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Zero Basis Hoax or Contingent Debt and Failure of Proof? Sorting Out the Issues in the *Lessinger* Case

Jasper L. Cummings, Jr.

The author practices law in Raleigh, North Carolina with Womble Carlyle Sandridge & Rice, PLLC. He argues that commentary on the Second Circuit's 1989 *Lessinger* decision involving section 357(c) has not clearly identified the tax logic issues that are at stake in the case. He agrees that the controlling shareholder's obligation is not section 351 "property" and should not be accorded basis in the shareholder's hands. Instead, the obligation should be treated as a purchase money obligation that affords basis in the shareholder's stock unless it is properly viewed as contingent. In any event, proper structuring of section 351 exchanges of property subject to debt in excess of the property's basis for stock in order to reflect an actual retention of liability on that debt by the shareholder should prevent shareholder gain recognition under section 357(c).

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I. INTRODUCTION

In *Lessinger v. Commissioner*,¹ the Court of Appeals for the Second Circuit held that the impact of section 357(c)—which requires that any excess of the debt assumed or taken subject to by the corporation in a section 351 exchange must be recognized as gain by the transferor/shareholder—can be avoided if the shareholder, as part of the exchange, promises to pay to the corporation an amount equal to the excess. Continuing commentary on the decision indicates that disagreement and confusion persist about the tax consequences of a shareholder's issuance of an obligation to a controlled corporation.² The commentary reflects two disturbing views about the problem in *Lessinger*. One view questions the proposition that a maker has no basis (or a zero basis) in his or her own obligation.³ The other view is that the *Lessinger* result can best be justified by analyzing the obligation as if it were cash.⁴

While these views add insight on some issues, they fail to identify fully or resolve properly the range of basic issues raised by *Lessinger*, including (1) whether *Lessinger* reaches a desirable result, (2) what having basis in one's own obligation has to do with that result, (3) what role a transferor's obligation should generally play in section 351 exchanges, (4) how courts can better justify the *Lessinger* result when appropriate, and (5) what legislative solution or administrative guidance may be desirable.

Lessinger involved a transfer of "property," as that term is used in section 351(a),⁵ by a controlling shareholder,⁶ Sol Lessinger, to his pre-

1. 872 F.2d 519 (2d Cir. 1989), rev'g 85 T.C. 824 (1985).

2. For recent commentary, see Kenneth P. Brewer, *The Zero Basis Hoax*, 63 Tax Notes 457 (Apr. 25, 1994) [hereinafter Brewer]; Kenneth P. Brewer, *Revenge of the Zero Basis Hoax*, 64 Tax Notes 1615 (Sept. 19, 1994) [hereinafter Brewer II]; Kenneth P. Brewer, *Hoax Busters*, 65 Tax Notes 778 (Nov. 7, 1994); J. Clifton Fleming, *A Second Look at the Zero Basis Hoax*, 64 Tax Notes 811 (Aug. 8, 1994); Ronald G. Bauer, *Zero Basis Opponent Puts in His Two Cents*, Letter to the Editor, 65 Tax Notes 129 (Oct. 3, 1994); George K. Yin, *Was Lessinger Decided Correctly? More on Zero Basis*, Letter to the Editor, 65 Tax Notes 131 (Oct. 3, 1994). Other articles on the subject not cited elsewhere in this article include Michael M. Megaard & Susan L. Megaard, *Can Shareholder's Note Avoid Gain on Transfer of Excess Liabilities?* 71 J. Tax'n 244 (1989); Lee A. Sheppard, *Reading Section 357(c) Out of the Code*, 47 Tax Notes 1556 (Jun. 25, 1990); Colleen M. Martin, *Note, Lessinger and Section 357(c): Why a Personal Guarantee Should Result in Owen Taxes?*, 10 Va. Tax. Rev. 215 (1990); Louis S. Nunes, *Comment, Taking Section 357(c) Out of the Scheme of Things: Has the Second Circuit Stranded this Section of the Internal Revenue Code?*, 65 Tul. L. Rev. 663 (1991).

3. See Brewer, *supra* note 2; but see Brewer II, *supra* note 2 (clarifying that giving basis to the obligation is only his second-best approach).

