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Tax Free Transfers - Tips for the Unsophisticated

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TAX FREE TRANSFERS—
TIPS FOR THE UNSOPHISTICATED

by

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NUMEROUS sections of the internal Revenue Code allow taxpayers to transfer property without recognizing the gain realized in the transfer.[1] In these tax free transfers, the transferor's basis in the property transferred carries over to his stock, partnership interest, or other property received in the exchange.[2] Likewise, the transferee receives the property with a carry-over basis.[3] Some of the applicable sections have special provisions for the treatment of "boot" gain.[4] The non-recognition sections typically provide that gain is recognized to the extent of boot, while basis sections concomitantly provide that the carry-over basis of property is increased by the amount of boot gain recognized upon the transfer.[5] If the section controlling the transfer makes no provision for boot, then, of course, the corresponding basis section makes no such allowance either.[6]

Currently, section 357 has given rise to more litigation than any of the other sections of the Internal Revenue Code which provide exceptions to the general rule of non-recognition of gain in tax-free transfers. The basic rule of section 357(a) is that the assumption of liability upon a transfer shall not be treated as boot in the form of money or other property received and shall not prevent the transfer from being tax-free.[7] The operative subsections, however, are subsections (b) and (c). Subsection (b) applies to those situations in which the transfer to a corporation is made for the purpose of tax-avoidance. If it appears that the principal purpose of the taxpayer with respect to the assumption of a liability on the acquisition of mortgaged property was to avoid income tax on the exchange,[8] or was not meant to effectuate a bona fide business purpose, then the assumption is considered to be money received by the transferor on the exchange. The entire amount of liability assumed is treated as money received and not merely the amount of the particular liability with respect to which the pro-

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1. INT. REV. CODE OF 1954, §§ 351, 361, 371, 721, 1031(a), 1032, 1034-36.
2. *Id.* §§ 358, 722, 1031(d).
3. *Id.* §§ 362, 723. The section controlling adjusted basis to the transferee provides a formula different from that used in the basis section controlling adjusted basis of the property, stock, or partnership interest, received by the transferor, except in those instances where the transfer section makes no allowance for boot. *Id.* § 357(a).
4. *Id.* §§ 351(b), 357, 361(b), 1031(b). *But see id.* § 721.
5. *See, e.g., id.* §§ 358(a)(1)(B), 1031(d).
6. *Id.* § 722.
7. *Id.* § 357(a).
8. The motive must be to avoid tax *on the exchange.* Drybrough v. Commissioner, 376 F.2d 350, 356 (6th Cir. 1967).

hibited tax avoidance motive existed.[9]

Unlike section 357(c), sections 357(a) and (b) have predecessors in the 1939 Code.[10] The lack of legislative history associated with § 357(c) has contributed in large measure to the conflicts of authority that now exist as to its application.[11] The House Report provides that in an exchange to which section 351 applies, the amount by which the liabilities assumed, or taken subject to, exceed the adjusted basis of the property transferred, shall be considered as gain from the sale or exchange of a capital asset.[12] The Senate Report similarly provides that the excess of liabilities assumed plus liabilities to which the property is subject over the total adjusted basis of the transferred property shall be considered as a gain from the sale or exchange of a capital asset, or of property other than a capital asset, as the case may be.[13] The regulations state that where there is more than one type of asset involved in the transfer, the section 357 gain is allocated among the various classes of transferred assets according to their proportionate fair market values.[14] The gain on each asset is then characterized according to the nature of the asset and its holding period.[15] These rules seem anomalous in two respects: First, although section 357(c) is applied on a shareholder-by-shareholder basis,[16] each shareholder may transfer additional property to the corporation as part of the section 351 transaction, and the basis of this additional property will diminish any "spread" of assumed debt or liabilities over the basis of the property transferred. Second, it seems that when the assumption of a mortgage on a particular asset gives rise to section 357(c) gain, such gain should not be spread to other assets through the apportionment rules of the applicable regulations, but rather be characterized by the nature and holding period of the asset.[17] In any event, it should be noted that section 1239, disallowing capital gain treatment in certain situations,[18] applies to section 357(c) gain.[19]

The present controversy over the proper application of section 357(c) has its foundation in the *Peter Raich* case.[20] In that case the cash basis taxpayers effectuated a tax-free transfer under section 351 of the assets in their sole proprietorship to their wholly owned corporation. Among the assets transferred were trade accounts receivable in the amount of $77,361.66

9. Treas. Reg. § 1.357-1(c) (1955); S. REP. No. 1622, 83d Cong., 2d Sess. 270 (1954).

10. INT. REV. CODE of 1939, § 112(k). This section was enacted to overrule United States v. Hendler, 303 U.S. 564 (1938), except in those situations where there is a tax-avoidance motive. Hendler had held that assumption of liabilities in a reorganization automatically constituted boot; the Treasury was unwilling to trade off the accompanying increase in adjusted basis in exchange for getting an "automatic boot" rule.

