basis, book value, and fair market value all equal to \$35. It is also assumed that the entire amount of the accounts payable would be deductible if paid by the transferor prior to the exchange.²⁴ Assuming an arm's length transfer, the value of the stock received would be \$15. Under *Hendler* and *Crane*, the \$40 assumption of liabilities must be added, producing an amount realized of \$55. Subtracting the transferor's \$35 basis in the properties produces a realized gain of \$20. Pursuant to section 351, this gain would be recognized only to the extent that the transferor received property other than stock or securities in the transferee. Under the general rule of section 357(a), the amount of the liabilities assumed would not be regarded as "other property" subject to tax, but under section 357(c) the excess of the liabilities assumed over the basis of the properties transferred, or \$5, would be subject to tax. The transferor's basis in the stock received in the exchange would be zero,²⁵ and the properties transferred to the corporation would acquire a tax basis of \$40.²⁶

Prior to the transfer, had events taken their normal course, the transferor would have been in a tax loss position. By hypothesis, the transferor had an unrecovered investment in the equipment of \$35, but the net worth of the business was only \$15. If the transferor had not incorporated, this loss would have been recognized through the collection of \$20 of taxable income and the payment of \$40 of deductible liabilities. Immediately after incorporation, through the operation of sections 351, 358, and 357, as constructed in *Raich*, the transferor owned stock worth \$15 which had a tax basis of zero. In addition, the transferor had been subjected to tax on \$5. In effect, the potential income from the accounts

²⁴ Deductible payables include current interest and taxes, in addition to most operating expenses such as salaries and supplies. *See* I.R.C. §§ 162, 212.

²⁵ I.R.C. § 358(a)(1), (d) (a substituted basis of \$35 from the properties transferred, reduced by the \$40 of liabilities assumed, and increased by the \$5 recognized gain).

²⁶ I.R.C. § 362(a) (a \$35 carryover basis increased by the \$5 gain).

receivable had been partly taxed, and partly deferred in the basis adjustment to the stock received by the transferor. Any tax benefit from the potential deduction, however, had been lost.²⁷ Indeed, the transferor's tax position had been converted from a position of loss to a position of gain. Since the purpose of section 351 and related sections is merely to defer recognition of gain or loss, this result is clearly wrong on principle.²⁸

When the transferee assumes a *nondeductible* liability²⁹ in a section 351 exchange, the inadequacies of the *Raich* approach disappear. If the liabilities in our illustration had been nondeductible, the transferor would have a gain of \$20 inherent in the business property prior to the exchange.³⁰ Thus, the result in *Raich* of taxing the transferor on a gain of \$5 and deferring a further gain of \$15 would leave the transferor in the correct position. Furthermore, if section 351 were properly applied to the exchange, the gain inherent in the properties acquired by the transferee would equal the gain deferred in the stock acquired by the transferor.³¹ Since the transferee's basis of \$40 in properties having a value of \$55 defers a gain of \$15, the transferee also would be left in the correct position.

II

THE SEARCH FOR A SOLUTION

A. By the Judiciary

Presumably because the literal language of section 357(c) seemed to produce the proper result when the assumed liabilities were nondeductible, the *Raich* problem was regarded as stemming from the deductible character of the liabilities, and the search for a solution was so focused.

²⁷ Aside from the special problem considered herein, it is entirely possible for a taxpayer in a § 351 exchange to be subject to tax upon the receipt of cash "boot," even though in the aggregate the transferred properties are depreciated in value. Each item of transferred property is treated separately; although the cash allocated to the appreciated assets is taxable as "other property," the loss on the depreciated assets is not recognized. See I.R.C. § 351(b); Rev. Rul. 68-55, 1968-1 C.B. 140. When the loss is inherent in fixed assets, however, § 358 functions properly, preserving the loss in the substituted basis of the stock received.

²⁸ See text accompanying notes 119-21 *infra*.

²⁹ For example, a borrowing by the transferor, such as a bank loan, a purchase money mortgage, or a public issue of debentures, is such a liability.

³⁰ Of course, the net worth of the business would remain \$15. In the process of incurring a nondeductible liability, however, such as a loan, the transferor would have received cash upon which it was not taxed. Therefore, the cash must be taken into account with the \$15 in stock to measure the gain or loss. Accordingly, the transferor's total receipts of \$55 would exceed its investment, or tax basis, of \$35 by \$20.

³¹ This is the function of the carryover basis prescribed by I.R.C. § 362(a).

In a series of cases after *Raich*, a variety of judicial opinions were expressed on why, and to what extent, deductible and nondeductible liabilities might be treated differently for the purposes of section 357(c).³² In 1975, Kahn and Oesterle developed a theoretical basis for such a distinction,³³ setting the stage for *Focht v. Commissioner*.³⁴ Reexamining the early cases that had precipitated the problem, the authors noted that in *Crane* the government had not asserted that the purchaser's assumption of the seller's obligations with respect to deductible items, such as interest, constituted an amount realized on the sale. The government had not required the reporting of income from the assumption and offsetting deduction, but rather had chosen to ignore both items, permitting, in effect, a netting of the items prior to computing the amount realized. From this and similar evidence the authors concluded that in enacting section 357(c), Congress intended that the only assumed liabilities to be taken into account for any purpose in a section 351 exchange are those that in a taxable sale or exchange under *Crane* would be treated as an additional amount realized.³⁵ Thus, deductible liabilities should be ignored in applying sections 357 and 358.

This analysis, which was accepted by a majority of the Tax Court in *Focht*, would substantially change the results in our illustration. Since the liabilities to be taken into account³⁶ no longer exceed the basis of the properties transferred, the transferor would recognize no gain on the exchange. With the deductible liabilities ignored, the transferor's tax basis for the stock received would simply be the substituted basis of the properties transferred, which was \$35.³⁷ The transferee corporation

³² In *Bongiovanni v. Commissioner*, 470 F.2d 921 (2d Cir. 1972), *rev'g* 30 T.C.M. (CCH) 1124 (1971), the court concluded that the liabilities referred to in § 357(c) were "tax" liabilities, i.e., liens in excess of tax costs The payables of a cash basis taxpayer are liabilities for accounting purposes but should not be considered liabilities for tax purposes under Section 357(c) until they are paid." *Id.* at 924 (emphasis in original). This solution appears to be approaching the latest position of the Tax Court. See text accompanying notes 34-42 *infra*. In *Thatcher v. Commissioner*, 533 F.2d 114 (9th Cir. 1976), *rev'g* 61 T.C. 28 (1973), the court accepted the *Raich* solution on the exchange itself. It then allowed the transferor a deduction upon the transferee's payment, within the year, of the assumed accounts payable. The court limited the deduction to the amount of the transferred accounts receivable that were collected by the transferee during the year.

³³ Kahn & Oesterle, *supra* note 6.

³⁴ 68 T.C. 223 (1977).

³⁵ This solution goes far beyond the problem posed by *Raich*, as would the solution suggested herein. See note 86 *infra*. Disregarding deductible liabilities would increase the transferor's basis in the stock received regardless of whether the liabilities exceeded basis.

³⁶ In our illustration, no liabilities would be taken into account. See text accompanying note 24 *supra*.

³⁷ I.R.C. § 358(a)(1), (d).

similarly would acquire a carryover basis of only \$35.³⁸

The Tax Court explained that from the transferor's perspective, the result reached was as if the transferee had paid cash in the amount of the deductible liabilities assumed, and the transferor had discharged its own obligations.³⁹ With one added qualification this summary explanation is correct: both the income and the deduction that would have been generated by an actual cash payment are deferred in the basis of the stock received and are thereby converted from ordinary to capital gain and loss. If \$40 in cash had actually been paid in lieu of the assumption of liabilities, the transferor would have recognized the full gain inherent in the properties transferred, which was \$20.⁴⁰ This amount would have been taxable as ordinary income.⁴¹ Upon use of the cash to discharge its obligations, the transferor would have been entitled to a deduction against ordinary income in the full \$40 amount of the discharged liabilities. The resulting hypothetical net deduction of \$20 is equal to the unrealized loss in the stock actually received, that is, the excess of its \$35 basis over its \$15 value. This approach would charge the transferor not only with the gain inherent in the accounts receivable but also with the loss inherent in the accounts payable. The problem of recognizing gain to the transferor, which arose from treating the unaccrued accounts payable as liabilities yet giving no effect to unrealized accounts receivable, is eliminated.⁴² Clearly, this result is far superior to the inequitable result in *Raich*.

B. By Congress

The *Focht* result, although perhaps not its analysis, was embraced by Congress with surprising speed. The last minute legislative scramble in October, 1978, produced several pieces of tax legislation. One of them, the Revenue Act of 1978,⁴³ added a new paragraph, (3), to section 357(c) and amended section 358(d) to codify, and somewhat refine, the treatment of liabilities adopted in *Focht*. New section 357(c) (3) provides:

(3) CERTAIN LIABILITIES EXCLUDED.—

(A) IN GENERAL.—If—

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

³⁸ I.R.C. § 362(a) (1).

³⁹ 68 T.C. at 236.

⁴⁰ I.R.C. § 351(b) (1).

⁴¹ The nature of the gain recognized is determined by the character of the properties transferred.

⁴² Indeed, gain attributable to the assumption of the payables is eliminated regardless of whether any accounts receivable are transferred.

⁴³ Pub. L. No. 95-600.

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

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

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

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

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

In addition, the existing section 358(d) became section 358(d)(1), and a new section, 358(d)(2), was added providing:

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

1. Uncertain Scope of the Amendment

These new provisions plainly resemble both the approach and result in *Focht*. Deductible liabilities are ignored in determining liability for tax under section 357(c) and in adjusting the basis of the stock received by the transferor. There are significant differences, however, between *Focht* and these provisions. The decision in *Focht* rested on the principle that the assumption of deductible liabilities should not produce an additional amount realized. While that principle may be criticized—the government's concession in *Crane* may have been more of a shortcut expedient than a matter of principle—the *Focht* decision attempted at least to achieve an internal consistency within the Code. Thus, the Tax Court specifically asserted that its redefinition of the term *liabilities* was applicable for all purposes of sections 357 and 358.⁴⁴ Indeed, one of the most disturbing aspects of *Focht* was the possibility that the term would consequently have to be redefined, or at least reexamined, in each of its occurrences throughout the Code.⁴⁵

The foundation for the amendment of sections 357 and 358 is far less clear. The Senate Report accompanying the legislation twice states that the provision “would codify the approach taken by the Tax Court in *Focht*.”⁴⁶ The rule of new section 357(c)(3), however, is by its terms only applicable for the purposes of section 357(c), the provision imposing a tax on the excess of assumed liabilities over basis, and then only for the purposes of section 351 exchanges.⁴⁷ These limitations appear

⁴⁴ 68 T.C. at 238.