4. See Fleming, *supra* note 2.

5. Section 351 does not define "property," but § 351(d) excludes certain items, including services, which resemble a maker's obligation in that services are created by the

existing wholly owned corporation in exchange for stock (actually a deemed issuance of additional stock), coupled with the corporation's assumption of debts of the shareholder in an amount exceeding the property's basis. The court found the nonrecognition rule of section 351 applicable to the transfer. Under the basis rules for section 351 exchanges, Sol's basis for the transferred property became the corporation's basis for the property, and his basis for the stock deemed received in the transaction equaled the property's basis, reduced by the debts assumed by the corporation.⁷ The tax basis rules effectively preserve and double any gain or loss that goes unrecognized in the section 351 exchange.

Sol's basis in the transferred property was less than the amount of his debt assumed by the corporation. Section 357(c) alters the nonrecognition rule of section 351(a) by requiring the transferor/shareholder to recognize gain equal to any amount by which debt that the corporation assumes or takes subject to in a section 351 exchange exceeds the adjusted basis of the transferred property. Sol tried to avoid the application of section 357(c) by issuing his own obligation to the corporation. He did this by entering in the corporation's books an account receivable from himself for the amount of the excess debt. The entry was purportedly part of the section 351 transaction, but it was not made until five months after the debt assumption.

In similar cases, the Service and the courts have ruled that a transferor like Sol must recognize gain under section 357(c), notwithstanding the transferor's promise to pay to the corporation an amount equal to the excess debt.⁸ The Tax Court in *Lessinger* dispatched Sol's arguments summarily on the basis of its earlier decisions, observing that either (1) his obligation should be ignored as artificial and not a true asset of the corporation or (2) the obligation was "property" transferred to the corporation under section 351 but had a zero basis and therefore did not reduce the imbalance of debt assumed in excess of basis in property transferred.⁹

The Second Circuit reversed. It did not say that Sol had a basis for his obligation. It did not deny that the corporation assumed Sol's debt.

services-performer, usually without incurring cost. See *Raich v. Commissioner*, 46 T.C. 604, 610 (1966) (holding that a cash method taxpayer has no basis in his services or accounts receivable therefor), overruled on other grounds by *Focht v. Commissioner*, 68 T.C. 223 (1977).

6. A transferor has control for purposes of § 351 if, immediately after the transfer, the transferor (alone or together with others making contemporaneous transfers of property in exchange for stock) owns stock of the corporation carrying 80% of the voting power and also owns 80% of each class of nonvoting stock. IRC §§ 351(a), 368(c).

7. IRC §§ 358(a), (d); 362(a).

8. *Smith v. Commissioner*, 84 T.C. 889 (1985), aff'd, 805 F.2d 1073 (D.C. Cir. 1986); *Christopher v. Commissioner*, 48 T.C. Memo (CCH) 663, T.C. Memo (P-H) ¶ 84,394 (1984); *Alderman v. Commissioner*, 55 T.C. 662 (1971); Rev. Rul. 68-629, 1968-2 C.B. 154.

9. *Lessinger v. Commissioner*, 85 T.C. 824 (1985), rev'd, 872 F.2d 519 (1989).

Rather, the court employed a more novel theory: By assuming debts in exchange for Sol's obligation, the corporation incurred a cost and thereby acquired a basis (apparently under section 1012) in the obligation equal to its face amount. Finding that to be the basis referred to in section 357(c), the court concluded that the corporation did not assume debt in excess of its basis for the transferred property.

As virtually all commentators have pointed out,¹⁰ the Second Circuit's analysis is surely incorrect. The section 357(c) debt-over-basis comparison refers to Sol's basis for the property, not to a cost basis obtained by the corporation. The corporation could obtain a cost basis for the obligation under section 1012 only if the obligation's transfer were excluded from the section 351 exchange; under section 362(a), the corporation takes a carryover of the shareholder's basis, not a cost basis, for property received in a section 351 exchange. Presumably, the obligation could be outside the section 351 exchange only if it is not "property" to which that section applies. But, if the obligation is excluded from the section 351 exchange, it is also excluded from the section 357(c) debt-over-basis computation because that computation includes only the basis of property transferred in the section 351 exchange.¹¹ Thus, even if one believes that the nonrecognition result in *Lessinger* is desirable on policy grounds, it requires a better justification than the Second Circuit provided. As discussed below, the view that Sol had basis in his own obligation is not a better justification.

The result in *Lessinger* may be reasonable. In substance, the corporation did not assume the excess debts *if* Sol's obligation is recognized as bona fide and *if* it is netted against his debt nominally assumed by the corporation. However, the result probably is not permitted under the statute because the corporation *did* assume Sol's debts, and netting is not justified because Sol did not prove that he intended to remain liable for the excess debts. In the absence of such proof, Sol's obligation should be disregarded for purposes of section 357(c); it is not "property," with or without basis, and it does not reduce the amount of debts assumed or to which transferred property is subject.