11. *See* notes 20-42 *infra* and accompanying text.

12. H.R. REP. No. 1337, 83d Cong., 2d Sess. 40, A129 (1954).

13. S. REP. No. 1622, 83d Cong., 2d Sess. 270 (1954).

14. Treas. Reg. § 1.357-2(b) (1955).

15. *Id.*

16. Rev. Rul. 66-142, 1966-1 CUM. BULL. 66.

17. This should be the rule at least in those instances where the money derived from the mortgage has been spent on the property and become a part of its adjusted basis.

18. Section 1239 applies to sales or exchanges of depreciable property between husband and wife or by individuals to an 80% controlled corporation.

19. Rev. Rul. 60-302, 1960-2 CUM. BULL. 223. *See also* Velma W. Alderman, 55 T.C. 662, 666 (1971).

20. 46 T.C. 604 (1966).

and trade accounts payable in the amount of \$37,719.78.[21] The Commissioner contended successfully that the accounts receivable had a zero basis and consequently that the aggregate basis of the transferred property, \$11,251, was exceeded by aggregate liabilities assumed, \$45,992,[22] which resulted in a recognized gain to the taxpayers of \$34,741. The taxpayer argued that the liabilities assumed did not exceed book value of the property transferred,[23] and that the accounts receivable had a basis, for section 357(c) purposes, equal to the amount of the basis for the trade accounts payable.[24] Finally, the argument was made that the amount of the accounts payable was, in effect, the cost of the accounts receivable and was, therefore, the basis of the accounts receivable under section 1012.[25] The Tax Court rejected these arguments, holding that the accounts receivable in the hands of a cash basis taxpayer have a zero basis and that the entire excess of liabilities assumed over adjusted basis of property transferred was taxable under section 357(c).[26] None of the property transferred by the Raiches was a capital asset, and consequently all of the section 357(c) gain was taxed at ordinary income.[27]

Bongiovanni v. Commissioner[28] involved virtually an identical fact situation as *Raich*, except that the Bongiovannis had attempted to change from the cash to accrual method of reporting income in the year of the transfer under section 351.[29] Accrual of the accounts receivable would have caused recognition of income and, correspondingly, would have given those accounts a basis equal to the amount of income recognized. The Second Circuit refused to read section 357(c) literally, holding instead that the word "liability" as used in section 357(c) refers to "tax liabilities," not mere accounting liabilities.[30] The court further stated that the Government's argument for a strict application of section 357(c) would twice tax transferor-shareholders such as the Bongiovannis and the Raiches: First, in denying the cash basis taxpayer a deduction for accounts payable owed but not yet paid, and second, in making these same liabilities recognized gain to the extent liabilities exceed the basis of property transferred.[31] The transferor-shareholder's basis in his stock was a problem that was not discussed in *Bongiovanni.* When liabilities exceed basis and gain is recognized on the excess under section 357(c), the corrresponding basis of the stock will be zero.[32] If, following the reasoning of *Bongiovanni,*[33] gain is not recognized on the

21. *Id.* at 605.
22. *Id.* at 607.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.* at 611.
27. *Id.*
28. 470 F.2d 921 (2d Cir. 1972), *rev'g* 30 CCH Tax Ct. Mem. 1124 (1971).
29. *Id.* at 922. *See also* Rev. Rul. 69-442, 1969-2 CUM. BULL. 53, which ruled that for the purposes of recognition of gain under § 357(c) of the Code, trade account receivables transferred in a § 351 transaction by a cash method taxpayer are given a zero basis.
30. 470 F.2d at 924.
31. *Id.* at 925.
32. INT. REV. CODE OF 1954, §§ 358(a)(1)(A), (B).
33. *See* note 28 *supra* and accompanying text.

transfer, a negative basis must be assigned the transferor-shareholder's stock or the gain realized on the transfer will completely escape recognition. *Easson v. Commissioner*[34] faced this problem and held that under section 112(k) of the 1939 Code (predecessor of section 357(b)) and section 113(a)(6) of the 1939 Code (predecessor of section 358) a negative basis must be assigned to the transferor-shareholder's stock to avoid this tax avoidance possibility. It should be noted that the transferee-corporation has no possibility of being assigned a negative basis. The corporation's basis in acquired property under section 362 is a carry-over basis increased by any gain recognized on the transfer.[35] The transferee corporation is not subject to the provisions of section 351(b) or section 357, therefore there is no "netting out" formula as in section 358(a)(1) to determine the basis of the transferor's stock.