⁴⁵ Judge Hall, dissenting in *Focht*, expressed this concern in noting that the term *liabilities* appeared 400 times in the Code. *Id.* at 244.

⁴⁶ S. REP. NO. 95-1263, 95th Cong., 2d Sess. 185 (1978) [hereinafter cited as SENATE REPORT].

⁴⁷ I.R.C. § 357(c)(1) is also applicable to transfers in type D reorganizations.

wholly inconsistent with the principle adopted in *Focht*. The Senate Report further states that the provision "is not intended to affect the definition of the term liabilities for any other provision of the Code, including sections 357(a) and 357(b)."⁴⁸ This statement is clearly ambiguous. It may be read as neutral: Congress is taking no position on the *Focht* analysis and is content to allow further judicial development of the definition of the term *liabilities* for purposes other than section 357(c).⁴⁹ On the other hand, the statement may be read as affirmatively limiting the change in the law to section 357(c) and prohibiting judicial redefinition of the term *liabilities* when appearing elsewhere. The clear implication of this construction of the Report would be that elsewhere the term retained a different meaning; presumably that meaning would be the one assigned to the term *liabilities* in *Raich*. Accordingly, it is uncertain whether in adopting section 357(c)(3) Congress has indicated a willingness to accept *Focht's* broad application of the new meaning of the term *liabilities* or has rejected that analysis. As a result, the tax consequences of transactions not covered by section 357(c)(3) are in doubt. Since the amendment is applicable only prospectively,⁵⁰ the greatest area of doubt is that surrounding section 351 exchanges occurring prior to October, 1978.⁵¹

Unfortunately, neither construction is satisfactory. If it is concluded that the *Focht* redefinition is not necessarily limited to section 357(c)(3), then the Code will contain a restrictive definition of *liabilities* that is ostensibly applicable only to specific provisions, although the same word elsewhere may acquire the same restrictive meaning. Thus, in time, sections 357(c)(3) and 358(d)(2) will be rendered meaningless. Although such a result is theoretically desirable, nothing could be more confusing or more likely to trap the unwary.

The alternative is that Congress intended section 357(c)(3) to be

If a corporate transferor in a § 351 exchange distributes the securities it receives to its shareholders, the transaction may constitute both a § 351 exchange and a type D reorganization. I.R.C. §§ 351(c), 368(a)(1)(D). Since there is no provision coordinating these two provisions, it is unclear whether, in the situation described, § 357(c)(3) is applicable.

⁴⁸ SENATE REPORT, *supra* note 46, at 185.

⁴⁹ Some support for this construction can be found elsewhere in the Report, where the reason for the amendment is given as the need to resolve ambiguities of definition that several decisions following *Raich* had created. *Id.* at 184-85.

⁵⁰ Revenue Act of 1978, Pub. L. No. 95-600, § 365(c).

⁵¹ Regardless of this ambiguity, the Internal Revenue Service may choose to permit transferors in exchanges occurring prior to October, 1978, to report their gain in accordance with *Focht*. That restraint, however, might not solve every problem. For example, a pre-1978 transferor may desire a stepped-up basis in the assets transferred and thus prefer the *Raich* result. It would seem unduly lenient for the Service to permit taxpayers to elect either the *Raich* or the *Focht* approach, but it is far from clear that it can compel reporting in accordance with *Focht*.

the exclusive redefinition of *liabilities*; thus *Focht* is to be applied only to situations that are explicitly covered by the legislation. Conceivably, Congress could have concluded that in some situations the result reached in *Raich* is preferable to the result in *Focht*. But that conclusion would surely be wrong.⁵² It seems more probable that Congress simply made the minimum change in the statutory law necessary to resolve the specific problem brought before it. It would be more reasonable for Congress to have adopted a neutral posture concerning other applications of the *Focht* analysis.⁵³ It is obviously impossible, however, to predict with assurance whether the *Focht* analysis retains vitality outside the narrow scope of the new legislation. The suggestion here is that, in spite of the ensuing confusion, it should.⁵⁴

2. Technical Defects in the Amendment

In addition to this basic ambiguity, the draftsmanship of the new provisions leaves much unresolved. The most significant ambiguity in sections 357 and 358, as amended, is the extent to which the basis of the stock received by the transferor is to be reduced as a consequence of the transferee's assumption of deductible liabilities. Under *Focht*, of course, no such reduction would ever be made because deductible liabilities would be ignored for all purposes of section 358. The general basis reduction provision is now found in section 358(d)(1). It requires, in effect, that the basis of the stock received by the transferor be reduced by the amount of all liabilities assumed by the transferee. New section 358(d)(2) creates an exception to this rule for the amount of any liability "excluded under section 357(c)(3)," apparently conforming section 358(d) with the result reached in *Focht* to the extent that section

⁵² See text accompanying notes 27-28 *supra*. The Senate Report states that the redefinition of *liabilities* is not applicable to § 357(b). See text accompanying note 48 *supra*. Under that subsection, if an assumption is shown to have a tax avoidance purpose, then the amount of all liabilities assumed in the § 351 exchange is excluded from the general rule of § 357(a) and treated as a distribution of money. The provision is expressly punitive: all liabilities are so treated, not only those liabilities the assumption of which constitutes tax avoidance. See Treas. Reg. § 1.357-1(c), T.D. 6528, 1961-1 C.B. 81. Nevertheless, there is no indication that Congress ever intended that this provision impose a greater penalty than to preclude the deferral of tax. See W.H.B. Simpson, 43 T.C. 900, 914-15 (1965). If *Focht* was correctly decided, it is because *Raich* wrongfully deprived the transferor of a deduction to which it was entitled and taxed it on a greater amount of gain than it realized on the exchange. If that result is improper under § 357(c), it is equally improper under § 357(b).

⁵³ It is particularly difficult to understand why, for example, Congress would wish to deprive pre-October, 1978, transferors of the protection of *Focht*.

⁵⁴ This suggestion assumes that § 357(c)(3) will remain in the Code unaltered. The thesis herein, of course, is that the *Focht*-§ 357(c)(3) approach to the *Raich* problem is fraught with difficulties, and that there is a more desirable solution.

357(c)(3) is applicable. New section 357(c)(3), however, is only applicable for the purposes of section 357(c)(1); that is, deductible liabilities are ignored only for the purpose of reducing or eliminating the tax that otherwise would be imposed upon the assumption of liabilities in excess of basis. If section 357(c)(1) is not applicable to a section 351 exchange because the total liabilities assumed do not exceed the basis of the transferred assets, no liabilities will have been "excluded" under section 357(c)(3). Literally, therefore, section 358(d)(2) would be inapplicable, and the basis of the transferor's stock would be reduced by the amount of the deductible liabilities assumed. Thus, contrary to the result reached in *Focht*, the transferor would be subject to tax in the future on the amount of the deductible liabilities assumed in the section 351 exchange.

If section 357(c)(1), and thus section 357(c)(3), is applicable to the exchange, then section 358(d)(2) will be applicable. The basis of the transferor's stock will not be reduced, and the transferor will never be subject to tax with respect to assumed deductible liabilities. Section 357(c)(3) will be applicable, however, even though the liabilities assumed exceed basis by only one dollar. In that event, a one dollar difference in the liabilities assumed, or in the basis in the assets transferred, could produce an enormous difference in the tax ultimately imposed on the transferor. Clearly that result could not have been intended.

The language of section 357(c)(3) suggests that if it is applicable, all deductible liabilities are to be ignored. For purposes of sections 357(c)(1) and (3), it does not matter, however, whether all such liabilities are ignored or only an amount sufficient to prevent the imposition of tax. The sharp disparity in treatment under section 358(d) could be eliminated by reading section 357(c)(3) as excluding only an amount of liabilities necessary to avoid tax under section 357(c). But there is no support for such a construction in the language of section 357(c)(3) or elsewhere.

Regardless of the statutory ambiguity, section 358(d)(2) must be read broadly to prohibit in a section 351 exchange a basis reduction attributable to the assumption of any liability described in new section 357(c)(3)(A)(ii), regardless of whether section 357(c)(1) is actually applicable.⁵⁵ The effect of not reducing basis pursuant to section 358(d)(1) is to achieve a permanent exemption from tax, not merely a deferral. To permit this exemption with respect to only certain deductible liabilities—depending solely on the tax basis of the assets transferred in the exchange—would be absurd. The unfortunate draftsmanship of section 358(d)(2) cannot be permitted to produce such a result.

⁵⁵ Section 358(d)(2) is, under this construction, applicable in one situation in

There are many other interpretive difficulties with the new amendments.⁵⁶ It is not the purpose of this Article, however, to examine the details of these provisions, but rather to question their desirability in principle. For the purpose of identifying that which is to be criticized, it may be concluded that the result itself in *Focht* has been codified (with a minor ambiguity as to the basis of the stock received by the transferor), that the codification is narrower than the scope of the case, and that the continued vitality of the *Focht* analysis in areas not covered by the legislation is debatable.

III

INADEQUACY OF THE SOLUTION

Aside from whatever interpretive complexities these new provisions create, there are two basic defects in the *Focht*-section 357(c)(3) solution. Both reflect the fact that the nonrecognition provisions of section 351 were not designed to affect the taxation of ordinary business income

which Congress would probably not have intended it to apply. If the § 357(c)(3) redefinition of *liabilities* is exclusive, the assumption of deductible liabilities in an exchange to which § 357(b) applies would subject the transferor to tax. The transferor's basis in the stock received would be increased accordingly by the amount so taxed. I.R.C. § 358(a)(1)(B)(ii). If its basis in the stock were not then reduced by the amount of the liability assumed, the transferor might be regarded as receiving a double tax benefit. If one accepts the argument that the imposition of tax with respect to deductible liabilities is always improper, *see* note 52 *supra*, this double benefit would produce a nearly correct result by extending a future tax benefit to offset the tax imposed. The mechanism for achieving that result would of course be rather contorted. However, if Congress did not intend to redefine *liabilities* for purposes of § 357(b), it is unlikely that it would concur in this justification for the double benefit.

