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arbitrageur is only interested in a short term investment. If delay increases through hearings in state administrative agencies, the uncertainty of the outcome discourages participation of the arbitrageur. This uncertainty will ultimately cause the market price to drop and may deprive the shareholder of an attractive market. Thus, delay alone does not inherently harm the shareholders, and at times may benefit the shareholders.[59]

The court did not discuss the ability of an efficient target company to take these same or other active defenses during the post-effective delay required by federal law.[60] A crucial distinction should be drawn between post-effective delay in the federal law and pre-effective delay under the Idaho statute. Congress allowed the shareholder ten days after the offer was effective to consider the options and to decide whether to tender his shares. Traditionally shareholders have taken advantage of this waiting period and tendered their shares at the last minute the offer is open or immediately before the end of the period of pro rata take-up of tenders.[61] The state law, however, places the tools of control in the hands of the target company's management which may delay and defeat the offer before it becomes effective. The state law would, therefore, deprive the shareholders of any participation in the decision and deprive them of an enhanced market and the opportunity to participate in that market. In practical effect, the state law thus placed an onerous burden on interstate commerce.

IV. CONCLUSION

The decision of Judge Hill in *Great Western United Corp. v. Kidwell* is truly landmark, as it casts serious doubt on the validity of all state take-over statutes. Because the numerous state statutes are remarkably similar, the impact of this decision is far reaching. Due to the lack of previous judicial review of these take-over laws, *Great Western* becomes the sole precedent upon which to rely.

Mary Emma Ackels

Redefinition of "Liability" for Section 357(c) Purposes: Focht v. Commissioner

Donald Focht owned and operated a plumbing and heating service, conducting the business as a sole proprietorship on the cash receipts and

59. There is also the paradox that management's ability to fight and delay the offer may produce a better offer, thereby benefiting the shareholders.

60. Companies who are susceptible to a take-over usually have "blue books" which are check lists of defenses ready to be used at a moment's notice. *See* E. ARANOW & H. EINHORN, *supra* note 7, at 224.

61. Bromberg, *supra* note 58, at 616; *see* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 792 (2d Cir. 1969) (85% of the tenders made on the very last day of the contested exchange offer).

disbursements method of accounting.[1] Focht incorporated his business during the taxable year of 1970, transferring all of the assets and liabilities of the sole proprietorship to the newly formed corporation in exchange for all of the stock of the corporation.[2] The bulk of the liabilities transferred consisted of accounts payable and the bulk of the assets transferred consisted of accounts receivable. Internal Revenue Code section 357(c) requires that gain be recognized by the transferor in such a transaction to the extent that the liabilities assumed by the new corporation exceed the adjusted basis of the assets transferred.[3] Because the sole proprietorship was operated on the cash method, the accounts receivable transferred had an adjusted basis of zero. The Commissioner, however, in computing the amount of liabilities assumed, valued the accounts payable in full. The result was that the newly formed corporation assumed greater liabilities than assets. The Commissioner assessed a deficiency in the taxpayer's 1970 return, and Donald Focht filed suit in the Tax Court to dispute the deficiency. In deciding for the taxpayer, the Tax Court held that an obligation, payment of which would have been deductible if made by the transferor, shall not be treated as a "liability" for purposes of sections 357 and 358. *Focht v. Commissioner*, 68 T.C. 223 (1977).

I. EVOLUTION AND INTERPRETATION OF SECTION 357(c)

When a going business incorporates, the owners usually transfer all of the assets and liabilities of the business to the newly formed corporation in exchange for the stock of the corporation.[4] As Congress requires any gain or loss from a sale or other disposition of property to be recognized, such a transfer would appear to be a taxable event.[5] In the context of the incorporation of a going business, however, Congress has provided a specific exception to the recognition requirement.[6] When stock is received pursuant to the nonrecognition principle of section 351(a), its basis is adjusted by section 358 to the basis of the property for which it was transferred.[7] Incorporations have thus been made easier through the nonrecognition provisions, while the basis adjustment provision allows the government to tax any realized gain upon subsequent sale of the stock. The exemption of section 351(a), however, only applies when the transferor receives stock or securities in ex-