A recent Tax Court decision, *Wilford E. Thatcher*,[36] dealt with a similar fact situation as presented in both *Raich* and *Bongiovanni*. A cash basis partnership transferred all of its assets and liabilities to a controlled corporation. The accounts payable, when added to the other liabilities assumed, resulted in a total of assumed liabilities greater than the total basis of assets transferred.[37] The taxpayers argued, first, that the accounts receivable had a basis equal to the amount of accounts payable and, second, that the accounts payable of a cash basis taxpayer are not the type of liabilities covered by section 357(c).[38] The majority of the Tax Court considered the reasoning of both *Raich* and *Bongiovanni* and held that the *Bongiovanni* rationale could not be reconciled with the express language of section 357(c).[39] The majority opinion expressly recognized that its strict interpretation of section 357(c) totally negated the availability of section 351 tax-free transfers to cash method taxpayers such as Thatcher, Bongiovanni, or Raich when accounts payable exceed accounts receivable.[40]

Five members of the court dissented in part and concurred in part. Judge Quealy wrote a short dissenting opinion agreeing with the Second Circuit opinion in *Bongiovanni* that section 357(c) was not meant to apply to accounting liabilities.[41] Judge Hall, in a longer dissenting opinion, thought that the transferor's accounts receivable and accounts payable should have been offset against each other, apparently in a simple "wash" context.[42]

A recent article proposes a solution to the section 357(c) problem[43] along the line suggested by the taxpayer in *Raich*.[44] Mr. Wellen argues convincingly that, under section 1012, the accounts receivable should take a basis equal to the amount of accounts payable assumed on the transfer.[45]

34. 294 F.2d 653 (9th Cir. 1961).
35. INT. REV. CODE OF 1954, § 362; Treas. Reg. § 1.362-1 (1955).
36. 61 T.C. 28 (1973).
37. *Id.* at 31.
38. *Id.*
39. *Id.* at 33.
40. *Id.* at 34.
41. *Id.* at 44 (Quealy, J., dissenting).
42. *Id.* at 42 (Hall, J., dissenting).
43. Wellen, *New Solutions to One Section 357(c) Problem*, 52 TAXES 361 (1974).
44. 46 T.C. at 607.
45. Wellen, *supra* note 43, at 375-77.

This theory solves the difficult application of section 357(c) to a *Raich-Bongiovanni* situation, but may not work at all when dealing with the application of section 358 and the ultimate disposition of the transferor's stock.[46]

Each of the different theories on the interpretation of section 357(c) will now be analyzed in the context of a *Raich-Bongiovanni*-type balance sheet in order to illustrate their strengths and weaknesses. Consider a cash method taxpayer who transfers under section 351 the following assets and liabilities to a corporation:

	Assets		Liabilities
	f.m.v.	adjusted basis	book
Property	50	50	
Accounts receivable	50	0	
Accounts payable			60

Under each theory, section 357(c) gain to the transferor-shareholder is: (1) *Bongiovanni*: 0; (2) *Raich-Thatcher*: 10; (3) the *Thatcher* dissenting opinions: 0; and (4) Wellen: 0. The taxpayer's basis in his stock under section 358 is: (1) *Bongiovanni*: 0 or -10, depending upon whether you accept negative basis; (2) *Raich-Thatcher*: 0; (3) the *Thatcher* dissenting opinions—Judge Hall: 40, Judge Quealy: 50; and (4) Wellen: 50.[47] The corporation's basis in assets received under section 362 is (1) *Bongiovanni*: 50, all apparently allocable to property; (2) *Thatcher*: 60; (3) the *Thatcher* dissenting opinions—Judge Hall: 50, Judge Quealy: 50; and (4) Wellen: 110, allocable apparently 50 to property and 60 to accounts receivable. Unlike section 357, the regulations under section 358[48] have no requirement of allocation of basis according to respective fair market values without regard to which assets were encumbered.[49] If the taxpayer sells

46. *See* note 52 *infra* and accompanying text.

47.

	Bongiovanni	Raich-Thatcher	Hall
basis property transferred:	50	50	50
— liabilities assumed:	—60	—60	—10 (net)
+ gain recognized:	0	+10	0
§ 358 basis	(10)	0	40

	Quealy	Wellen
basis property transferred:	50	110
— liabilities assumed:	— 0	— 60
+ gain recognized:	+ 0	+ 0
§ 358 basis	50	50

48. Treas. Reg. § 1.358-2 (1955).

49. *Id.* § 1.357-2(b).