⁵⁶ For example, it may be difficult to identify allowable deductions given the multitude of Code sections that give, take away, and limit deductions that are allowed elsewhere. Thus, § 163(a) allows a deduction for interest, but § 163(d) limits the deductibility of investment interest as a function of certain classes of income. For purposes of § 357(c)(3), is the amount of the allowable interest deduction a function of income earned as of the date of the § 351 exchange, or can the amount be enlarged by subsequent earnings during the year?

The proper scope of the exception in § 357(c)(3)(B) is also uncertain. The Senate Report states that the exception would apply if a taxpayer purchased small tools on credit and thereafter transferred the tools and the related account payable in a § 351 exchange. The Report takes the position that until the payable is discharged and the amount thereof deducted, the transferor has a basis in the tools. *See* SENATE REPORT, at 185 n.7. It is true that in the described situation there is no need for the relief extended by § 357(c)(3), because the amount of the payable assumed will be offset by the transferor's basis in the corresponding asset. The extension of this illustration, for example, to paperclips would create a rather unusual definition of basis and in effect limit the scope of the new provisions to liabilities incurred for services.

and expense and do not function properly when forced to accommodate those items.⁵⁷ First, the solution is technically inconsistent with the general structure of the incorporation sections; it thus creates unnecessary confusion and necessitates further adjustments to the pattern of taxation to compensate for the inconsistency. Second, the solution assumes that the assignment of income doctrine is inapplicable to incorporation exchanges; this assumption is wrong as a matter of law and objectionable as a matter of tax policy.

A. Structural Inconsistencies

The technical inconsistencies created by the *Focht*-section 357(c) (3) solution become apparent when attention is turned from the transferor to the corporate transferee. Initially, it is clear in our illustration that the transferee acquires a \$35 basis in the transferred properties.⁵⁸ The full effect of the section 351 exchange on the transferee, however, depends upon the income tax consequences of its payment of the assumed accounts payable, and those consequences are not clear. The uncertainty requires a measure of explanation.

The other side of decisions such as *Crane* is that the purchaser is treated as having paid an amount for the property equal to the sum of the cash actually paid plus the amount of the liabilities assumed. In our illustration, the purchaser paid \$15 in cash, plus \$40 by way of assumed liabilities, in exchange for property having a value of \$55. From a purely economic perspective, it is immaterial to the purchaser whether the liabilities assumed would have been deductible if paid by the seller. Functionally, all of the purchaser's payments are of the purchase price for the property. As such, these payments are not deductible but must be capitalized by addition to the purchaser's cost basis in the properties acquired.⁵⁹

In the absence of section 351, the transfer of property to a corporation in exchange for its stock and the assumption of liabilities would constitute a sale.⁶⁰ Since neither the present nor prior versions of section 351,⁶¹ nor any other provision in the Code, addresses the treatment of the transferee on its discharge of assumed liabilities, the courts were required to infer the extent to which the predecessors to section 351 had

⁵⁷ See text accompanying notes 122-24 *infra*.

⁵⁸ See note 38 and accompanying text *supra*.

⁵⁹ *E.g.*, *Magruder v. Supplee*, 316 U.S. 394 (1942); *Leavitt v. Commissioner*, 31 T.C.M. (CCH) 453 (1972).

⁶⁰ I.R.C. § 1001(c). See *Marr v. United States*, 268 U.S. 536 (1925) (stockholder subject to tax on shares received in exchange following reincorporation in another state).

⁶¹ *E.g.*, Int. Rev. Code of 1939, ch. 1, § 112(b) (5), 53 Stat. 37; Revenue Act of 1921, ch. 136, tit. II, § 202(c) (3), 42 Stat. 230.

altered the character of the exchange for purposes other than the transferor's recognition of gain. Perhaps because the reorganization provisions reversed a series of early decisions by the Supreme Court,⁶² and thus were regarded as exceptions to the common-law concept of a corporation, the courts declined to read the early nonrecognition provisions broadly. They failed to find a congressional intent that the transferee should be regarded as merely a continuation of the transferor and thus entitled to the same income tax deductions that would have been available to the transferor.⁶³ From the perspective of the transferor, there may be a sufficient continuity of its investment between the unincorporated business and the transferee corporation to permit deferral of gain on the exchange.⁶⁴ But, from the entity perspective, the transferee should be regarded as wholly separate and distinct from its predecessor. The courts have specifically rejected the argument that the requirement of a carryover basis to the transferee implies the carryover of other tax attributes, such as the deductibility of expenses attributable to the transferor's business.⁶⁵ This principle of lack of continuity at the entity level remains firmly established today.⁶⁶

⁶² *E.g.*, *Rockefeller v. United States*, 257 U.S. 176 (1921); *United States v. Phellis*, 257 U.S. 156 (1921).

⁶³ *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946); *Merchants Bank Bldg. Co. v. Helvering*, 84 F.2d 478 (8th Cir. 1936). *Cf.* *M. Buten & Sons v. Commissioner*, 31 T.C.M. (CCH) 178, 181 (1972) (fact that expenditure would have been deductible if paid by partnership does not establish its deductibility when paid by successor corporation).

⁶⁴ This assumes that the several requirements of § 351 are met, including the transferor's control over the transferee as defined in § 368(c).

⁶⁵ *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323, 324-25 (8th Cir. 1946).

⁶⁶ *See* *Dearborn Gage Co.*, 48 T.C. 190 (1967); *Ezo Products Co.*, 37 T.C. 385 (1961); *Treas. Reg. § 1.312-11(a)*, T.D. 6476, 1960-2 C.B. 113; *Rev. Rul. 56-256*, 1956-1 C.B. 129. *See also* *Nash v. United States*, 398 U.S. 1 (1970). In *Nash*, the Court held that an accrual method transferor was not required to restore the amount of its bad debt reserve to income. Consistent with the principle of discontinuity, the Court concluded that in the exchange the transferor received no more than the net value of the receivables.

It is beyond the scope of this Article to reexamine the principle of discontinuity; however, the decisions cited above are undoubtedly correct. Section 351 is the broadest of the Code's nonrecognition provisions. It may apply to the transfer of a single item of property, to the simultaneous transfer of several previously unrelated items, or to the incorporation of an entire ongoing business. Although it might be appropriate to find continuity if an entire business were transferred in a section 351 exchange, it is clearly inappropriate to permit the shifting of deductions to the transferee merely because it has assumed liabilities in connection with the transfer of a minor item of property. In the absence of a statutory basis for discriminating among diverse transactions, the courts have found it necessary to apply a blanket rule of discontinuity.

Even if an entire business were incorporated, it might still be undesirable to find continuity between one or more individual transferors and the corporation. The

Prior to the adoption of the Internal Revenue Code of 1954, it was unclear whether, even in a statutory merger or other acquisitive reorganization, the transferee could carry over the transferor's items of income and expense and deduct the payment of assumed liabilities.⁶⁷ However, since nonrecognition is extended only to reorganizations in which there is substantial business continuity,⁶⁸ Congress deemed it appropriate to permit the transferee to "step into the 'tax shoes' of its predecessor" in such circumstances.⁶⁹ Accordingly, section 381 was added by the 1954 Code to require the transferee to "succeed to and take into account" certain enumerated items of the transferor. Section 381(c)(16) specifically provides for liabilities assumed by the transferee that would have been deductible if paid by the transferor: such liabilities are deductible by the transferee upon their discharge.

Section 381, however, is applicable only to those reorganization exchanges in which substantially all of the properties of a corporation are transferred to a second corporation; it is not applicable to section 351 exchanges.⁷⁰ Since the transferor in a section 351 exchange need not be a corporation and need not transfer either its entire business or a major portion thereof, continuity at the entity level was evidently regarded as insufficient to permit the carryover of these items. Although the Committee Reports to the 1954 legislation observed that no inferences were to be drawn from the adoption of section 381 with respect to transactions not subject to the new provision,⁷¹ Congress clearly intended no change in existing law with regard to section 351. Existing law prohibited deduction of assumed liabilities by the transferee. At the very least, the adoption of section 381 indicated that Congress regarded treatment of the transferee as a mere continuation of its predecessor as less appropriate in a section 351 exchange than in the reorganizations specified in the new section.

Thus, under the decided case law, supported both by principle and by

income distorting effect of transactions between an individual and a corporation, particularly the shifting of items of income and expense, is substantial. Indeed, several provisions of the Code specifically address the tax avoidance potential of such transactions. *See, e.g.*, I.R.C. §§ 179(d)(2), 267(b)(2), 1235(d)(1), 1239(b)(2).

⁶⁷ H.R. REP. NO. 1337, 83d Cong., 2d Sess. 41, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4066-67; *see* VCA Corp. v. United States, [1977] FED. TAXES INC. (P-H) (40 A.F.T.R.2d) ¶ 77-5113 (Ct. Cl. trial judge's opinion).

⁶⁸ *See* I.R.C. § 368(a)(1).

⁶⁹ H.R. REP. NO. 1337, *supra* note 67, at 41, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS at 4067.

⁷⁰ I.R.C. § 381(a). Even in the specified situations, application of § 381 can be troublesome. *See* VCA Corp. v. United States, [1977] FED. TAXES INC. (P-H) (40 A.F.T.R.2d) ¶ 77-5113 (Ct. Cl. trial judge's opinion).

⁷¹ H.R. REP. NO. 1337, *supra* note 67, at A135, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS at 4273.

the legislative history of the reorganization provisions, the transferee is not entitled to a deduction for its discharge of assumed accounts payable. It does not follow, however, that the corporation must capitalize these payments and add their amount to the tax basis of the acquired properties. In fact, at least in those circumstances in which the transferor would not have been able to deduct its payment of the liability, it is clear that the transferee may not capitalize the payment. If the transferee were permitted to do so, its basis would consist of a carryover basis under section 362 plus the cost basis attributable to the liabilities. This result would be clearly improper.⁷²

⁷² The effect of permitting such an adjustment to basis can be seen by reference to the illustration of the *Raich* case in which we assumed that the liabilities either were attributable to a borrowing by the transferor or were the previously deducted accounts payable of an accrual method transferor. See text accompanying notes 29–32 *supra*. The corporate transferee acquired a basis of \$40 in the transferred properties (a carryover basis of \$35 plus the \$5 recognized gain) and assumed liabilities of \$40. The \$40 basis properly left the transferee with a gain of \$15 inherent in its properties, which had a value of \$55. If the \$40 basis were increased by the amount of the assumed liabilities, the resulting \$80 basis would create a \$25 unrealized loss in the properties, a nonsensical result.