On different and stronger facts, shareholders whose actions better reflect an intent to remain liable on their debts should be able to escape section 357(c) gain recognition, without relying on either the Second Circuit's dubious approach or the equally dubious theory that an obligation has basis in the obligor's hands. The sounder justification for a taxpayer victory in such cases would be proof that there has been no debt assumption and no transfer

10. See, e.g., John A. Bogdanski, *Closely Held Corporations: Shareholder Debt, Corporate Debt: Lessons from Leavitt and Lessinger*, 16 J. Corp. Tax'n 348, 352 (1990) (labeling the Second Circuit's reasoning "preposterous").

11. IRC § 357(c)(1).

subject to debt because the shareholders are found to have a continuing obligation to pay their debts.

The broader issue of how a transferor's obligation should generally be treated under section 351 (regardless of whether section 357(c) applies) is particularly confused. The Service and the Tax Court indicate (but without a bold display of confidence) that the obligation is section 351 "property."¹² That is an erroneous analysis, which only accidentally happens to produce some results that are defensible under the following analysis (such as no immediate basis in stock on account of the transferor's obligation).

Characterizing the obligation as property diverts attention from a preferable characterization: a purchase money obligation. The principal implication of the latter characterization is that it provides a section 1012 cost basis for the stock acquired in exchange for it unless it is considered contingent. If it is contingent, the obligation represents an open transaction for which treatment as section 351 "property" may be a serviceable proxy, so long as we understand that proxy's limitations. While the justification for treating the obligation as contingent is not clear cut, this treatment is far more satisfying than the zero-basis-property approach.

II. IS THE *LESSINGER* RESULT DESIRABLE AS A MATTER OF POLICY?

Does the *Lessinger* result frustrate the purposes of section 357(c)?¹³ It does not *if* one treats the transferor's obligation as undoing the debt assumption and *if* one ignores the administrative difficulties of determining whether related party transactions are bona fide. The abuses at which section

12. Cf. *Gemini Twin Fund III v. Commissioner*, 62 T.C. Memo (CCH) 104, T.C. Memo (P-H) ¶ 91,315 (1991) (assuming that a partner's contribution was "property" and calling it "only a contractual obligation").

13. The Fleming and Brewer articles, *supra* note 2, reflect a general lack of sympathy for the goals of § 357(c). This is even clearer in Professor Fleming's earlier article, *The Highly Avoidable Section 357(c): A Case Study in Traps for the Unwary and Some Positive Thoughts About Negative Basis*, 16 J. of Corp. L. 1 (1990). While § 357(c) may be a trap for the unwary, that is hardly grounds to repeal it; as Brewer noted, much of the code can be similarly characterized.

Fleming argues that if § 357(c) is aimed at loan recapture it operates improperly because it does not require recognition of the entire loan amount but only the part that exceeds basis. He does not understand why the transferor's basis should protect him from taxation on a loan that the corporation will repay. However, when property is sold subject to a mortgage, gain is realized only to the extent the sum of the mortgage and any other consideration received by the seller exceeds the property's basis. In other words, in the case of a sale, as under § 357(c), the original exclusion of the loan proceeds from income is reversed only to the extent the mortgage is not covered by basis. In any event, I will not go further here in defending § 357(c) except to illustrate in the text the classic abuses that it is or should be intended to curb.

357(c) aims probably do not exist if the parties intend that the transferor will pay the debt that the corporation nominally assumes or takes property subject to. The Second Circuit and many of the commentators apparently agree.

Although the reasons for its enactment are unclear,¹⁴ section 357(c) can be viewed as aimed at two abuses.¹⁵ Those abuses are illustrated below, together with an analysis of how the addition of the transferor's obligation can ameliorate the abuses.

Pre-transfer borrowing abuse: Transferor *T* borrows and pockets \$75. Shortly thereafter, *T* transfers property worth \$100, basis of \$50, to newly formed *X* Corp. in exchange for all of the *X* stock and *X*'s assumption of the \$75 debt, from which *T* is released. These transactions reach the same economic results as if *T* had incorporated the property unencumbered and the \$75 had been borrowed by *X* and distributed to *T*. In the latter case, if *X* has no earnings and profits for its first taxable year, \$50 of the distribution would be characterized by section 301(c)(2) as a return of basis, and \$25 would be gain to *T* under section 301(c)(3). Under section 357(c), *T* gets the same result in the original illustration.¹⁶

In the distribution alternative, if *T* also issues a note to *X* promising to pay \$25, it appears that \$25 of the corporation's payment to *T* is a loan, and the corporation has distributed only \$50, reducing *T*'s stock basis to zero.¹⁷ If *T*'s note is worth \$25, the stock should be worth \$50, and the \$50 of gain that *T* avoided

14. The early legislative history is not illuminating. S. Rep. No. 1622, 83d Cong., 2d Sess. 270 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4908.