50.

	Bongiovanni	Raich-Thatcher	Hall	Quealy	Wellen
amount realized	40	40	40	40	40
— adj. basis in stock	—(10)	— 0	—40	—50	—50
gain on sale	50, or 40 if negative basis is not allowed	40	0	(10)	(10)

his stock his gain is (1) *Bongiovanni*: 50, or if no negative basis is allowed, 40; (2) *Raich-Thatcher*: 40; (3) the *Thatcher* dissenting opinions —Judge Hall: 0, Judge Quealy: -10; and (4) Wellen: -10.[50] The corporation's gain on the total of the sale of the property at fair market value, the collection of the outstanding receivables, and the payment of the accounts payable is: (1) *Bongiovanni*: -10; (2) *Raich-Thatcher*: -10; (3) the *Thatcher* dissenting opinions—Judge Hall: 50, Judge Quealy: -10; and (4) Wellen: -10.[51]

The total gain or loss on the entire transaction is:

	Bon-giovanni	Raich-Thatcher	Hall	Quealy	Wellen
Gain on transfer to the corporation:	0	10	0	0	0
Gain on sale of stock:	50*	40	0	(10)	(10)
Gain on corporation's collections; sale of property; payment of payables:	(10)	(10)	50***	(10)	(10)
Net[52]	40**	40	50****	(20)	(20)

* 40 if negative basis is not allowed.
** 30 if negative basis is not allowed.
*** A loss of 10 if a deduction of 60 for the payables is allowed.
**** A net loss of 10 if the deduction for the payables is allowed.

It should be noted that it does not matter if the assumed liabilities are secured or unsecured.[53] Also it makes no difference that the shareholder-transferor remains personally liable on the assumed debts[54] or adds his note to the property being transferred.[55] Of course, the literal appli-

51.

	Bongiovanni	Raich/Thatcher	Hall	Quealy	Wellen
gain on property					
amt. realized	50	50	50	50	50
— adj. basis	50	50	50	50	50
gain	0	0	0	0	0
gain on receivables	50	50	50	50	50
deduction for payables	(60)	(60)	0*	(60)	(60)
net gain or loss	(10)	(10)	50**	(10)	(10)

* No deduction for payment of the accounts payable because the transferor netted them against the receivables.
** If a deduction of 60 for the payables is allowed, the net loss is (10). The tax benefit rule, if applicable, will deny this deduction. However, see notes 102-04 *infra* and accompanying text.

52. The fault with Wellen's theory is that it will not work unless the accounts payable are used *both* as a basis for the accounts receivable on the transfer *and* as a deduction by the corporation. Hempt Bros. v. United States, 490 F.2d 1172 (3d Cir. 1974), indicates that the accounts payable can be used for both purposes. Nash v. United States, 398 U.S. 1 (1970), indicates strongly that they cannot be so used.

53. *See, e.g.*, Testor v. Commissioner, 327 F.2d 788 (7th Cir. 1964).

54. David Rosen, 62 T.C. 11 (1974).

55. Rev. Rul. 68-629, 1968-2 CUM. BULL. 154; Velma W. Alderman, 55 T.C. 662, 665 (1971).

cation of section 357(c) is most devastating in the case of a shareholder in a subchapter S corporation. Transferor-shareholder has a section 358 stock basis of zero and, under section 1374(c)(2), cannot deduct his share of the corporation's net operating loss.[56]

Consider now the same taxpayer transferring property to a partnership instead of a corporation. The balance sheet of the taxpayer's assets and liabilities is the same as before:

	Assets		Liabilities
	f.m.v.	adjusted basis	book
Property	50	50	
Accounts receivable	50	0	
Accounts payable			60

The taxpayer transfers all of his assets, subject to his liabilities, to a general partnership in exchange for a fifty percent partnership interest. The other partner transfers $40 in exchange for his fifty percent partnership interest. Under a section analogous to section 351, the taxpayer does not recognize gain on the transfer of his property and accounts receivable to the partnership.[57] Section 721 itself has no provision for the transferor's receipt of money or "other property" on the transfer, but the regulations provide that the receipt of such "boot" converts the otherwise tax-free exchange into a sale under section 707.[58] The transfer of the accounts payable is governed by the provisions of section 752(b). The transferor-partner is relieved of one-half of the liability and thus is treated as having received a distribution of money under section 731.[59] The transferor-partner's basis in the property and accounts receivable carries over to his partnership interest,[60] but is reduced by the amount of the constructive distribution under section 752(b).[61] The partnership acquires the same basis in the transferred assets as the assets had in the hands of the transferor-partner.[62] Note that neither section 722 nor section 723 has any provision for increasing or decreasing the basis of the partnership interest or the transferred property in accordance with the assumption of liability or the payment of boot, as is the