1. I.R.C. § 446(c)(1).
2. This exchange was carried out pursuant to *id.* § 351(a) which provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities, if after the exchange the transferors are in control of the corporation.
3. *Id.* § 357(c) states that, "if the sum of the amount of the liabilities assumed . . . exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain . . . ."
4. *See* Comment, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154 (1967).
5. I.R.C. § 1001(c).
6. *Id.* § 351(a).
7. *Id.* § 358(a) states that, the basis of the property received under § 351(a) is the same as that of the property exchanged, decreased by the amount of any "money" received by the taxpayer and increased by the amount of gain to the taxpayer which was recognized on such exchange.

Id. § 358(d) further provides that for purposes of § 358(a) assumption of a liability by a transferee shall be treated as money received by the transferor on the exchange.

change for the transferred property. Section 351(b) provides that if the transferor receives "money or other property," in addition to stock or securities, gain to that extent must be recognized.[8]

The statutory design created by the interplay of these sections of the Internal Revenue Code reflects the original design of the Internal Revenue Code of 1939,[9] the congressional intent being to alleviate the burden of incurring taxation on a mere change in the form of a business.[10] The Supreme Court's decision in *United States v. Hendler*,[11] however, presented a major obstacle to the smooth operation of this statutory scheme. In *Hendler* there had been a transfer by Hendler of assets subject to liabilities in exchange for stock. The Court treated the assumption of Hendler's liabilities as "money or other property," thus bringing the transaction within the purview of the predecessor to section 351(b).[12]

As a practical matter, most business assets are generally subject to some liabilities. To treat the assumption of such liabilities as "boot" requiring immediate recognition by the transferor would certainly make incorporation a less desirable alternative. Thus, realizing the implications of such a holding, Congress enacted the predecessor of sections 357(a) and (b),[13] which in effect stated that an assumption of liabilities by a transferee was not to be treated as "money or other property" as long as its assumption had a bona fide business purpose and was not motivated simply to avoid the payment of taxes.[14] In treating the assumption of liabilities in this manner, however, another problem arose: a taxpayer could mortgage property he owned for an amount in excess of his adjusted basis in the property prior to the tax free transfer, and have the corporation assume the obligation.[15] Presuming this

8. *Id.* § 351(b) provides that if subsection (a) would apply to an exchange but for the fact that money or other property was received, then, "gain (if any) to such recipient shall be recognized, but not in excess of . . . the amount of money received, plus . . . the fair market value of such other property received.".

9. *See* Int. Rev. Code of 1939, ch. 1, § 112(b)(5), 53 Stat. 37 (now I.R.C. § 351(a)); Int. Rev. Code of 1939, ch. 1, § 112(c)(1), 53 Stat. 39 (now I.R.C. § 351(b)); Int. Rev. Code of 1939, ch. 1, § 113(a)(6), 53 Stat. 41 (now I.R.C. § 358(a)).

10. Comment, *supra* note 4, at 1154.

11. 303 U.S. 564 (1938).

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

13. Int. Rev. Code of 1939, § 112(k), *as amended by* Revenue Act of 1939, ch. 247, § 213(a), 53 Stat. 870 (now I.R.C. §§ 357(a), (b)).

14. H.R. REP. No. 855, 76th Cong., 1st Sess. 19 (1939) states:

> The recent Supreme Court case of *United States v. Hendler* . . . has been broadly interpreted to require that, if a taxpayer's liabilities are assumed by another party in what is otherwise a tax-free reorganization, gain is recognized to the extent of the assumption. In typical transactions changing the form or entity of a business it is not customary to liquidate the liabilities of the business and such liabilities are almost invariably assumed by the corporation which continues the business. Your committee therefore believes that such a broad interpretation as is indicated above will largely nullify the provisions of existing law which postpone the recognition of gain in such cases. To enable bona fide transactions of this type to be carried on without the recognition of gain, the committee has recommended [the following:]
>
> . . . [A]dding a new subsection (k) which provides that . . . . gain shall not be recognized to the transferor on account of the assumption of liabilities or the transfer of property subject to liability. It is expressly provided that this provision shall not apply where it appears that the principal purpose of the [transferor] . . . was a purpose to avoid Federal income tax on the exchange, or . . . was not a bona fide business purpose.