15. See S. Rep. No. 1263, 95th Cong., 2d Sess. 183-84 (1978), reprinted in 1978 U.S.C.C.A.N. 6761, 6946 (confirming the dual aim of § 357(c)); *Wiebusch v. Commissioner*, 59 T.C. 777, 781 (stating that § 357(c) is intended to recapture depreciation or tax-free cash), *aff'd*, 487 F.2d 515 (8th Cir. 1973).

16. Section 357(b) could apply instead if the debt assumption were found to have no bona fide business purpose. When § 357(b) applies, the transferor is deemed to receive money equal to the debt assumed. In the example, § 357(b) would cause *T* to recognize gain of \$50 (lesser of the realized gain of \$50 or the boot deemed received of \$75). It might seem that § 357(c) is inappropriately less harsh on the transferor. The difference in treatment can be explained by (1) the lack of business purpose causing the exchange to be subject to § 357(b), (2) the aim of § 357(b) to reverse § 357(a) and thus to treat the entire debt assumption as cash, and (3) the view that § 357(c) is partly aimed at avoiding negative basis plus recognition of the minimum amount of gain required by the rationale of *Commissioner v. Tufts*, 461 U.S. 300 (1983). See Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 3.06[4][a] n. 138 (6th ed. 1994). Furthermore, § 357(c) can require gain recognition where § 357(b) could not: when there is no gain realized on the property disposition but the debt assumed still exceeds the basis of property transferred.

17. Cf. Regs. § 1.301-1(j) (providing partial distribution treatment for sale to shareholder at less than fair market value).

recognizing on the incorporation is deferred but not escaped. The *Lessinger* decision reaches that result. In effect, *T* remains liable on \$25 of his original \$75 debt and, arguably, only \$50 should be considered assumed by the corporation.

Pre-transfer depreciation abuse: *T* buys depreciable property for \$100, paying \$25 in cash and issuing a purchase money note for \$75. After taking \$50 of depreciation, *T* transfers the property to newly formed *X* Corp. in exchange for all of the *X* stock, and *X* assumes *T*'s debt of \$75, from which *T* is released. *T*'s depreciation was determined from a basis of \$100 on the presumption that *T* would eventually pay \$100 for the property. The transfer contradicts the presumption by shifting the debt to *X*, and the amount by which the depreciation of \$50 exceeds *T*'s actual investment of \$25 should be recaptured as income to *T*.¹⁸ Section 357(c) accomplishes this recapture, and *T* takes the stock with a zero basis.

If, in addition to the property, *T* gives to *X* a note by which *T* promises to pay \$25, *T* should arguably not recognize \$25 of gain because *X* will pay only \$50 of *T*'s debt. In effect, *T* remains liable on \$25 of his original \$75 note, and *T*'s presumed investment (\$25 already paid and \$25 to be paid on the note) does not exceed the depreciation allowed.

These examples show that Congress either was, or reasonably could have been, concerned with *T* effectively receiving cash from the corporation without the recognition that normally attends distributions or with *T* enjoying deductions without ever paying for them in cash or by gain recognition. *T*'s eventual recognition of this gain could have been arranged by providing a negative basis of \$25 for the stock received, but Congress chose not to permit that deferral, probably for either fiscal or administrative reasons.¹⁹

As shown above, the targeted abuses can disappear if *T* remains liable for part of the debt. *T* has merely obtained a continued deferral of his gain, at the price of his continued promise to pay. Similarly, the Second Circuit evidently did not believe that Sol had benefitted economically by the corporation's debt assumption; instead of being relieved of debt, Sol remained liable, albeit to a different creditor.

18. See *Crane v. Commissioner*, 331 U.S. 1 (1947) (holding that debt to which a buyer took subject was included in the seller's amount realized because the debt was included in the seller's basis in determining depreciation for prior years).

19. See generally George Cooper, *Negative Basis*, 75 Harv. L. Rev. 1352, 1358-60 (1962) (discussing the legislative history of § 357(c)).