To permit the transferee in a § 351 exchange to capitalize the amount of accounts payable that would have been deductible if paid by the transferor mitigates the harshness of disallowing all tax benefit, but it does so in an irrational manner. It is not clear whether the resulting increase in basis would be allocated among the acquired properties by a ratio of the relative values, relative tax bases, or relative amounts of appreciation. It is clear, however, that for given face amounts of accounts payable and receivable, changes in the quantity or character of the other properties contributed to the corporation affect the amount currently taxable to the transferee corporation. For example, assume an allocation on a ratio of the relative values of the contributed properties. A greater value of contributed fixed assets will result in a larger proportion of basis adjustment allocated to those assets; this will result in a greater income from collection of accounts receivable that will be currently taxable to the corporation.

In any context requiring the allocation of basis, the basis allocated to any given asset will be partly a function of the value or some other characteristic of the other assets involved. In the allocation formula, the presence of capital assets will affect the amount of ordinary income taxed to the *transferee*. Nevertheless, it is extraordinary, perhaps unique, for a basis allocation to affect the amount of current ordinary income that will be subject to tax. In a taxable purchase of assets, for example, the same allocation of basis must be made. Also, however, the seller will be required to allocate the purchase price received, and this allocation should correspond to the purchaser's allocation. Thus, the seller will be subject to a current ordinary income tax with respect to the transferred accounts receivable to exactly the same extent that the purchaser is relieved of tax through the basis allocation. Between the buyer and seller, the full amount of the accounts receivable will be subject to a current tax. In contrast, under *Focht* the transferor would be entirely relieved of any current tax. Thus, as between the transferor and the transferee in a § 351 exchange, the amount of ordinary business income earned in the year of the exchange that would be subject to current tax is indeterminate and would vary with the character of the fixed assets transferred. To say the least, this result is

From the perspective of the transferee, the nature of the assumed liability in the hands of the transferor is irrelevant. Except by premising continuity at the entity level and according tax relief to the transferee solely because that relief had been denied to the transferor, it is impossible to distinguish between assumed accounts payable of a cash method transferor and any other liability assumed by a transferee in a section 351 exchange. Since such continuity does not exist, there is no basis for a different treatment of deductible liabilities. Accordingly, the transferee may neither deduct the amount of assumed accounts payable nor add that amount to the basis of the acquired properties. As a result, under a consistent and principled construction of the tax law, the transferee is entitled to no tax benefit with respect to the payment of such amounts.

Under the *Raich* decision, this result might have appeared acceptable. The transferor in our illustration was left with stock having a basis of zero and a value of \$15 and thus was allowed to defer a gain of \$15. The transferee acquired property having a basis of \$40 and a value of \$55 and thus was left in the same tax position as the transferor. Although neither party would ever obtain a tax benefit from the discharge of the accounts payable, the symmetrical treatment of the parties provided the appearance that the Code had operated correctly. But under the treatment of the transferor prescribed in *Focht*, the denial of all tax benefit to the transferee plainly produces an unsatisfactory result. In our illustration of the effect of that decision, the transferor was not subject to any tax on the exchange. The transferor had received stock with a basis of \$35 and a value of \$15 and thus was allowed to defer a net loss of \$20. The transferee acquired a carryover basis of \$35 in properties having a value of \$55. If the transferee were denied all tax benefit attributable to discharge of the accounts payable, the transferee would be fully subject to tax on the collection of the accounts receivable, with no offsetting benefit. The tax position of the transferee would not reflect the position of the transferor; indeed, on these facts, the corporation would be placed in a gain, instead of a loss, position. Since this harsh result is not dictated by section 351's purpose of nonrecognition, it must be rejected as inconsistent with that section's policy of facilitating the incorporation of businesses.

In practice, however, even prior to *Raich*, the transferee corporation

rather odd.

Permitting the transferee corporation to deduct payment of assumed liabilities eliminates this random impact of the assumption of indebtedness. Since there would be no increase in basis to be allocated, the entire amount of the accounts receivable would be subject to a current tax. Thus, items of current income and expense would be fully taken into account for income tax purposes. Accordingly, if a tax benefit were to be extended to the transferee with respect to accounts payable, an immediate deduction would be far preferable to capitalization.

was able to avoid this result because the Internal Revenue Service, as a matter of policy, had permitted the corporate transferee to deduct its payment of assumed liabilities.⁷³ The Service did not adopt this policy in disagreement with the principles outlined above. Rather, the Service had made the correlative decision to abandon application of the assignment of income doctrine to incorporation exchanges. This resulted in taxing the transferee, rather than the transferor, on the assigned accounts receivable.⁷⁴ Since it would have been improper to tax the transferee on the collection of the receivables without granting offsetting relief for the discharge of the payables, the deduction was permitted. In effect, deviation from one basic principle of taxation, the assignment of income doctrine, compelled deviation from another, that no corporate transferee is entitled to a tax benefit for the payment of the transferor's obligations. Although unsatisfying in the abstract, this series of compromises at least leaves the transferee under the *Focht* approach in the correct tax position: the \$40 deduction offsets the \$20 of income from accounts receivable and produces a \$20 tax loss. The position of the transferee thus mirrors the position of the transferor.

Nevertheless, the result is unsatisfactory. There is a great advantage in the consistent and uniform application of those general and guiding principles that form the basic structure of our tax laws. Individual Code sections are far more readily understandable if they prescribe consequences that are consistent with expectations aroused by these principles. Conversely, ad hoc exceptions to the Code's general scheme create complexity, obscurity, and, in their wake, taxpayer error. Such deviations should be avoided unless a compelling policy clearly requires otherwise. Accordingly, although the Service's position produces an acceptable consequence for the transferee, it does not result in a satisfactory pattern of taxation.⁷⁵

This objection to the Service's policy would stand even if it had the clear force of law; here, however, the deviation from principle not only lacks statutory authority but also conflicts with existing case law. Moreover, there is some recent indication from the Tax Court that it disagrees with the Service's policy. The Tax Court in *Focht* was apparently aware that its treatment of the transferor created serious problems as to the proper treatment of the transferee. But that issue was not before it, and

⁷³ *Points to Remember*, TAX LAW., Apr. 1965, at 114. See *Hempt Bros. v. United States*, 354 F. Supp. 1172, 1179 n.16 (M.D. Pa. 1973), *aff'd*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974).

⁷⁴ See text accompanying note 109 *infra*.

⁷⁵ The pattern of taxation produced is not only unacceptable with respect to the transferee, but also, because of the failure to apply the assignment of income doctrine, the pattern is unsatisfactory with respect to the transferor. See text accompanying note 79 *infra*.

the majority specifically declined to comment on the corporation's entitlement to a deduction.⁷⁶ Somewhat cryptically, however, the court cited *Magruder v. Supplee*,⁷⁷ a case in which the Supreme Court refused to allow the transferee in a taxable transaction a deduction for its discharge of assumed liabilities, although the liabilities would have been deductible if paid by the transferor. The Tax Court was evidently suggesting that the position of the transferee in a section 351 exchange is indistinguishable from the position of the transferee in a taxable exchange; thus, such deductions are not allowable in either context.

It is not clear to what extent the drafters of section 357(c)(3) considered the tax position of the transferee. The Senate Report accompanying the amendment states that "the provision is not intended to affect the corporate-transferees' tax accounting for the excluded liabilities."⁷⁸ Given the ambiguities of present law, the most reasonable construction of this statement is that Congress simply declined to examine the position of the transferee. In any event, the Report clearly does not disapprove of *Focht's* reservation of this issue.

Thus, it appears probable that when the issue is presented the courts will reject the Service's policy of allowing the transferee a deduction for the discharge of obligations assumed in a section 351 exchange. Should they do so, an unacceptably large tax burden will be imposed on the transferee, and the *Focht* solution will fail.

B. Failure to Apply the Assignment of Income Doctrine

The objection to the *Focht*-section 357(c)(3) solution, however, is more basic than either its inability to treat the transferee in a principled and reasonable manner or its creation of future interpretive difficulties. The accounts receivable represent ordinary business income, which has been earned completely through the efforts of the transferor. The benefit that produced the accounts payable has been received entirely by the transferor in the form of purchased goods or services. Clearly, it does not accurately reflect the income of the transferor to omit these amounts, nor does it accurately reflect the income of the transferee, who neither earned the income nor incurred the expense, to include these amounts either in whole or in part.⁷⁹ If the transferor were required in its final income tax return to accrue and pay tax on these amounts, the incomes of both the transferor and the transferee would be more accurately reflected. This accrual would be compelled if the

⁷⁶ 68 T.C. at 238.

⁷⁷ 316 U.S. 394 (1942).

⁷⁸ SENATE REPORT, *supra* note 46, at 185.