15. The practice of mortgaging property for an amount in excess of the basis and then transferring the mortgaged property to the corporation is called "borrowing out" the property.

was conducted for a legitimate business purpose, there would be no gain recognition on the transaction. Thus, the Service's only alternative was to adjust the basis of the stock received by the transferor to reflect this assumption of liability.[16] As a result, if liabilities exceeded the basis of the property, the taxpayer acquired a negative basis in his stock.[17] To avoid the problematic "negative basis" situation, and the corresponding possibility of a large loss of revenue,[18] Congress enacted section 357(c).[19] To the extent that the liabilities assumed exceeded the adjusted basis in the assets transferred, section 357(c) provided for this excess to be treated as gain. In such a case, the basis of the stock acquired would be reduced to zero and the excess, which would have reduced the basis below zero, would be taxed as gain.[20]

Considered together, sections 351, 357, and 358 suggest a congressional design to defer recognition of gain on incorporations involving transfers of assets and liabilities for stock, but to avoid creation of a negative basis in the stock so acquired. This relatively coherent design may be strained, however, where pursuant to a section 351 transfer a taxpayer transfers accounts receivable and payable to the corporation. The problem is one of valuation of the receivables and payables, which depends in large part on the accounting method used by the taxpayer.[21] If the transferor is on the accrual

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See Comment, *Bongiovanni v. Commissioner: Tax-Free Transfer of Payables by Cash Method Taxpayer Upon Incorporation*, 35 U. PITT. L. REV. 158, 159 (1973).

16. Such an adjustment is provided for in I.R.C. §§ 358(a), (d).

17. *See* Easson v. Commissioner, 294 F.2d 653, 658 (9th Cir. 1961). This case arose prior to the enactment of § 357(c). The court stated that the taxpayer could not be required to recognize gain against the express words of the statute and, therefore, held the stock acquired by the transferor in the transaction to have a negative basis. *See also* Woodsam Assocs., Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952). For a case discussing the possibility of a negative basis in property, see Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951).

18. The loss of revenue was largely due to I.R.C. § 1014(a), which provides that the basis of property acquired by devise was "stepped-up" to its fair market value at the date of the decendent's death. Thus a transferor could hold this stock until his death, whereupon the basis in the hands of the person acquiring from the deceased was stepped-up, leaving the gain thus realized unrecognizable; this step-up in basis obviously created a large revenue loss for the government. Burke & Chisholm, *Section 357: A Hidden Trap in Tax-Free Incorporations*, 25 TAX L. REV. 211, 213 (1970); Comment, *Bongiovanni v. Commissioner: False Hopes for Cash Basis Taxpayers*, 10 SAN DIEGO L. REV. 857, 864 (1973). This problem, however, is largely obviated by I.R.C. § 1023.

19. I.R.C. § 357(c). Commentators generally agree that § 357(c) was designed in large part to avoid the negative basis problem. *See* Easson v. Commissioner, 294 F.2d 653, 657 (9th Cir. 1961). *See also* Cooper, *Negative Basis*, 75 HARV. L. REV. 1352, 1359-60 (1962); Wellen, *New Solutions to the Section 357(c) Problem*, 52 TAXES 361, 363-64 (1974). *But see* Del Cotto, *Section 357(c): Some Observations on Tax Effects to the Cash Basis Transferor*, 24 BUFFALO L. REV. 1, 6 (1974) (which suggests that an elimination of a negative basis is merely a by-product of a more fundamental purpose of § 357(c)).

The Tax Court in *Focht* suggested that § 357(c) was enacted simply to provide an objective replacement to the subjective test of § 357(b). 68 T.C. at 235. The court, however, cited no support for this theory. In addition, the treatment under the two approaches would be very different. Under § 357(b), the entire amount of the liabilities assumed is treated as "money received," subject to treatment as gain, while § 357(c) merely requires the excess of liabilities over the adjusted basis in the assets to be treated as gain. *See* [1975] 233-2d TAX MNGM'T (BNA) A-13 & A-23.