If Sol's obligation was bona fide, the Second Circuit surely was right in principle because Sol was simply taking advantage of the rule that the proceeds of borrowing are not income.²⁰ The borrowing was either Sol's original borrowing of cash or his original purchase money forbearance. That the creditor changed (or Sol became also liable to his corporation) should not change the substance of his borrowing.

Some commentators have defended the government's contrary view as based on a reasonable concern about the bona fides of obligations such as Sol's.²¹ However, the concern seems inapt because these obligations are simply a subset of shareholder-to-corporation liabilities generally. Every controlling shareholder of every corporation in America can borrow most of the corporate cash on any day of the year by the simple expedient of giving a note (and usually by just creating a book receivable, as Sol did). Such loans are occasionally reclassified as distributions, but the government audits for them, and the cases are replete with both government and taxpayer victories.²² The government has not attacked the abuses by taxing all shareholder loans as distributions.²³

There is a troubling difference between a loan to a shareholder and a substitution of the controlled corporation for an outside creditor. In the reported cases under section 357(c), it does not appear that the obligation given by the transferor had any business purpose,²⁴ aside from a desire to tidy up the corporate balance sheet. The normal shareholder loan is at least designed to get the cash.

Compounding this aura of tax avoidance (by deferral) is the fact that the issuance of the transferor's obligation seems suspiciously inconsistent with other parts of the transaction, thus possibly supporting a particular

20. See Rev. Rul. 72-2, 1972-1 C.B. 19, 20. See generally *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (defining income as an accession to wealth). See also *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983) (discussing whether loan proceeds are gross income); *Brewer II*, *supra* note 2, at 1619 (dismissing the *Tufts* discussion of loan proceeds as dictum); Deborah A. Geier, *Tufts* and the Evolution of Debt-Discharge Theory, 1 Fla. Tax Rev. 115, 124-25 (1992) (noting that the treatment of the nonrecourse loan as a "true loan" that was not recognized as income upon receipt is the foundation of the *Tufts* opinion).

21. See, e.g., Elliott Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 Tax L. Rev. 159, 193-97 (1984).

22. See Bittker & Eustice, *supra* note 16, at ¶ 8.05[6].

23. See Babette B. Barton, *Economic Fables/Tax-Related Foibles: On the "Cost" of Promissory Notes, Guarantees, Contingent Liabilities and Nonrecourse Loans*, 45 Tax. L. Rev. 471, 481 (1990).

24. Cf. Rev. Rul. 55-36, 1955-1 C.B. 340 (imposing a business purpose requirement on § 351 exchanges). However, possible business purposes might include avoiding bifurcating liability for debts that should be assumed by the corporation upon incorporation of a going business. See Part IV.C.5 below.

concern about whether the obligation will be paid. For example, Sol caused his corporation to affirmatively assume his debts. Why would he have done that if the parties intended that he retain the liability? Why shift Sol's liability to the corporation, refocusing the outside creditor on the corporation?

An obvious answer is that Sol wanted the corporation to pay the debts in the future without causing a constructive distribution to Sol.²⁵ If the transferor is obligated to and does reimburse the corporation not later than when the corporation pays the creditor, perhaps there is no economic benefit to the transferor, but the terms of the transferors' obligations in the reported cases have not closely mirrored the outside debt. For example, the book entry in *Lessinger* did not specify a time at which Sol was required to pay the corporation. The suspicion is that an uncircumscribed extension of liability for Sol has been arranged.

For another suspicious example, the transferor might not cause the corporation to assume debt, but the corporation might take the transferred property subject to debt, which the transferor attempts to offset by issuing a note. As discussed in Part IV.C below, even the Tax Court should rule for the transferor if the transaction is structured as a wrapped mortgage, wherein the transferor remains contractually obligated to pay the outside lender and does so. Aside from the paperwork, why would the transferor not use the wrap-around debt format if his intent is to pay the debt? The cases have not involved a transferor properly documenting and paying a wrapped mortgage; rather, transferors have shifted creditors, exchanging an arms length lender for a related lender that can be expected to be kinder and gentler.

These concerns loom larger if the *Lessinger* result is justified by a theory that accords basis to an obligation in the obligor's hands. As illustrated in Part III below, that theory is contrary to normal tax logic.

The focus of section 357(c) is to snare debt assumed or taken subject to in amounts exceeding the basis of the transferred property. The proper balancing of these concerns with the true economics of the cases should therefore cause taxpayers to try more accurately to distinguish debts that are assumed or taken subject to from debts with respect to which transferor retains liability. There are ways, not so heavily freighted with a tax avoidance aura, by which shareholders such as Sol can avoid section 357(c) recognition, albeit by turning square corners in proving that their debts have not been assumed or taken subject to.