56. George Wiebusch, 59 T.C. 777, *aff'd per curiam*, 487 F.2d 515 (8th Cir. 1973).
57. INT. REV. CODE OF 1954, § 721.
58. Treas. Reg. § 1.721-1(a) (1956). *See also* Westfall, *Corporate Analogues in Partnership Taxation*, 80 HARV. L. REV. 765 (1967).

The strongest argument against the regulation's out-of-hand conversion of a tax-free exchange into a taxable sale is the treatment of liabilities under §§ 752(b), 733, 731. An assumption of the transferor-partner's liability is treated by § 752(b) as a constructive distribution of cash. Under § 733 this constructive distribution reduces the partner's basis in his partnership interest and there is gain (under § 731(a)(1)) only if and to the extent that the constructive distribution exceeds the partner's basis. *At no point does the constructive distribution convert the exchange into a sale. How then can an actual distribution of cash or boot property convert a § 721 exchange into a sale?*

Further, the Service argued successfully in Jackson E. Cagle, 63 T.C. No. 9 (1974), that § 707(c) itself does not require that any guaranteed payment be automatically deductible under § 162(a). How then can § 707(a) be determinative of the character of an exchange accompanied by boot?

59. INT. REV. CODE OF 1954, §§ 752(b); Treas. Reg. § 1.752-1(b)(2) (1956).
60. INT. REV. CODE OF 1954, § 722.
61. *Id.* § 733.
62. *Id.* § 723.

case in sections 358 and 362. This is due to the fact that section 721, unlike section 351, makes absolutely no provision for the assumption of liability or the payment of boot. If the transferor enters the partnership as a limited partner, the entire amount of his accounts payable is constructively assumed by the general partner.[63] As described above this results in a constructive distribution under section 752(b) which would be the entire amount of the accounts payable, and the limited partner's basis in his partnership interest would be reduced by this amount under section 733.

If the partner sells his interest at its fair market value, $40, his total gain is 20.[64] If the account payables are netted against all three of the assets in determining the value of the partnership interest, $14.29 is allocable to the receivables.[65] Since these have a section 732(a) basis of zero, the section 751(a) ordinary income is $14.29.[66] The remainder of the amount realized, $25.71, is offset against the remaining basis in the partnership interest, $20, and the excess, $5.71, is treated as section 741 long-term capital gain.[67]

If the partnership sells all of its property, collects the accounts receivable, and pays the accounts payable, it recognizes a gain of zero on the sale, a net loss of 10 when the payables are offset against the receivables, and can distribute cash to the partners in liquidation of their partnership interests. The partners' distributive shares of this loss will then be $5 each,[68] which in turn reduces each partner's basis in his partnership interest,[69] and thereby increases the recognized gain upon a distribution in liquidation of his interest or upon the sale of his partnership interest.

Total gain or loss upon this transaction is:

	If the partnership is sold *before* the partnership sells assets, etc.	If the partnership is sold *after* the partnership sells assets, etc.
On transfer to the partnership:	0	0
On sale of assets; collection of receivables; payment of accounts payable:	To the partnership: (10) To the partner: (5)	(10) (5)

63. Treas. Reg. § 1.752-1(e) (1956).
64. Such gain is computed as follows:

Amount realized	40
— basis	20
gain	20

65.

Assets	f.m.v.	% of total f.m.v.
property	50	35.7%
accounts receivable	50	35.7%
cash	40	28.6%
total	140	100%

35.7% x $40 = $14.29 alllocated to accounts receivable

66. Treas. Reg. § 1.751-1(a)(2) (1956).
67. *Id.*
68. INT. REV. CODE OF 1954, § 704(b).
69. *Id.* § 705(a)(2)(A).

On sale of partnership interest:	20*	25**
Net[70]	10	15

* Of which $14.29 is ordinary income and $5.71 is capital gain. *See* note 69 and accompanying text, *supra*.
** Of which $14.29 is ordinary income and $10.71 is capital gain.

The use of the partnership instead of a corporation to avoid the problem of section 357 is best illustrated by an example wherein one partner transfers assets and liabilities to a general partnership in return for a fifty percent interest, and the other partner transfers assets and liabilities having a duplicate balance sheet.