20. *See*, Treas.Reg. § 1.357-2(a), T.D. 6528, 1961-1 C.B. 81-82.

21. I.R.C. § 446(c). The methods relevant to this discussion are the accrual method and the cash method. Accrual method accounting takes the asset or liability into income when the right to receive it becomes fixed or the obligation to pay it is incurred. Cash method accounting, on the other hand, receives the asset or liability into income when the money is actually or constructively received or the debt is actually paid.

method, there is no problem as receivables and payables have been taken into income and are valued at their face value.[22] In this context, the scheme of sections 351, 357, and 358 is not disrupted.[23] If, however, the transferor is on the cash method, receivables have an adjusted basis of zero, and the payables are valued by the Service at their full face value.[24]

The case of *Peter Raich*[25] brought the dilemma of the cash method transferor into clear focus. In that case, Raich, a cash method taxpayer, incorporated a going business, exchanging receivables and payables for the stock of the newly formed corporation. Because Raich was on the cash method, his receivables had an adjusted basis of zero,[26] while the Commissioner determined that the amount of liabilities transferred included the full value of the payables.[27] Pursuant to section 357(c), Raich was required to recognize as gain the excess of the liabilities assumed over the adjusted basis of the assets received. This gain recognition was required notwithstanding the fact that the market value of the receivables transferred exceeded the value of the payables. The Tax Court admitted that the Commissioner's approach worked a hardship on the taxpayer and might not be consistent with the congressional intent to facilitate incorporations of going businesses,[28] but nonetheless upheld the Commissioner's literal reading of section 357(c) While this approach was criticized,[29] the Tax Court continued to apply this analysis when confronted with cases involving similar facts.

22. If, however, the liabilities are greater than the basis in the assets, gain to that extent must be recognized by the accrual method taxpayer. *See* Alderman v. Commissioner, 55 T.C. 463 (1971).

23. "Section 357(c) of the Code operates in a fair and consistent manner in the instance of the accrual basis taxpayer and seems to have been written with him in mind." Comment, *supra* note 18, at 861.

24. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.07, at 3-27 (3d ed. 1971). By the cash method, receivables have an adjusted basis of zero because by definition items of this nature are not properly considered income until collected despite the fact that they maintain their market value.

In a strict tax sense, for the cash method taxpayer, payables also should be given a zero value because the payables are not deductible until paid. Presumably the payables were valued in full, however, because in a practical sense, they do constitute an obligation and, therefore, would be considered liabilities. Comment, *supra* note 15, at 164. Valuation of payables at face value, nevertheless, is conceptually sound for accrual basis taxpayers. *See, e.g.*, Rosen v. Commissioner, 62 T.C. 11 (1974), *aff'd mem.*, 515 F.2d 507 (3d Cir. 1975).

25. 46 T.C. 604 (1966).

26. *Id.* at 607.

27. *Id.*

28. *Id.* at 611.

29. The decision in *Raich* has been criticized for many reasons. One reason was that it would be incongruous to value receivables at zero and to value payables at fair market value. Either both should be valued at face or both at zero, "but to combine the two makes neither tax nor accounting good sense." Comment, *supra* note 4, at 116. However artificial it may sound to say that in this case the payables are not liabilities, for tax purposes they actually are not liabilities until paid and deducted. The situation is the same with receivables, as they do not appear on the tax balance sheet until the money is actually received and reported as income. Comment, *supra* note 18, at 866.