Thus, the result reached by the Second Circuit in *Lessinger* accords with good tax policy if one believes the transfer of Sol's obligation proved

25. See Bittker & Eustice, *supra* note 16, at ¶ 3.06[2]. Instead, the tax detriment to Sol (future income recognition) was accomplished by the stock basis reduction that attended the initial debt assumption. See IRC § 358(d)(1).

the corporation did not assume his debts. But the corporation did assume Sol's debts, and the Tax Court properly expressed serious doubts about the bona fides of the account receivable from Sol. Thus, the *Lessinger* case does not involve a zero basis hoax so much as a failure of proof.

III. WHAT HAS ZERO BASIS TO DO WITH *LESSINGER*?

A. *Zero Basis Has Nothing to do With the Correct Answer in Lessinger*

Zero basis should play no role in the analysis under section 357(c) of a transferor's obligation. The *Lessinger* result, if justifiable, should flow from the fundamental rule that Sol can borrow without realization because he is obligated to repay the debt, not because Sol had a basis in his own obligation. It is true that the section 357(c) gain would disappear *if* Sol's obligation were treated as property for purposes of section 351 and *if* it were accorded basis equal to its face amount. As discussed in section B below, according basis to Sol's obligation in Sol's hands is tax-illogical.

There is, however, a kernel of truth at the core of the anti-zero basis argument: The issuance of an obligation in exchange for property normally produces basis in the property equal to the amount of the obligation.²⁶ Perhaps, that result should obtain even when the obligation is given at the same time as a section 351 exchange, as discussed in Part V below. But this approach would not prevent section 357(c) gain recognition.

Assume *T* issues a \$50 note to a wholly owned corporation, and simultaneously transfers to the corporation land worth \$100, subject to debt of \$50 and having a basis of \$25; *T* receives in exchange 100 shares of the corporation's stock. If one half of the stock is deemed received for the land and the other half for the note, *T* might have a cost basis of \$50 for the latter shares. If so, the exchange of the note for these shares cannot be governed by sections 351 and 358, which do not provide a cost basis in stock, but must be governed by section 1012. Thus, under this approach, the obligation is not section 351 "property," and the exchange of the note for stock is not part of the section 351 exchange, which consists of the exchange of the land, subject to the debt, for the other 50 shares. In the section 351 exchange, the debt assumed (\$50) exceeds the basis of the transferred property (\$25) by \$25, which section 357(c) requires that transferor recognize as gain.

26. See, e.g., Brewer, *supra* note 2, at 460. However, the basis acquired for purchase money debt may not equal the debt's face amount if the debt carries original issue discount.

B. *Zero Basis is Correct if the Obligation is Section 351 Property*

Because the section 357(c) problem is not solved by treating the transferor's obligation as given in a purchase transaction yielding a cost basis in stock under section 1012, as illustrated in section A above, some have agreed with the tentative position of the Service and the Tax Court that the obligation should be viewed as "property" for section 351 purposes.²⁷ They disagree with the position that the obligation has a zero basis and argue that the obligation has its own positive cost basis to the obligor. The argument goes that (1) the obligor incurs a cost in obligating himself to pay,²⁸ (2) this cost is reflected in the basis acquired in property bought for debt, and (3) the obligation must therefore have basis to the obligor (as evidenced by the lack of section 1001 gain recognition by the obligor on issuing an obligation). Each step of this proof is faulty.²⁹

The view that the obligation is property in the obligor's hands, the sale or other disposition of which produces section 1001 gain or loss, has been rebuffed in a definitive 1984 article by Professor Manning.³⁰ Instead, as shown in Part V below, the normal role of the issuance of an obligation is not as a property disposition but as evidence of section 1012 cost. In the section 357(c) context, Manning proposes viewing the obligation as an open purchase transaction that will provide stock basis to the transferor when it is paid in cash.³¹ This approach seems correct and is further explained by viewing the obligation as contingent, as discussed in Part V.C below.

Even if the obligation were property in the obligor's hands, the obligor does not acquire the obligation in exchange for promising to pay it. Therefore, it cannot be said that the obligor has a section 1012 cost basis in

27. See *Alderman v. Commissioner*, 55 T.C. 662 (1971) (refraining from calling the note property, but grounding the result in its zero basis); Rev. Rul. 68-629, 1968-2 C.B. 154 (same). See also *Gemini Twin Fund III v. Commissioner*, 62 T.C. Memo (CCH) 104, 107, T.C. Memo (P-H) ¶ 91,315 (1991) (assuming for purposes of petitioner's argument that note contributed to partnership was property, but stating that it was "only a contractual obligation to the partnership"), *aff'd*, 8 F.3d 26 (9th Cir. 1993).