⁷⁹ If the transferee were allowed a deduction upon its discharge of the assumed obligations, the transferred accounts receivable would be only partly reflected in the transferee's income.

assignment of income principles that are generally applied throughout the Code were applied to section 351 exchanges. If the assignment doctrine were applied, the *Raich* problem of the cash method transferor would simply disappear.⁸⁰ Stated differently, the *Raich* problem is merely the result of failing to apply the generally applicable assignment of income principles to section 351 exchanges. The proper solution must come from a reversal of that omission. Therefore, aside from the technical difficulties it creates, the *Focht*-section 357(c)(3) solution is objectionable because it assumes that the assignment of income doctrine will not be applied to incorporation transfers.⁸¹

Requiring the transferor to accrue all current items would have the following effect on our illustration. In the final income tax return of the unincorporated business, the transferor would be subject to tax on the accounts receivable and would be permitted a deduction for the accounts payable, producing a net deduction of \$20.⁸² Having been subject to tax, the accounts receivable would acquire a basis equal to their face amount of \$20.⁸³ Thus, the basis of the properties transferred to the corporation would be \$55 (\$35 plus \$20), and the \$40 of liabilities to be assumed would not exceed that amount. Accordingly, the transferor would recognize no gain on the incorporation. The basis of the stock received would be the substituted basis of \$55 reduced by the \$40 of assumed liabilities, or \$15. Since the amount of the accounts payable will have been deducted, their assumption would produce a recognized gain in a taxable transaction. Thus, the treatment of deductible liabilities becomes irrelevant; all liabilities must be taken into account under sections 357 and 358, thereby reducing the basis of the stock received by the transferor.⁸⁴ Since the transferor would have reported all items of current

⁸⁰ See Roha, *The Application of Section 357(c) of the Internal Revenue Code to a Section 351 Transfer of Accounts Receivable and Payable*, 24 CATH. U.L. REV. 243, 260 (1975) (calling for a similar solution by legislative amendment of § 357).

⁸¹ The reference herein to the assignment of income doctrine is to that body of tax law established by cases such as *Lucas v. Earl*, 281 U.S. 111 (1930). Broadly speaking, the doctrine requires that income be taxed to the one who earned it and possessed the right to receive it. The term is also used in other contexts. See note 92 *infra*.

⁸² The transferor is treated as if it had received cash in the amount of the liabilities assumed and discharged its own obligations. See text accompanying notes 9–11 *supra*.

⁸³ Presumably the transferor either would not be required to accrue the amount of worthless accounts or would be entitled to accrue an offsetting bad debt deduction under § 166(a). See *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961). This adjustment is ignored in our illustration.

⁸⁴ New § 357(c)(3) would presumably not apply to a transferor who was required to accrue all items of current income and expense, because the transferor would no longer be employing the cash method of accounting. If the suggestion made herein is adopted, however, then new §§ 357(c)(3) and 358(d)(2) would serve no purpose and should be repealed.

income and expense, no further gain or loss would be deferred in the basis of its stock; the stock would have a \$15 value also. The transferee corporation would receive a carryover basis of \$55 in the properties acquired in the exchange, an amount equal to their value. Thus the transferee would have no income upon collection of the accounts receivable. Since a full tax benefit would have been obtained with respect to the accounts payable, the actual payment of these obligations by the corporate transferee would have no further income tax consequences.⁸⁵ The result thus obtained would be correct: the transferee and the transferor would be in an identical tax position, both having no gain or loss inherent in their respective properties attributable to items of current income or expense.⁸⁶

The difference in income tax consequences between the accrual proposal above and the *Focht*-section 357(c)(3) approach is not the difference between deferral and immediate taxation of items of current income and expense. Although under the latter approach the net amount

⁸⁵ Deduction of the liability would convert its tax status to the equivalent of a borrowing by the transferor; thus, assumption and payment by the transferee produces neither a deduction nor an adjustment to basis. Just as the transferor may be regarded as having received cash constituting a return of capital, rather than a realization of gain, so the transferee may be regarded as having borrowed the cash and as having delivered it to the transferor. If the transferee were to convert \$40 of its properties to cash, at no gain or loss, and discharge the accounts payable, it would possess property having a tax basis and value of \$15. The transferee's position would thus mirror the position of the transferor.

⁸⁶ The assignment of income doctrine could, of course, impose a tax on the transferor of accounts receivable even if the liabilities assumed by the transferee did not exceed the basis of the assets transferred. If the transferred deductible liabilities exceeded the accounts receivable, then the transferor would be entitled to a net deduction. In the reverse position, the transferor would be subject to tax. Further, if the total of the liabilities assumed, deductible or not, exceeded the tax basis of the assets transferred, then the excess would also be subject to tax under § 357(c). The tax basis of those assets, however, would first be increased by the amount of the accounts receivable subject to tax under the assignment of income doctrine. Thus, if in the example in the text the \$40 liability were attributable to a borrowing, then under either the *Raich* or the *Focht* approach the transferor would be subject to tax on \$5 pursuant to § 357(c) and would receive a basis of zero in stock worth \$15, thus deferring an additional tax on \$15. If the assignment of income doctrine were applied, the transferor would be subject to an immediate tax on the \$20 of receivables, producing a total basis of \$55. Since the liabilities assumed would no longer exceed the basis of the assets transferred, no further tax would be imposed under § 357(c). The transferor would have a basis of \$15 in stock having the same value. If the liability assumed were \$60 and the equipment had a value in excess of its tax basis, the transferor would be subject to tax under the assignment of income doctrine on the \$20 of accounts receivable and, under § 357(c), on the \$5 excess of the liabilities assumed over the \$55 basis of the assets transferred. The transferor's basis in the stock received would be zero, deferring tax on any gain inherent in the equipment in excess of the \$5 already taxed under § 357(c).

of such items would produce a deferred tax consequence to the transferor, the transferee corporation would be subject to a current tax on all such items. The significant distinction between these approaches is that under the accrual approach the transferor, not the transferee, is subject to current tax.⁸⁷ The accrual approach also, of course, eliminates the interpretive complexities introduced by section 357(c)(3), particularly the need to redefine the term *liabilities* for purposes of the incorporation provisions of the Code. Furthermore, it obviates the need to grant the corporate transferee a deduction of dubious validity for the discharge of another's obligations.

IV

EFFECT OF ACCOUNTING METHODS

Before examining the suggestion that the transferor should be required to include accounts receivable in income under assignment of income principles, it will be useful to put a preliminary argument to rest. Although the *Raich* problem is obviously attributable to the transferor's use of the cash method of accounting, the use of that method was entirely proper. One possible objection to the accrual approach suggested above is that under the cash method the accounts receivable do not themselves constitute taxable income to the unincorporated business and do not produce taxable income until after their transfer to the corporation, at which time the income is that of the corporate transferee.⁸⁸ This objection, however, misapprehends the function of an accounting method.

Income, regardless of how defined, is taxed under our system with respect to a period of time.⁸⁹ Unless items of income and expense can be assigned with relative accuracy to a particular period, taxpayers will be able to marshal their receipts and expenditures in a manner that could substantially reduce their burden of taxation.⁹⁰ A method of accounting is merely a set of rules used to assign items of income and expense to a particular period of time. The rules are fashioned solely to resolve ques-

⁸⁷ The accrual approach also eliminates a second, albeit deferred, tax to the transferor on current items. This elimination is theoretically preferable but is of little practical importance.

⁸⁸ See, e.g., *Palmer v. Commissioner*, 267 F.2d 434, 437 (9th Cir. 1959) (taxpayer's argument); Dauber, *Accounts Receivable in Section 351 Transactions*, 52 A.B.A.J. 92 (1966).

⁸⁹ I.R.C. § 441. A transactional approach is permitted for certain long-term contracts. Treas. Reg. § 1.451-3, T.D. 7397, 1976-1 C.B. 115.

⁹⁰ The incentive for such activities is provided primarily by the progressive tax rate structure and by various Code provisions that limit the deduction of certain expenditures as a function of income. See, e.g., I.R.C. §§ 163(d), 170(b), 172(d)(4), 613(a), 1211.

tions of timing ; the use of an accounting method for any other purpose is improper.⁹¹ In particular, an accounting method should not be used to select the taxable person with respect to an item of income, because the method assumes the prior determination of that person. Accordingly, in a section 351 exchange, the transferor's choice of accounting method should not determine who is to report the items of income and expense represented by the accounts receivable and payable. In other words, the *Focht* result, which allows the transferor to forego a current tax on income and taxes the transferee instead, cannot be justified by the transferor's use of the cash method of accounting.

V

THE ASSIGNMENT OF INCOME DOCTRINE

In order to protect the integrity of the tax rate structure, with its progressive impact and distinction between ordinary income and capital gains, the courts have evolved a series of loosely related principles that in the aggregate are somewhat confusingly referred to as the *assignment of income doctrine*. In this Article, the expression is used in its primary sense, namely, that income should be taxed to the one who earned it and not to the one who merely receives the payment.⁹² In addition to these judicially developed principles, there are some provisions in the Code that in application parallel the assignment of income doctrine in some of its permutations.⁹³

⁹¹ See *Hempt Bros. v. United States*, 354 F. Supp. 1172, 1176 (M.D. Pa. 1973) ; *Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946). " 'Ascertainment of income' is chiefly a matter of accounting. 'Allocation of income' is chiefly a matter of the application of income tax law to basic legal rights. The terms are not synonymous." *Id.* at 685. See also *Williamson v. United States*, 292 F.2d 524, 530 (Ct. Cl. 1961).

⁹² The doctrine applies to income earned either through the performance of services, *Lucas v. Earl*, 281 U.S. 111 (1930), or through the employment of capital, *Helvering v. Horst*, 311 U.S. 112 (1940). When the taxpayer sells the right to receive income, instead of giving the right away, the doctrine does not normally apply, because the seller will be subject to tax on the proceeds of the sale. When a seller has contended that the rights sold constituted a capital asset, however, the courts have resorted to the assignment of income doctrine to deny capital gains treatment. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). The issue presented in *Earl* and *Horst* was the selection of the appropriate person to tax ; the issue presented in *P.G. Lake* was the definition of a capital asset. Nonrecognition under § 351 may properly extend to the transfer of the type of property involved in *P.G. Lake*, although such a transfer is sometimes referred to as an assignment of income. See *E.I. DuPont de Nemours & Co. v. United States*, 471 F.2d 1211 (Ct. Cl. 1973) ; *H.B. Zachry Co.*, 49 T.C. 73, 80 n.5 (1967).

⁹³ These Code provisions are allied to the tax accounting rules. Section 446 is of particular interest here. If the Commissioner determines that a taxpayer's normal method of accounting does not clearly reflect income, then the Commissioner is

Regardless of which of these manifestations of the doctrine is applied, the specific issue presented is whether the transferor or the transferee should be taxed with respect to receivables earned and payables incurred by the transferor prior to the section 351 exchange but respectively collected and paid by the transferee. If this question were presented outside the context of section 351, the answer would be clear: income is taxed to the one whose services or capital produced the right to receive it. Thus, the question is whether section 351 overrides this general principle of taxation.