Treating payables as liabilities within § 357(c) creates a situation where one single transaction is split into two taxable gains, resulting in a partial loss of deferral. The use of payables as liabilities within § 357(c) warrants the same use under § 358, which determines the basis of the stock acquired. If receivables have a zero basis and payables are § 358(d) liabilities, a cash method taxpayer with a balance sheet similar to that of the taxpayer in *Raich* will (1) recognize gain on the § 351 exchange, and (2) have a zero basis in the stock and securities received so that upon subsequent sale of the stock, he would realize and recognize the entire sales price as taxable gain. The unfairness of this result is that the knowledgeable incorporator can avoid it either by retaining both receivables and payables or by having the corporation purchase the

As in *Raich*, the transferor in *Bongiovanni v. Commissioner*[30] was on the cash method. The Tax Court valued the payables at full face amount and the receivables at zero. On appeal, however, the Second Circuit reversed, stating that the definition of section 357(c) "liabilities" was intended to include "tax" liabilities, not "accounting" liabilities. The payables were treated as "accounting" liabilities and, thus, were also valued at zero.[31] While achieving what most commentators agreed to be an equitable result, the *Bongiovanni* approach was also questioned.[32]

In spite of this reversal, the Tax Court remained steadfast in its analysis when subsequently faced with another incorporation involving treatment of a cash method taxpayer's transfer of receivables and payables. In *Thatcher v. Commissioner*[33] the Tax Court again valued the payables at face amount and the receivables at zero. On appeal to the Ninth Circuit, the Tax Court was again reversed. The Ninth Circuit rejected the approach offered by the Second Circuit,[34] however, and devised yet another approach. Relying on Judge Hall's dissent in the Tax Court opinion,[35] the Ninth Circuit held that to the extent the assumed payables were actually paid by the transferee, the receivables should be given a corresponding value in order to work a set-off.[36] This set-off of payables actually paid against receivables otherwise

receivables, using the amount received in the purchase to pay off the payables. *See* Kahn & Oesterle, *A Definition of "Liabilities" in Internal Revenue Code Sections 357 and 358(d)*, 73 MICH. L. REV. 461, 464 (1975).

The alternatives illustrate that it would be more profitable for a potential incorporator to liquidate and settle accounts before incorporation. This circumvention of the generally harsh treatment resulting from the *Raich* approach might be inhibited, however, for fear of the transaction's then coming within the "tax avoidance" clause of § 357(b). Thus, as recognized by the Tax Court in *Raich*, Congress' objective of facilitating incorporations is not furthered. 46 T.C. at 607. In defense of the analysis used in *Raich*, however, it has been suggested that strict interpretation of the statute is the only way to avoid substantially twisting the statutory language. White, *Sleepers That Travel With Section 351 Transfers*, 56 VA. L. REV. 37, 42 (1970).

30. 40 T.C.M. (P-H) 1182 (1971), *rev'd*, 470 F.2d 921 (2d Cir. 1972). For further discussion of this case, see Note, *Payables of a Cash Basis Taxpayer Under § 357(c)*, 10 HOUS. L. REV. 1170 (1973); Note, *Section 357(c): The Quest for Equality Between Accrual and Cash Basis Taxpayers*, 52 NEB. L. REV. 527 (1973).

31. 470 F.2d at 924. The court specifically held that:

> Section 357(c) was meant to apply to what might be called 'tax' liabilities, i.e., liens in excess of tax costs, particularly mortgages encumbering property transferred in a Section 351 transaction . . . [whereas] [t]he 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. (emphasis in original).

32. The *Bongiovanni* decision was criticized because it redefined the term "liability" in order to correct an inequity. In so doing it created a new concept, "tax liabilities." Exactly what constitutes a tax liability within § 357(c) will have to be defined on a case-by-case basis, as the court did not set the limits for this definition. Until this is settled the seemingly simple mechanical rule of § 357(c) will be uncertain and difficult to apply. Wellen, *New Solutions to the Section 357(c) Problem*, 52 TAXES 361, 373 (1974). Another question raised by this redefinition is its application to § 358(d) for purposes of determining the basis of the stock acquired. For discussion of this point, see Barnett, *Problems in Incorporating the Going Business*, 59 A.B.A.J. 1190, 1191 (1973).

[1975] 233-2d TAX MNGM'T (BNA) A-26 raised a similar question of the application of the *Bongiovanni* definition of "liabilities" to § 357(a). If the use of the terms is the same, it could mean a revitalization of *Hendler*.

33. 61 T.C. 28 (1973), *aff'd in part, rev'd in part*, 533 F.2d 1114 (9th Cir. 1976).