28. See *Barton*, *supra* note 23, at 479 (arguing that the maker's economic cost in executing a note makes zero basis therein "fallacious"). However, as explained below, *Barton's* reliance on economic cost and cash equivalence fails to explain why *Sol's* obligation should be treated as property with basis to *Sol*.

29. See *Brewer II*, *supra* note 2, at 1619 (clarifying his view that assigning basis to the transferor's obligation is only a second-best solution).

30. Manning, *supra* note 21, at 195. But see IRC § 311(b)(1)(A) ("If a corporation distributes property (other than an obligation of such corporation) . . .").

31. Manning, *supra* note 21, at 193-95. Cf. Rev. Rul. 80-235, 1980-2 C.B. 229 (indicating that basis in partnership interest increases as partner pays his note); *Jeremiah Luxemburger & Mark S. Lange*, An "Open Transaction" Analysis of Promissory Note Transactions Among Partners, Their Partnerships, and Third Persons, 8 Va. Tax Rev. 1 (1988).

the obligation.³² Furthermore, the fact that the issuance of an obligation creates basis in the property received in exchange does not mean that the obligation had basis. Rather, it means that the tax law assumes the obligation will be paid and thus allows advance (often depreciable) basis for the promise of future payment,³³ despite the normal inability of a cash method taxpayer to obtain a deduction by issuing an obligation. The only theoretically possible way for the obligation to have basis to the obligor would be for its issuance to be a taxable exchange of property for property, which it is not.³⁴

Furthermore, it is not necessary to give the obligor basis for the obligation in order to prevent the obligor from recognizing gain under section 1001 on the obligation's issuance.³⁵ Even if the obligation is treated as property exchanged for other property, there is no accession to the obligor's wealth, and thus no income, because the value received is offset by the obligation to pay.³⁶ Thus, the fundamental absence of income precludes the applicability of the gain computation rule of section 1001, which does not itself define income realization events.³⁷

32. A general principle of unadjusted basis can be stated as follows: An owner's unadjusted basis in property should equal its value when received, or the value of the property exchanged for it, which amount was or will be included in the gross income of the owner or an alter ego of the owner. See Jasper L. Cummings, Jr., *The Silent Policies of Conservation and Cloning of Tax Basis and Their Corporate Applications*, 48 *Tax L. Rev.* 113, 119-20 (1992).

33. See *Commissioner v. Tufts*, 461 U.S. 300, 307-08 (1983) ("Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property . . ."); *Mayerson v. Commissioner*, 47 T.C. 340, 352 (1966) ("The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability."), acq., 1969-2 C.B. xxiv. Cf. *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976) (holding that purchase money debt cannot be included in basis if it is not economically reasonable for the purchaser to pay the debt); *Estate of Isaacson v. Commissioner*, 860 F.2d 55 (2d Cir. 1988) (following *Franklin* and denying all depreciation deductions); *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3d Cir. 1988) (including excessive nonrecourse debt in basis up to value of property), cert. denied sub nom. *Commissioner v. Prussin*, 493 U.S. 901 (1989).

34. For example, if *T* exchanges land with a zero basis and a \$100 value for a car worth \$100, *T* recognizes the \$100 of gain built into the land. Arguably, at the moment of the transfer, the land takes a basis of \$100 to *T*, deriving from the \$100 gain recognition. In contrast, a taxpayer does not realize gain in issuing an obligation, and therefore cannot claim that giving the obligation invests it with basis, even for an instant.

35. But see *Brewer*, supra note 2, at 459.

36. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (defining income as accession to wealth); *Rev. Rul. 72-2*, 1972-1 C.B. 19 (holding that taxpayer realized no income on borrowing money).

37. See T.D. 7741, 1981-1 C.B. 430, 431 (describing the § 1001 regulations, and declining to define "disposition" as being beyond the scope of § 1001).