A. Application to Section 351 Exchanges

The history of the relationship between the predecessors to section 351 and the assignment of income doctrine is a curious one. In the early cases, the courts had no difficulty concluding that the assignment of income doctrine as evolved by the Supreme Court in *Lucas v. Earl*,⁹⁴ *Helvering v. Horst*,⁹⁵ and *Helvering v. Eubank*⁹⁶ could be applied consistently with the predecessors to section 351 to tax the transferor of accounts receivable.⁹⁷ The early cases, however, did not involve accounts receivable generated in the ordinary course of business that were transferred absent a transparent tax avoidance scheme upon the incorporation of the business. In *Thomas W. Briggs*,⁹⁸ the first case to present that pattern, the government's attempt to tax the cash method transferor failed. The decision in *Briggs*, however, was considerably clouded by the manner in which the issue arose. The government first argued that in fact the taxpayer employed an accrual method of accounting. Its alternative theory, based on the predecessors to sections 446 and 482, rather than on the doctrine of *Lucas v. Earl*, was that the taxpayer must

authorized to change the taxpayer to a method that does. I.R.C. § 446(b). If a method of accounting does not clearly reflect income, because income earned by the taxpayer would be taxed to another, such as the transferee in a § 351 exchange, then the considerations warranting the application of § 446 would be identical to those underlying the assignment of income doctrine. In addition, § 482 authorizes the Commissioner to allocate items of income and expense among taxpayers under common control so as to reflect clearly their respective incomes. See note 102 and accompanying text *infra*.

⁹⁴ 281 U.S. 111 (1930).

⁹⁵ 311 U.S. 112 (1940).

⁹⁶ 311 U.S. 122 (1940).

⁹⁷ Thus, in *Brown v. Commissioner*, 115 F.2d 337 (2d Cir. 1940), *aff'g* 40 B.T.A. 565 (1939), the court specifically noted that § 351's predecessor had no effect on its conclusion that a lawyer was subject to tax on a claim for fees that he had transferred in return for stock in his wholly owned corporation. The court reasoned that the Commissioner was not taxing gain on the transfer of property but rather was taxing ordinary business income to the one who had earned it. *Id.* at 340. See also *Clinton Davidson*, 43 B.T.A. 576 (1941).

⁹⁸ 15 T.C.M. (CCH) 440 (1956).

accrue the amount of accounts receivable transferred to the corporation. The court, after a detailed review of the facts, rejected the government's primary argument and then summarily rejected its alternative theory.⁹⁹

Briggs might best be viewed as aberrational. Shortly thereafter, in *Alden C. Palmer*,¹⁰⁰ the Tax Court upheld the Commissioner's authority under the predecessor to section 446 to change the transferor's method of accounting in a section 351 exchange. In *Palmer*, both the transferor and transferee had used the completed contract method of accounting for construction contracts. This method allows the taxpayer to postpone recognition of income and expense attributable to a contract until its completion.¹⁰¹ In its income tax return for the year of the exchange, the transferee in *Palmer* included the entire amount of profit on contracts yet to be completed on the date of the transfer. Pursuant to the predecessor to section 446, the Commissioner required the transferor to change to the percentage-of-completion method. The court sustained this change. The effect of this decision was to tax the transferor on income that was neither reportable under its normal method of accounting nor actually received by it; in this respect, the taxpayer was precisely in the position of a cash method transferor of accounts receivable. Meanwhile, another series of cases established that the Commissioner's authority under section 482 and its predecessor prevailed over section 351 and allowed the Commissioner to reallocate items of income and expense in order to reflect income clearly.¹⁰²

Thus, by 1962 the application of assignment of income principles to exchanges under section 351 appeared to be well established.¹⁰³ In that year, however, the Tax Court decided *Arthur L. Kniffen*¹⁰⁴ and again held that a cash method transferor in a section 351 exchange would not be taxed on transferred accounts receivable. The transferor in *Kniffen* was in the business of renting real property. He exchanged his proper-

⁹⁹ *Id.* at 450-51. Further, these issues were only two of a very large number of disputes between the parties that the court addressed.

¹⁰⁰ 29 T.C. 154 (1957), *aff'd on other grounds*, 267 F.2d 434 (9th Cir.), *cert. denied*, 361 U.S. 821 (1959).

¹⁰¹ See Treas. Reg. § 1.451-3(d), T.D. 7397, 1976-1 C.B. 117.

¹⁰² See, e.g., *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962); *cf. Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946) (predecessor to § 482 applied upon liquidation of corporation).

¹⁰³ Cases such as *Orange Sec. Corp. v. Commissioner*, 131 F.2d 662 (5th Cir. 1942), and *P.A. Birren & Son v. Commissioner*, 116 F.2d 718 (7th Cir. 1940), are not inconsistent with this conclusion, although the courts held the transferee taxable on assigned accounts receivable. In these cases, the government sought successfully to tax the *transferee* on the theory that the receivables were subject to § 351 and acquired a carryover basis in the hands of the transferee. The courts did not address the assignment of income question.

¹⁰⁴ 39 T.C. 553 (1962). As in *Briggs*, assignment of income was not the principal issue in controversy. See note 99 *supra*.

ties and other assets for stock and the transferee's agreement to assume liabilities in excess of the basis of the assets transferred. The transferor had originally reported his income in accordance with assignment of income principles. In a claim for refund, he raised the issue concerning taxation of the accounts receivable.¹⁰⁵ The government's theory was apparently that the exchange of receivables for stock in the transferee constituted an assignment of income, which subjected the transferor to tax upon receipt of the stock.¹⁰⁶ This argument hopelessly confuses the problem of conversion of ordinary income into capital gain by the mere sale of the right to receive income, which is barred by one aspect of the assignment of income doctrine,¹⁰⁷ with the problem of selecting the appropriate taxable person. The court seemed to accept the assignment of income analysis, but nevertheless held that the receipt of stock in a section 351 exchange was not subject to tax.¹⁰⁸

Although *Kniffen* cannot reasonably be construed as a rejection of the assignment of income doctrine in the context of a section 351 transaction, shortly thereafter the Internal Revenue Service reversed its policy in this area. In 1965, it was reported that the Service would issue private rulings to the effect that the transferee, not the transferor, would be taxed on those accounts receivable that were transferred by a cash method taxpayer in a section 351 exchange¹⁰⁹ and, moreover, that the transferee would be allowed a deduction with respect to the discharge of assumed accounts payable. Evidently this policy continues to the present time.¹¹⁰

¹⁰⁵ The receivable in question was accrued interest on certain notes and deeds of trust. Although no interest was collected prior to the transfer, the taxpayer nevertheless reported the entire amount of accrued interest in his income tax return for the year of the transfer. 39 T.C. at 563-64.

¹⁰⁶ "The [Commissioner] contends that . . . [the transferor] nevertheless collected this interest from [the transferee] . . . upon the receipt . . . of stock" *Id.* at 564.

¹⁰⁷ See *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958); note 92 *supra*.

¹⁰⁸ One of the transferred receivables arose in circumstances substantially identical to the receivable that was taxed to the transferor in *Brown v. Commissioner*, 115 F.2d 337 (2d Cir. 1940). The *Kniffen* court reached the contrary result without reference to the earlier case. 39 T.C. at 565-66. See note 97 *supra*.

¹⁰⁹ *Points to Remember*, TAX. LAW., Apr. 1965, at 114.

¹¹⁰ Cf. *Hempt Bros. v. United States*, 354 F. Supp. 1172, 1179 n.16 (M.D. Pa. 1973), *aff'd*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974) (Commissioner would allow deduction for discharge of assumed accounts payable provided transferee entered into closing agreement to report income from transferred accounts receivable). Prior to the 1965 announcement, inconsistency, or at least uncertainty, apparently marked the Service's position. In 1962, one commentator reported that "for many years" the Service had ruled that the transferred accounts receivable and payable were to be included in the income of the transferee, but that a change in policy was being considered. Hickman, *Incorporation and Capitalization*, 40 TAXES 974, 978 (1962). Four years later, another commentator reported

Strangely, in the same year that this change in policy was reported, the Tax Court indicated in *Adolph Weinberg*¹¹¹ that it might indeed be willing to apply assignment of income principles to a section 351 exchange. The transferor in *Weinberg* was a cash method farmer who had deducted expenses attributable to growing crops that he claimed to have transferred in exchange for stock pursuant to section 351. The court held that the assignment was only of the proceeds from the sale of the harvested crop, and that it was ineffective to shift the incidence of taxation. As an alternative ground for its decision, however, the court said that, under assignment of income principles, the proceeds of sale would be taxable to the transferor because he had earned the income.¹¹²

The most recent attempt to apply the assignment of income doctrine evidences the change of the Service's policy. In *Hempt Brothers v. United States*,¹¹³ it was no longer the transferor in a section 351 exchange whom the government sought to tax, but rather the transferee. In a lengthy opinion, which reviewed much of the available authority, the district court sustained the Commissioner's position that the income derived from the transferred accounts receivable was properly taxable to the corporate transferee. On appeal to the Third Circuit, the decision was affirmed. Because of the rearrangement of the parties on the issue, it is not completely clear for what proposition the case stands. Indeed, one of the grounds specified for the lower court's holding was that the Commissioner's position was a proper exercise of his discretion under section 446.¹¹⁴ It seems probable that a contrary position by the government would have been sustained as in prior cases; in fact, the district court stated that even in the context of a section 351 exchange, the Commissioner was empowered under the assignment of income doctrine and section 482 to prevent the distortion of income or the avoidance of tax.¹¹⁵

that "for at least a decade" the Service had insisted upon taxing such items to the transferor, but that a change in policy was contemplated. Dauber, *supra* note 88, at 92.

Evidently such a ruling can be obtained even if the primary reason for incorporation is the transferor's desire to have the income from an extraordinarily large account receivable taxed at the lower corporate rate, the classic case in another context for application of the assignment of income doctrine. There may be a limit, however, on the extent to which the Service will ratify a distortion of the transferor's income. See *Hempt Bros. v. United States*, 490 F.2d at 1178 n.9. Cf. I.R.C. § 357(b) (denying § 357(a) treatment when liabilities are assumed for a tax avoidance purpose).

¹¹¹ 44 T.C. 233 (1965), *aff'd per curiam sub nom. Commissioner v. Sugar Daddy, Inc.*, 386 F.2d 836 (9th Cir. 1967), *cert. denied*, 392 U.S. 929 (1968).