34. The Ninth Circuit rejected the approach offered because, "the court [in *Bongiovanni*] defined liabilities in an ad hoc manner that may have worked equity in that case, but the definition is likely to produce unforeseen results in other cases." 533 F.2d at 1117.

35. 61 T.C. at 42.

36. 533 F.2d at 1117-18.

valued at zero achieved an equitable result, but was also questioned.[37]

Thus, prior to the *Focht* case, three alternatives for dealing with a transfer of receivables and payables by an incorporating cash method transferor had emerged. In *Raich* the Tax Court, applying the explicit language of section 357(c), gave receivables an adjusted basis of zero and valued payables at market, despite its recognition of the inequity of the results.[38] On appeal, the courts in *Bongiovanni* and *Thatcher*, however, rejected the *Raich* approach because of its inequity. The approach used in *Bongiovanni* was to give receivables an adjusted basis of zero and value payables at zero. The final alternative was that suggested in *Thatcher*, to value payables in full and to give receivables an adjusted basis to the extent of the payables. With this background, the Tax Court was presented with the case of *Focht v. Commissioner.*

II. FOCHT V. COMMISSIONER

In *Focht* the petitioner, pursuant to an incorporation, had transferred all of his assets and liabilities to the controlled corporation in exchange for the stock of the corporation. Accounts receivable constituted the bulk of the assets transferred, while accounts payable constituted the bulk of the liabilities. The issue before the court was how receivables and payables should be treated on their transfer to the corporation by the cash method transferor. The court chose not to follow its holding in *Raich*,[39] but also declared that it would not alter the *Raich* result by revaluing the receivables as was done in *Thatcher*. The court stated flatly that receivables have an

37. The Ninth Circuit itself recognized one weakness in the solution it offered when it stated that an approach treating receivables and payables as an ordinary sale and thereby setting each other off "encroaches upon the strict construction of cash basis accounting." *Id.* at 1115.

The Ninth Circuit's valuation of receivables to the extent they equalled payables and taxing the excess was criticized as making the transfer an ordinary taxable transfer, not a § 351 nonrecognition transfer.

> The language of Section 357(c) does not suggest that it is a means of removing transactions or parts of transactions from Section 351 . . . . If the transaction meets the prerequisites set out in Section 351(a), it is a Section 351 transaction, by definition. The fact that Section 357(c) gain . . . is recognized does not make the transaction even in part an ordinary exchange.

Wellen, *New Solutions to the Section 357(c) Problem*, 52 TAXES 361, 375 (1974).

This approach may be conceptually unsound for yet another reason. In stating its reasoning for allowing this set-off, the Ninth Circuit said that its holding "prevents treatment as gain of something that was not in fact gain, but only appeared to enhance the partner's balance sheet position because of the cash basis accounting method." 533 F.2d at 1118. The court reasoned that the assumption of the accounts payable was not gain because their payment would have been deductible to the transferor. *Id.* at 1118 n.9. As the Tax Court in *Focht* pointed out, however, if the gain from the assumption of payables of a cash method taxpayer was not really a gain, as suggested in *Thatcher*, then the problem would only be successfully handled where the receivables were equal to or greater than payables. If payables were greater than receivables, there would merely be a partial offset and that which was admittedly not gain would be treated as if it were.

38. Testor v. Commissioner, 327 F.2d 788 (7th Cir. 1964), has been considered to be authority in support of the *Raich* approach. *See* Comment, *supra* note 18, at 865; Comment, *supra* note 15, at 166. In *Testor* the Seventh Circuit held that open account liabilities came within the § 357(c) meaning of "liabilities." The facts in that case, however, may be distinguished from the facts in *Raich* in that the taxpayer's liabilities exceeded not only the adjusted basis of the assets, but also their fair market value.