	Assets		Liabilities
	f.m.v.	adjusted basis	book
Property	50	50	
Accounts receivable	50	0	
Accounts payable			60

The transferor incurs no gain or loss on the transfer of his property and accounts receivable.[71] His transfer of accounts payable comes under section 752(b), and he is relieved of one-half of the liabilities which is treated as a dollar distribution under sections 733 and 731. However, he has assumed an equal share of the other partners' liabilities which is treated as a contribution of dollars to the partnership under section 752(a), increasing his basis and offsetting the constructive distribution under sections 752(b), 733, and 731.[72] Consequently, the partner will have a carry-over basis of $50 in his partnership interest[73] and the partnership will have a carry-over basis in the transferred assets of $50.[74] This example best illustrates the advantageous position of the partnership's basic conduit nature, which in allowing offsetting entries under sections 752(a) and (b) will eliminate any possibility of boot treatment to the transferor-partner. This is not possible if the business entity is a corporation, because the corporation is always a separate entity interposed between the shareholder and the actions of any other shareholder.

If the partner sells his partnership interest at its fair market value, $40, his ordinary loss under section 751(a) is $10.[75] There is no further realized amount to be treated as capital gain or loss under section 741. If, instead, the partnership sells the property, collects the receivables, and pays the accounts payable, it will have recognized neither a gain nor loss. It will have a net loss of 20 when the payment of the accounts payable is offset against the collection of the accounts receivable, and the distributive share of loss

70. Consider the possible effect of a § 704(b)(2) agreement: The partner contributing cash may raise the possibility of a § 704(b) allocation of income, according to the economic effect of each partner's contribution. *See* Treas. Reg. § 1.704-1(b)(2) (1956).
71. INT. REV. CODE OF 1954, § 721.
72. *Id.* §§ 752(a), (b), 731.
73. *Id.* § 722.
74. *Id.* § 723.
75. *Id.* § 702(b).

to each partner will be $10.[76] Each partner's distributive share of loss serves to reduce his basis in his partnership interest.[77]

The total gain or loss on the entire transaction is as follows:

		If the partnership interest is sold *before* the partnership sells property, etc.	If the partnership interest is sold *after* the partnership sells property, etc.
On transfer to the partnership:		0	0
On sale of assets; collection of receivables; payment of accounts payable:	To the partnership:	(20)	(20)
	To the partner:	(10)	(10)
On sale of partnership interest:		(10)	0
Net		(30)	(20)

The treatment of tax-free exchanges of like-kind property under section 1031 falls somewhere between the treatment of transfers to a controlled corporation under sections 351 and 357 and the treatment of transfers to a partnership under section 721. Similar to section 351(b), section 1031(b) provides for boot treatment upon the receipt of money or other property in an otherwise tax-free exchange. Unlike both sections 351, 357, and sections 721, 752, there is not a provision for treating the assumption of liability or debt as boot. This omission allows taxpayers great latitude in equalizing the equities in like-kind properties as well as in drawing cash out of the exchange. The accompanying cost is a basis adjustment. Take, for example, the following section 1031 exchange and consider the alternative methods of handling the assumption of liabilities on the exchange.

Taxpayers *A* and *B* will exchange like-kind real property, with each party's property being encumbered by a purchase money mortgage. The respective facts and figures with regard to the property are:

	A's property	*B*'s property
f.m.v.	250	280
encumbrance	100	180
equity	150	100
basis	120	160

76.

		Partnership	Partner
Sale of property			
amt. realized	100		
— adjusted basis	100		
gain		0	0
Collection of accounts receivable		100	50
Payments of accounts payable		(120)	(60)
Net		(20)	(10)

77. INT. REV. CODE OF 1954, § 705(a)(2)(A). If the original partner sells his interest before the partnership sells the property, etc., the new partner has a cost basis of $40. His recognized loss, $10, reduces this basis to $30. If the transferor still is a partner at this time, the recognized loss of $10 reduces his basis from $50 to $40. This reduces his loss on the sale of his partnership interest from $10 to zero.

In our first example *B* agrees to pay *A* $50,000 cash to make up the difference in the equities of the two properties. The extra liabilities assumed by *A*, $80,000, do *not* offset the $50,000 cash boot received and *A* has to recognize gain to the full extent of cash received.[78] *A* realizes a gain of $130,000 and *B* realizes a gain of $120,000 on the exchange.[79] *A*'s gain is recognized to the extent of boot received in the amount of $50,000.[80] *B*'s boot is the amount of the excess liability assumed by *A* on the exchange,[81] and his recognized gain is $30,000.[82] *A*'s adjusted basis in the property received in the exchange is $200,000.[83] *B*'s adjusted basis in property received is $160,000.[84]

Next, contrast the situation wherein *B* applies the $50,000 to his liability of $180,000, reducing it to $130,000.[85] This permits *A* to avoid recognition of any portion of his realized gain, because he has not received cash or boot property and *B*'s tax position is not impaired. The gain realized by

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78. Treas. Reg. § 1.1031(d)-2 (1956).