¹¹² 44 T.C. at 244-45.

¹¹³ 354 F. Supp. 1172 (M.D. Pa. 1973), *aff'd*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974).

¹¹⁴ 354 F. Supp. at 1181.

¹¹⁵ *Id.* at 1180.

The appellate court seemed to agree, at least in part.¹¹⁶ Thus, rejection of the assignment of income doctrine when urged by the taxpayer does not entail its rejection when asserted by the Commissioner.

Thus, as to selecting the appropriate taxable person, the case law concerning the relationship between the assignment of income doctrine and section 351 is ambiguous. The majority of decided cases supports application of the doctrine, but those cases most nearly resembling *Raich* and *Focht* reject it. In those cases rejecting the doctrine, however, the grounds which have been set forth for the decision have been defective. On balance, it seems that these authorities would support a renewed effort by the Service to require the transferor in a section 351 exchange to accrue all untaxed items of income and expense. At least they do not preclude such an approach.¹¹⁷ Regardless of the state of the case law, it is necessary to take a fresh look at whether the assignment of income doctrine is inconsistent with the policy of section 351.

B. Consistency with the Objective of Section 351

Upon the incorporation of a profitable business, the amount of transferred receivables will commonly exceed the amount of transferred payables. Thus, the accrual requirement is likely to result in the recognition of income by the transferor upon incorporation. The authorities that have rejected the assignment of income doctrine in this context have asserted that this recognition is inconsistent with the underlying purpose of section 351.¹¹⁸ The general purpose of section 351, to facilitate the incorporation of businesses through tax relief, is apparent.¹¹⁹ But that generality, not elaborated in the legislative history, adds little to the resolution of the alleged conflict. In a long series of administrative and judicial constructions of the relatively brief language of section 351, it has

¹¹⁶ 490 F.2d at 1178 n.9. The court of appeals affirmed on grounds similar to the Tax Court's reasoning in *Kniffen*. Although the court of appeals referred to both the *Earl* and *Lake* cases, it treated the question as a conflict between *Lake* and § 351 and concluded that the policy of nonrecognition should prevail. 490 F.2d at 1176-78.

¹¹⁷ See Biblin, *Assignments of Income in Connection with Incorporating and Liquidating Corporations*, 21 S. CAL. TAX INST. 383 (1969). See also *Nash v. United States*, 398 U.S. 1 (1970) (discussed in note 66 *supra*). The effect of the decision in *Nash* was to tax the transferor in his final return on an amount approximating as closely as possible the amount upon which he would have been taxed if the § 351 exchange had not occurred. The assignment of income doctrine seeks the same result.

¹¹⁸ Kahn & Oesterle, *supra* note 6, at 476-77; Weiss, *Problems in the Tax-Free Incorporation of a Business*, 41 IND. L.J. 666, 681 (1966). See also *Hempt Bros. v. United States*, 354 F. Supp. at 1177-78; Arthur L. Kniffen, 39 T.C. at 564-66.

¹¹⁹ H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921), reprinted in 1939-1 C.B. (pt. 2) 168, 175-76.

become entirely clear that the tax relief extended by Congress was of a defined and limited type. Numerous income tax consequences flow from the incorporation of a business, many of which are adverse to the transferor. Yet relief from such consequences has been denied when it appeared to exceed the dispensation granted by Congress.¹²⁰

Absent section 351, an exchange of property for stock would constitute a taxable event. The appreciation in value of the properties transferred would be subject to tax. But since after the exchange the transferor's investment in the transferred properties would be represented solely by corporate securities, its ability to consume or to pay tax has not been enhanced. If it nevertheless were subject to tax, it would need to obtain funds through partial liquidation of its investment. The result would be a significant contraction of the incorporated business. The purpose of section 351 is to alleviate the adverse income tax consequences of such an incorporation by waiving the technical realization of gain.¹²¹ Therefore, it is deemed that at the time of the transfer a non-taxable change in the ownership of the business properties occurs.

Nothing in the purpose of section 351, however, concerns the ordinary income and expense of the business being incorporated. Since such items will be converted into cash within a relatively brief time following the section 351 exchange, the payment of tax on this income would not require the contraction of the transferred business. Thus, the imposition of tax with respect to accounts receivable and payable would not impede the incorporation of businesses.

More importantly, the "gain" inherent in accounts receivable differs fundamentally from the gain inherent in fixed assets. The disposition of a cash method taxpayer's accounts receivable does not technically amount to a realization in the same sense as does the disposition of appreciated fixed assets.¹²² The receipt of the receivable is a realization of income that could be taxed at that time. For accrual method taxpayers, this re-

¹²⁰ See, e.g., *Dearborn Gage Co.*, 48 T.C. 190 (1967); *Ezo Products Co.*, 37 T.C. 385, 393-94 (1961) (loss of § 481 adjustment upon incorporation); Rev. Rul. 67-286, 1967-2 C.B. 101 (transferred assets become used property for accelerated depreciation purposes). In *Dearborn Gage*, the Tax Court said:

We recognize that, if petitioner had never been formed, and the predecessor partnership had continued in business . . . respondent would have been precluded by the express provisions of section 481 from making any adjustments. . . . Thus, petitioner—a taxpayer separate and distinct from its predecessor—appears to fare worse than its predecessor would have.

48 T.C. at 199-200. See also I.R.C. § 351(d) (investment companies); Rev. Rul. 68-55, 1968-1 C.B. 140 (allocation of boot).

¹²¹ Note, *Section 351 of the Internal Revenue Code and "Mid-Stream" Incorporations*, 38 U. CIN. L. REV. 96, 107-08 (1969).

¹²² *Id.*

ceipt constitutes the taxable event.¹²³ The only reason that the cash method taxpayer has a gain in its accounts receivable is that its method of accounting permits a deferral of tax until the subsequent collection of those accounts. Thus, with respect to accounts receivable, the incorporation exchange does not accelerate the realization of income, as it does with respect to transfer of a business's fixed assets. Indeed, the extension of nonrecognition to accounts receivable has an effect nearly the reverse of section 351's effect on the appreciation of fixed assets. Regarding fixed assets, section 351 prevents acceleration of income tax to the transferor that, in the absence of incorporation, need not be incurred. Regarding accounts receivable, however, nonrecognition relieves the transferor of an income tax that it otherwise would have been required to pay. In this context, to say that the corporation will be subject to tax on the income is no more of an answer to this objection than it is in any other context in which the assignment of income doctrine is applicable.

Indeed, the district court in *Hempt* recognized that "the question of non-recognition upon the exchange itself is distinct from the issue [of] whether the partnership or the corporation is taxable when collections upon transferred receivables are made."¹²⁴ Nevertheless, primarily for practical reasons, the court determined that the transferee should bear the tax. The court expressed concern that the transferor would be treated as receiving large amounts of income without any offsetting deductions, since the deductions attributable to the income being taxed might have been previously taken.¹²⁵ That a cash method transferor has received a substantial benefit through the deduction of expenses in advance of the receipt of the income generated thereby scarcely justifies extending a further benefit. Perhaps the court was concerned that the deductions attributable to the transferred accounts payable would belong to the corporate transferee, but that of course would not be the case.¹²⁶

The court also found it "anomalous" to tax the transferor on income that it would not in fact receive.¹²⁷ It is at the core of the assignment of income doctrine, however, that the incidence of taxation does not necessarily follow the flow of cash. Although the receipt of cash is of some importance in the fashioning of the timing rules of the Code, such as those concerning realization and nonrecognition, it is irrelevant to the selection of the appropriate taxable person. Indeed, in this respect, the position of the cash method transferor is the same as that of the accrual method transferor, who has always been subject to tax on uncollected

¹²³ See note 20 *supra*.

¹²⁴ 354 F. Supp. at 1176.

¹²⁵ *Id.* at 1178.

¹²⁶ See note 82 and accompanying text *supra*.

¹²⁷ 354 F. Supp. at 1178.

accounts receivable transferred in a section 351 exchange. Both transferors will owe an income tax attributable to the preincorporation period and will find it necessary to withhold from the incorporation exchange sufficient cash or other assets to discharge that liability. Thus, no essential unfairness results from taxing the cash method transferor. Moreover, permitting the transferee to discharge this tax liability on behalf of, and without consequence to, the transferor extends an inequitable and inappropriate advantage to the cash method transferor that is not required by the policy of section 351.

In addition, the district court in *Hempt*¹²⁸ referred to specific Code sections that contain statutory or regulatory provisions reducing the adverse impact of those sections in a section 351 exchange. Presumably, the import of these references is that, since Congress intended to relieve the transferor of tax in such instances, it also intended that the section 351 transferor should not be taxed under the assignment of income doctrine. Yet the cited provisions support no such inference. One of the court's references was to section 381, which expressly shifts to the transferee both the benefits and the burdens of taxation in an acquisitive reorganization. The history of section 381 clearly refutes a congressional intent to treat section 351 exchanges in the same favored manner as such reorganizations.¹²⁹ Furthermore, the court noted that, under sections 1245(b)(3) and 1250(d)(3), the transfer of property in a section 351 exchange does not precipitate the recapture of depreciation. The depreciation recapture sections, however, are characterization provisions; they are designed to prevent the conversion of ordinary income into capital gain that results from taking excessive depreciation deductions against ordinary income and thereafter selling the property at a capital gain. If, however, gain is not recognized on a transfer, but rather is deferred through a basis adjustment, as in the case of a section 351 exchange, then there simply is no reason to recharacterize the gain.¹³⁰ Accordingly, the depreciation recapture provisions also do not apply to gifts,¹³¹ although the assignment of income doctrine most surely does.

Of greater relevance is the court's observation that in a section 351 exchange the transferor of an installment obligation, the gain on which

¹²⁸ *Id.* at 1179 nn.14-15.

¹²⁹ See text accompanying notes 70-72 *supra*.

¹³⁰ If one accepts the proposition that recaptured depreciation represents an artificial reduction of income for prior years, the failure to recapture that income on a § 351 exchange does in effect shift income from the transferor to the transferee. One justification for disregarding this effect is that computing the amount to be recaptured is difficult in the absence of a market transaction that establishes the value of the transferred property. This obstacle, however, will be surmounted when necessary to prevent the complete escape from tax of depreciation recapture. See, e.g., I.R.C. §§ 336, 1245(a)-(b).