39. 68 T.C. at 229.

adjusted basis of zero and, "this reasoning is now generally accepted."[40] Rather, the court chose to alter the *Raich* result by redefining "liability" for purposes of sections 351 and 358, and thus held that obligations such as payables, to the exent that their payment would be deductible if made by the transferor, should no longer be treated as "liabilities" under sections 357 and 358.[41]

In order to support this interpretation and its application to sections 357 and 358, the court analyzed legislative and judicial history, beginning with *United States v. Hendler.*[42] In response to the *Hendler* decision Congress had enacted legislation which recognized that the assumption of liability was in fact gain, but exempted such gain from the recognition requirement.[43] The Tax Court in *Focht* thus derived from this the idea that Congress meant to exempt through section 357(a) only those liabilities which, if assumed by a transferee in a tax free exchange, would cause gain recognition.[44]

The court next discussed which liabilities would cause gain when assumed. *Crane v. Commissioner*[45] was cited for the proposition that liabilities which are otherwise deductible items do not cause a recognition of gain when assumed, and, therefore, do not come within the meaning of "liability" in section 357(a).[46] The Tax Court concluded that for purposes of section 357(a) the word "liability" would not encompass accounts payable.

The court then applied this redefinition of "liability" for section 357(a) purposes to section 357(c). This was rationalized by stating that Congress had enacted section 357(c) to apply in an automatic and mechanical fashion[47] to situations formerly controlled by section 357(b). Congress had enacted section 357(c), the court stated, because section 357(b) was too subjective in that it required a determination of a taxpayer's motives. If section 357(c) acted only as an exception to 357(a), the court reasoned, the term "liability" in both sections must have the same meaning.[48] As such, it concluded that "liability" should be limited under both sections to apply only to those obligations which cause gain when assumed. An obligation, to the extent that its payment would have been deductible if made by the transferor, should therefore not be included within such a definition of "liability."[49]

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40. *Id. See, e.g.*, Birren & Son v. Commissioner, 116 F.2d 718 (7th Cir. 1940).
41. 68 T.C. at 229.
42. 303 U.S. 564, 566 (1938). For discussion of *Hendler*, see text accompanying note 11 *supra*.
43. *See* H.R. REP. NO. 855, *supra* note 14.
44. 68 T.C. at 233.
45. 331 U.S. 1 (1947).
46. The *Crane* case involved a transfer of real property subject to a mortgage on which interest was due. The Supreme Court concluded that the mortgage assumed by the transferee was part of the amount realized by the transferor, but the assumption of the interest payment due on the mortgage was not part of the amount received. The Court stated: "The Commissioner explains that only the principal amount, rather than the total present debt secured by the mortgage, was deemed to be a measure of the amount realized, because the difference was attributable to interest due, a deductible item." *Id.* at 4 n.6. Thus, because the interest payment would have been deductible if made by the transferor, it was not included as part of the amount received.
47. 68 T.C. at 235.
48. While the court characterized § 357(c) as being the product of congressional discontent with § 357(b), an alternative explanation has been noted. *See* note 19 *supra*.
49. The court stated that, "where section 357(a) does not apply, section 357(c) should not apply." 68 T.C. at 235. It further held that payables, to the extent deductible, should not come

The court arrived at what it determined to be an equitable result, yet gave full recognition to congressional intent "by preventing the recognition of gain or loss where there has been a mere change in the form of ownership."[50]

Judge Hall, the dissenting judge in the Tax Court in *Thatcher*,[51] criticized the decision in dissent as "inconsistent with the plain wording of the statute,"[52] and as lacking the support of the "legislative history" upon which the majority relied so heavily.[53] Judge Hall observed that in relying on the footnote in *Crane* the court constructed "a purely hypothetical legislative history out of a random footnote in a Supreme Court decision."[54] Judge Hall also postulated that the court's approach would lead to substantial questions in interpreting the word "liability" when it appeared in other sections of the Code.[55] Concern was further expressed that the majority position provided a deduction when the payables were assumed regardless of whether or not they were actually paid. If the payables were subsequently not paid, the profit went untaxed.

The most convincing opinion in *Focht* was presented by Judge Tannenwald in dissent. It was his conclusion that with the decision in *Focht*, there were then three different theories of the application of section 357(c) to section 351 incorporations of a cash method taxpayer transferring receivables and payables.[56] This, Tannenwald surmised, was the most compelling ground for according the word "liability" its ordinary meaning in the context of section 357(c). The court's efforts were seen as an attempt to legislate remedial matters regarding section 357(c), an effort appropriate for the legislative branch, not the judiciary.