79. Gain realized:

A		*B*	
280	f.m.v. property received	250	f.m.v. property received
50	cash received	80	net liabilities released
330		330	
−80	net extra liabilities assumed	−50	cash paid
250		280	
−120	adjusted basis	−160	adjusted basis
130	gain realized	120	gain realized

80. Gain recognized:

A	
100	release of liabilities
−180	liabilities assumed
0	net (not below zero)
+ 50	cash received
50	gain recognized

81. Treas. Reg. § 1.1031(d)-2 (1956).

82.

B	
180	release of liabilities
−100	liabilities assumed
80	net
− 50	cash paid
30	gain recognized

83. Adjusted basis:

A	
120	basis in property exchanged
50	gain recognized
80	net liabilities assumed
250	
− 50	cash received
200	basis in property acquired

84.

B	
160	basis in property exchanged
30	gain recognized
50	cash paid
240	
− 80	net liabilities released
160	basis in property acquired

85. Of course, there may be a prepayment penalty, but in order to keep the basic figures uniform in the three examples, this is not included.

the two parties is: *A*, $190,000, and *B*, $120,000.[86] The gain recognized by the two parties is: *A*, 0, and *B*, $30,000.[87] The adjusted basis in property acquired for each party is: *A*, $150,000, and *B*, $160,000.[88] A possible variation on this plan is for *B* to pay to *A* the $50,000, with the understanding that it be used immediately for the reduction of the liabilities assumed. A case under section 112(k)(1) of the 1936 Revenue Act, *Commissioner v. North Shore Bus Co.*,[89] held that cash received under these circumstances was not taxable boot to the recipient.[90]

Next consider the situation where *A* increases the encumbrance on his property from $10,0000 to $150,000 by borrowing an additional $50,000. He can use the money for any purpose he wishes and the equities of the two properties are equalized at $100,000 each. *A* has not received cash from *B*, thus he has no recognized gain. *B*'s tax position is not impaired and, unlike the previous two situations, he does not have to pay $50,000 cash to *A*. The gain realized by the parties on this exchange is: *A*, $130,000, and *B*, $120,000.[91] The gain recognized by the parties is: *A*, 0, and *B*, $30,000.[92] The adjusted basis in property received upon the exchange

86. Gain realized:

A		*B*	
280	f.m.v. property received	250	f.m.v. property received
30	net extra liabilities assumed	30	net liabilities released
310		280	
−120	adjusted basis	−160	adjusted basis
190	gain realized	120	gain realized

87. Gain recognized:

A		*B*	
100	liabilities released	130	liabilities released
−130	liabilities assumed	−100	liabilities assumed
0	net (not below zero)	30	net
+ 0	cash received	− 0	cash paid
0	gain realized	30	gain recognized

88. Adjusted basis:

A		*B*	
120	basis in property exchanged	160	basis in property exchanged
0	gain recognized	30	gain recognized
30	net liabilities assumed	0	cash paid
150		190	
− 0	cash received	− 30	net liabilities released
150	basis in property acquired	160	basis in property acquired

89. 143 F.2d 114 (2d Cir. 1944).

90. There is no further authority on this point, save for dicta in Carlton v. United States, 385 F.2d 238, 243 (5th Cir. 1967).

91. Gain realized:

A		*B*	
280	f.m.v. property received	250	f.m.v. property received
0	cash received	30	net liabilities released
280		280	
− 30	extra liabilities assumed	− 0	cash paid
250		280	
−120	adjusted basis	−160	adjusted basis
130	gain realized	120	gain realized

92. Gain recognized:

A		*B*	
150	release of liabilities	180	release of liabilities
−180	liabilities assumed	−150	liabilities assumed
0	net (not below zero)	30	net
+ 0	cash received	− 0	cash paid
0	gain recognized	30	gain recognized

is: *A*, $150,000, and *B*, $160,000.[93] A person planning to enter into a section 1031 like-kind exchange must always remember that while assumption of liabilities by the other party is treated as money received,[94] there is no provision for the assumption of liabilities to offset the receipt of money or boot property.[95]