¹³¹ I.R.C. §§ 102(a), 1245(b)(1), 1250(d)(1).

would be reported under section 453, is not subject to immediate taxation on the deferred gain inherent in the obligation.¹³² This exception is not statutory, but rather is found in the Treasury Regulations.¹³³ It is consistent with the Internal Revenue Service's present policy but is an exception to the assignment of income doctrine. Regardless of whether this exception can be justified, it does not support the complete disregard of the assignment of income doctrine in section 351 exchanges.

On the other hand, the district court in *Hempt* summarily dismissed a suggestion by the taxpayer to draw an analogy to the rapidly expanding body of case law that has applied assignment of income principles to the liquidation of corporations. With certain exceptions, section 336 of the Code provides that no gain or loss shall be recognized by a corporation on the distribution of property in complete or partial liquidation, and section 337 provides that no gain or loss shall be recognized by a corporation on the sale of its properties in a complete liquidation. With a minority of early cases to the contrary,¹³⁴ it is now firmly established that the assignment of income principles and the Commissioner's authority under section 446 prevail over the nonrecognition accorded by these sections.¹³⁵ In order to reflect clearly the income of the liquidating corporation, these authorities provide that a cash method corporation will be subject to tax on its accounts receivable whether or not they are distributed to shareholders under section 336 or sold pursuant to section 337. Although the reasoning of the several courts that have considered this issue varies, in essence they have concluded that Congress intended only to eliminate the double taxation of appreciation inherent in the corporation's fixed assets that otherwise would occur if the appreciation were first taxed to the corporation on the sale or distribution and then taxed again to the shareholders in computing their gain on the liquidation. In other words, Congress did not intend to exempt from tax the ordinary business income of the liquidating corporation.¹³⁶

In the context of a liquidation, the failure to apply assignment of income principles to the transfer of accounts receivable and other current income items would be far more serious than the similar failure under

¹³² 354 F. Supp. at 1179 n.14.

¹³³ Treas. Reg. § 1.453-9(c) (2) (1958).

¹³⁴ *E.g.*, *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963). *But see* *Tennessee-Carolina Transp., Inc. v. Commissioner*, 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978); *Rev. Rul. 77-67*, 1977-1 C.B. 33.

¹³⁵ *E.g.*, *Midland-Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973); *Family Record Plan, Inc. v. Commissioner*, 309 F.2d 208 (9th Cir. 1962), *cert. denied*, 373 U.S. 910 (1963); *Commissioner v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962), *cert. denied*, 373 U.S. 909 (1963); *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961).

¹³⁶ *Midland-Ross Corp. v. United States*, 485 F.2d at 117.

section 351. If such items were not taxed to the corporation, they would never be subject to tax, except to the extent that an increase in the corporation's value would increase the capital gain recognized by the stockholders upon liquidation. However, the perceptions that nonrecognition provisions should not bear on the taxation of ordinary business income and that the assignment of income doctrine should prevail over such provisions are still entirely relevant to section 351.

Under the assignment of income doctrine, the transferor in a section 351 exchange should be taxed on transferred items of ordinary business income and expense. Since in principle the transferor should be taxed, rejection of the doctrine must be ultimately based on the belief that the tax cost of the doctrine's application would be so high that the incorporation of businesses would be significantly impeded. Any such impediment would presumably contravene section 351's policy of facilitating incorporation. The few cases that have considered the relationship between section 351 and the assignment of income doctrine have provided insufficient evidence to suggest that the doctrine's application would have an adverse impact on incorporations.¹³⁷ By the same token, one would expect that before casting aside the protection of a basic rule of taxation the evidence of needed relief would be far greater than that relied on by the court in *Hempt*.¹³⁸

If application of the assignment of income doctrine were to result in an undue increase in the cost of incorporating a business, relief of course would be warranted. Certainly, legislation could be tailored to provide no more than the necessary relief.¹³⁹ The present pattern of taxation, however, produces a distortion of income that goes far beyond any legitimate need. The cumulative effect of section 357(c)(3) and *Hempt* is twofold. First, it relieves the transferor of all income—and denies it a deduction for all expenses—not properly includible in income on the date of the section 351 transfer. Second, it shifts the incidence of tax on all such items to the transferee. This dispensation is granted regardless of whether the transferor would be subject to tax on the exchange either

¹³⁷ In *Arthur L. Kniffen*, 39 T.C. 553 (1962), the cash method transferor had filed his return on the accrual method and only raised his objection to the assignment of income doctrine in a claim for refund, perhaps in response to the deficiency asserted against him on other issues. In *Raich*, the accounts receivable considerably exceeded the accounts payable, 46 T.C. at 605; in *Focht* the reverse was true, 68 T.C. at 225.

¹³⁸ 354 F. Supp. at 1177-80.

¹³⁹ For example, Congress might determine not to impose a current tax on the amount by which the accounts receivable exceed the accounts payable. Taxation of such gain could be deferred as in § 358(d), through a basis reduction in the stock received by the transferor. The tax ultimately imposed, however, should be at ordinary income rates. Thus, a recapture provision would be needed to characterize the portion of any future gain that is attributable to the deferral.

under present law or pursuant to the assignment of income doctrine. Clearly, the breadth of this result cannot be justified by the desire to avoid the limited tax liability that otherwise would be imposed.

C. Compatibility with the 1978 Legislation

Prior to the precipitous amendment of Code sections 357 and 358, it was possible that the *Raich* problem could have been eliminated, and the pattern of taxing incorporation transfers improved, without the need for congressional intervention. The Internal Revenue Service could have applied the assignment of income doctrine through a reversal of its ruling and litigation policies in the same manner as its present policy was adopted a decade ago. Had the Service reversed its position, it seems probable that the courts would have endorsed the application of the doctrine.

In the 1978 legislation, however, Congress clearly assumed a pattern of taxation that disregards the assignment of income doctrine. To apply the doctrine now would render those amendments meaningless. It may thus be questioned whether the Service remains free to reverse its present policies and whether the courts are free to endorse such a reversal.

The enactment of section 357(c)(3) should not be regarded as precluding judicial adoption of the assignment of income doctrine. The Senate Report to section 357(c)(3) contains no indication that Congress knew the provision was in any way inconsistent with the application of the assignment doctrine to section 351 exchanges. The new legislation merely addressed the problem created by the failure to apply assignment of income principles to incorporation transfers; it surely does not follow that Congress would object if that problem disappeared. The adoption of section 357(c)(3) does indicate that Congress thought the *Raich* decision imposed too great a tax burden on incorporation transfers. The tax cost of the *Raich* approach, however, is likely to be far greater than the tax cost of the assignment of income approach.¹⁴⁰ Moreover, the tax imposed in *Raich* was clearly unfair. The suggestion here is that imposition of tax under the assignment of income doctrine would be far more equitable. Application of the doctrine would subject a cash

¹⁴⁰ Under *Raich*, the tax imposed is a function of the excess of all liabilities assumed over the tax basis of all assets transferred. Thus, the amount of tax will depend on the amount of accounts payable, but not on the amount of accounts receivable. Under the assignment of income doctrine, the tax is a function of the accounts payable and receivable. Accordingly, in the extreme case of the transfer of only an equal amount of accounts payable and receivable, under *Raich* the tax would equal the amount of payables transferred, while under the assignment of income doctrine no net tax would result. On the other hand, a relatively small tax would be common under the assignment of income doctrine even though the total liabilities assumed did not exceed the basis of the transferred assets.

method transferor to tax consequences identical to those imposed upon an accrual method transferor. Since there is no indication that Congress regards as unjust the impact of the incorporation provisions on an accrual method transferor, it should not be presumed that Congress would object if the same consequences were extended to all transferors.

To conclude that the *Raich* problem can still be solved without congressional intervention is not to say that the present statutory pattern is acceptable. Even without regard to the assignment of income doctrine, sections 357(c)(3) and 358(d)(2) are at best incomplete and at worst superfluous and thus misleading. In order to achieve a rational statutory pattern for taxing section 351 exchanges, Congress inevitably must reexamine the 1978 legislation. If Congress considers the tax positions of the transferor and the transferee, and the issues presented in *Hempt* as well as in *Raich*, perhaps the complexities created by *Hendler* can finally be satisfactorily resolved.

CONCLUSION

The proper adjustment of the tax liabilities resulting from a section 351 exchange is a difficult task. It would be facile to suggest that the solution proposed here is superior in every respect. The Internal Revenue Service's policy of taxing the transferee has practical merit and will often not result in significant income distortion. Within this isolated framework, the best resolution of the *Raich* problem may be the one suggested by Kahn and Oesterle and adopted in *Focht* and section 357(c)(3).

This approach, however, entails significant costs, by adding complexity to the tax laws. Disregard of the assignment of income doctrine and the attendant disregard of the principle of discontinuity in this solitary area causes needless confusion. Continuity at the entity level is asserted to justify the transferee's reporting of income and expense, although for a variety of other purposes such continuity is lacking. No principle is offered for this distinction by which future disputes may be resolved. Furthermore, under the present policy the Service, with the acquiescence of the courts, will tax the transferor if the transaction would result in an excessive distortion of income. Since shifting income or expense to another is itself normally regarded as a distortion, it is difficult to predict when the distortion becomes excessive. Moreover, section 357(c)(3)'s redefinition of *liabilities* injects into an otherwise relatively simple provision an unnecessary interpretive complexity with unknown implications for other transactions.

If these special exceptions are necessary to achieve an important objective of tax policy, such as facilitating the incorporation of businesses, the tax law could accommodate these exceptions as it has many others.

Surely incorporations will be promoted by waiving a tax liability of the transferor, but it is not clear that the imposition of tax would materially burden such transactions. Even assuming a material burden, the relief presently granted is wholly disproportionate to the need. As such, the present relief is an unjustifiable subsidy, and the provisions granting it are an unnecessary source of complexity.

This Article suggests that the overall pattern of taxation of incorporation transfers would be improved if the transferor were taxed under the assignment of income doctrine. This approach would conform the treatment of incorporation transfers to the generally applicable principles of taxation and would avoid the increased complexity that the current alternative entails.