The obvious "separation of powers" considerations aside, serious prob-

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within the meaning of § 351(a). This particular holding might raise the problem of treating payables under the § 351(b) treatment of "money or other property." If so, the problem created by *Hendler* may re-emerge.

50. *Id.* The court stated that this approach, unlike the Ninth Circuit's *Thatcher* approach, "alleviates the problems raised when a cash method taxpayer transfers insufficient receivables to cover the proposed gain under section 357(c)." *Id.* at 237. Thus, the offset or wash approach would be of little help to the taxpayer whose payables were greater than the receivables. For criticism of *Thatcher* along these lines, see note 37 *supra*.

In a concurring opinion Judge Wilber made the point that in all likelihood Congress never focused on the matter presently before the court. Thus, he concluded, the court's function in this case was to determine what the legislature would have intended on this point had it been presented. 68 T.C. at 240.

51. Judge Hall's dissenting opinion in *Thatcher* was adopted by the Ninth Circuit on appeal. *See* note 37 *supra*.

52. 68 T.C. at 243.

53. In reference to the footnote cited in *Crane*, upon which the court so heavily relied, Judge Hall stated:

> This footnote . . . provides insufficient reason for us to conclude that Congress in enacting section 357 had anything in mind beyond the normal meaning of the word 'liability.' It may or may not be that had Congress thought about it, it would have so limited section 357 á la Crane. But since we do not sit as a legislature, it is not for us to rewrite the statute.

Id. at 244.

54. *Id.*

55. Judge Hall observed that by computer search it had been determined that the word "liability" appears in the Code some 400 times. *Id.*

56. *Id.* at 242-43. With the Seventh Circuit's holding in *Testor* there are probably four varying approaches, as the Seventh Circuit could be cited as approval for the *Raich* approach. For the different approaches, see notes 30, 34, 38 *supra* and accompanying text.

lems may arise when courts attempt to reach an equitable result in cases where a literal application of legislation might not follow congressional intent. The decision in *Focht* may be cited as an illustration of this fact. After *Hendler*, an assumption of a liability by a transferee in an incorporation was considered to be "boot," requiring gain recognition to that extent by section 351(b). Section 357(a) and (b) were enacted in response to eliminate the necessity for gain recognition when a liability was assumed. The court's redefinition of liability for section 357(c) purposes, however, raises the question of whether an assumption of an account payable by a transferee would constitute "boot" under section 351(b), thereby requiring gain recognition.[57] As a practical matter the Tax Court has illustrated that it will not be bound by rigid applications of section 357(c). As such, there should be little concern that an attempted revitalization of *Hendler* by the Service would be effective if the question were litigated. As a theoretical matter, however, it is more than mere cavil to urge that legislation have a clear meaning and a consistent application. When taxpayers must resort to the courts to circumvent inequities arising from the literal application of legislation, it is an indication that it is time for the legislation in question to be reevaluated. Section 357(c) should be reexamined by Congress with the problems of a transfer of receivables and payables by a cash method transferor in mind, so that changes in the mere form of a business produce the same tax consequences regardless of the taxpayer's method of accounting.

III. CONCLUSION

The cases prior to *Focht* illustrated the pervasive uncertainty of the application of section 357(c) in a section 351 incorporation involving a cash method transferor transferring receivables and payables. The Tax Court had remained steadfast in its literal application of section 357(c). In the face of strong opposition from the Second and Ninth Circuits, however, the Tax Court was forced to reevaluate its position. This retreat from adherence to the literal interpretation of section 357(c) has resulted in a redefinition of the word "liability" for purposes of sections 357 and 358. This redefinition achieves an equitable result, but raises problems of a consistent interpretation and application of section 357(c) by the various jurisdictions in the future.

Ben C. Broocks

57. *See* [1975] 233-2d TAX MNGM'T (BNA) A-26 for discussion of a similar problem as regards the *Bongiovanni* definition of "liability."