Finally, we should consider the possible application of the tax benefit doctrine. *Nash v. United States*[96] considered the incorporation of an accrual method partnership and the transfer of its accounts receivable and its bad debt reserves to the corporation. The value of the receivables was netted out by the amount of the bad debt reserves and a correspondingly smaller amount of stock was received in the exchange.[97] The Supreme Court held that the transfer was equal to the net value of the receivables, and therefore, it avoided the application of the tax benefit rule.[98] One can argue that the holding in *Nash* calls for a liberal interpretation of section 357(c) as adopted in *Bongiovanni* inasmuch as there is no windfall benefit to the transferor on the contribution. That is, the fair market value of the stock received is equal to the net value of assets transferred to the corporation, and the excess liabilities assumed over the basis of assets transferred has already been taken into account. A more recent case, *Hempt Bros. v. United States*,[99] considered application of the tax benefit rule to a section 351 transfer of a partnership's accounts receivable and inventory to a controlled corporation. The Third Circuit held that the tax benefit doctrine does not increase the basis of the inventory transferred (and previously deducted by the transferor) contrary to the formula in section 358's carry-over basis rule.[100] This interpretation argues for a literal reading of sections 357 and 358 and against the reasoning of *Bongiovanni*. This, and similar questions, are matters of tax-timing more than of tax-avoidance[101] and the needed solutions should be accessible and more certain.

Conclusion

There is obviously little room for creative tax planning in the areas of section 351 and 357 transfers until *Thatcher* has been decided by the court of appeals. Should *Thatcher* be decided the same as *Bongiovanni* then taxpayers will have the option of recognizing gain in a year preceding the

93. Adjusted basis:

A		*B*	
120	basis in property exchanged	160	basis in property exchanged
0	gain recognized	30	gain recognized
30	net liabilities assumed	0	cash paid
150		190	
− 0	cash received	− 30	net liabilities released
150	basis in property acquired	160	basis in property acquired

94. Treas. Reg. § 1.1031(d)-2 (1956).
95. Int. Rev. Code of 1954, § 1031(b); Treas. Reg. § 1.1031(b)-1(a), T.D. 6935, 1967-2 Cum. Bull. 276; Treas. Reg. § 1.1031(d)-2 (1956).
96. 398 U.S. 1 (1970).
97. *Id.* at 4.
98. *Id.* at 5.
99. 490 F.2d 1172 (3d Cir. 1974).
100. *Id.* at 1179-81.
101. *See* notes 28-30 *supra* and accompanying text.

transaction by shifting to the accrual method or by recognizing the gain at the later date upon disposal of their stock.[102] In contrast, the conduit nature of a partnership allows for a great deal of tax planning as the liabilities of the transferring partners flow through the partnership and offset each other.[103] Treatment of boot under section 1031 provides a reasonable degree of planning flexibility, although assumed liabilities may not offset cash or property received in the exchange.[104]

The rules of subchapter C are extremely complex; one should not have to overlay them with judicially-developed doctrines[105] in order to reach fair and uniform results. The best solution to the section 357(c) problem is a narrow amendment to section 357 providing that, for purposes of section 357 only, an assumption of a cash-method transferor's accounts payable and other general liabilities is not counted in figuring the excess over basis that is taxed. Liabilities assumed by a transferor for purposes of a cash wring-out on the transfer to the corporation are properly treated under section 357(b), so the amendment would not provide a loophole.[106] A corresponding narrow amendment to section 358 would specifically allow for negative stock basis in these situations.[107] In this manner, cash-method and accrual-method taxpayers would be treated equally and the difficult and far-reaching questions raised by *Bongiovanni* and *Thatcher* can be solved within the statutory scheme of subchapter C.

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102. This presumes that the stock is given a negative basis under § 358 and that the transfer thus serves tax-deferral and not tax-avoidance. *See* notes 32-37 *supra* and accompanying text.

103. *See* notes 59-63, 71-77 *supra* and accompanying text.

104. *See* notes 78-95 *supra* and accompanying text.

105. The tax benefit rule of § 111 is limited to bad debts, prior taxes, and delinquency amounts—none of which are in issue here.

106. *See* notes 10-17 *supra* and accompanying text. This, alone, would not be satisfactory for subchapter S corporations. *See* note 59 *supra* and accompanying text. Section 1376(b)(1) could be amended to allow a negative stock basis for the purpose of gain recognition on disposition, while not reducing basis below zero, as a result of the suggested amendments to §§ 357(c), 358(a)(1)(A), 358(d), for the purpose of allowing loss flow-through to the shareholder.

107. The negative basis rule allows deferral of gain, but prevents its avoidance. *See* notes 33-35 *supra* and accompanying text.

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