Most importantly, as I have argued elsewhere,³⁸ basis (here in one's obligation) cannot be created without a related income realization, immediate or deferred, either by the taxpayer or an alter ego. Basis in property acquired in exchange for a purchase money obligation does not contradict this principle because the cash needed to pay the obligation cannot be acquired without recognition of income, when the cash is received or at some earlier or later time, either by the taxpayer or an alter ego.³⁹

Arguably, if the transferor in a section 351 exchange issues an obligation offsetting debt assumed by the corporation in excess of the transferred property's basis, the transferor should not recognize section 357(c) gain, by virtue of the same sort of advance credit for anticipated future payment that a property purchaser gets in the form of basis credit. That argument has force if the transferor's obligation amounts to a debt retention that conforms with the Code's particularized requirement in section 357(c), which asks: Has the corporation assumed or taken property subject to the transferor's debts? If it has, it appears that Congress has chosen (as discussed in Part V) to bifurcate the transferor's obligation from the section 351/357 property exchange and debt assumption in order to close that transaction for section 357(c) gain recognition purposes at the time of the transfer.

IV. HOW CAN THE *LESSINGER* RESULT BE JUSTIFIED?

A. Overview

On the facts of *Lessinger*, the Code seems to require gain recognition in a situation where the Second Circuit evidently believed that no income had been realized. Section 357(c) refers to an exchange—the section 351 exchange—that the court found to have occurred. The section further refers to the property transferred in that exchange, its basis to the transferor, and the liabilities of the transferor that are assumed or taken subject to by the corporation. This statutory language seems to make no provision for an obligation issued by the transferor unless the obligation is property transferred in the exchange or the obligation reduces the liabilities assumed or to which transferred property is subject.

We already have seen that treating the obligation as property transferred in the section 351 exchange is illogical and does not eliminate the section 357(c) gain because the transferor/obligor cannot have a basis for the obligation. For section 357(c) purposes, the obligation should either be

38. See Cummings, *supra* note 32, at 119-20.

39. If the property is transferred in discharge of the obligation, the amount of the obligation is included in determining gain or loss on the transfer. See Regs. § 1.1001-2(c) ex. 7; Commissioner v. Tufts, 461 U.S. 300 (1983).

viewed as a bona fide obligation of the transferor to retain debt nominally assumed or taken subject to by the corporation or viewed as extraneous to the section 351 exchange (because it is not property). If it is viewed as a bona fide debt retention by the transferor, it can reduce the liabilities assumed or taken subject to, which can reduce the section 357(c) gain and reduce the stock basis reduction that otherwise would occur under section 358(d).

However, the alternative cash analogy justification for giving effect to a transferor's obligation is not satisfactory.

B. *The Cash Analogy*

It has been argued that "a buyer who acquires property with seller financing is effectively treated as if she had borrowed the financed amount from the seller and then paid it to the seller in cash."⁴⁰ Recharacterizing the *Lessinger* transaction in this way—as though Sol had borrowed cash from the corporation equal to the amount of his obligation and had included this cash among the property transferred to the corporation—would avoid section 357(c) by increasing the basis end of the debt-in-excess-of-basis computation by the amount of cash so deemed transferred. However, this analogy does not provide a reasoned basis for the result in *Lessinger*.⁴¹

The issuance of a note for property is treated for some computational and illustrative purposes like borrowing cash from the seller and paying the cash back.⁴² For example, in its often-cited decision in *Mayerson v. Commissioner*,⁴³ the Tax Court stated that a purchaser giving purchase money debt should get the same basis in the acquired property as one who borrowed from a third party in order to pay cash for property. The policy at work in *Mayerson*, however, is that debt gives basis because the law assumes it will be paid;⁴⁴ the cash analogy is a mere illustration.

Furthermore, as applied in *Lessinger*, the cash analogy runs counter to the fundamental (if sometimes conflicting) principles of integrating step transactions,⁴⁵ seeking substance over form,⁴⁶ holding taxpayers to their

40. Fleming, *supra* note 2, at 812.

41. See generally Cummings, *supra* note 32, at 143-52 (discussing and rejecting the cash analogy as used to explain certain deductions allowed to corporations on issuing their own stock). See also Brewer II, *supra* note 2, at 1617 (agreeing that the cash analogy does not provide a sound basis for the *Lessinger* result).

42. See, e.g., *Commissioner v. Tufts*, 461 U.S. 300, 312 (1983) (using an "as if cash" analogy to support a decision made on other grounds); *United States v. Hendler*, 303 U.S. 564, 566 (1938) ("Its gain was as real and substantial as if the money had been paid it and then paid over by it to its creditors.")

43. 47 T.C. 340, 349 (1966), acq., 1969-2 C.B. xxiv.

44. *Mayerson*, 47 T.C. at 349, 352.

45. See Bittker & Eustice, *supra* note 16, at ¶ 1.05[2][d].

chosen forms,⁴⁷ rejecting transitory steps (particularly in borrowing transactions),⁴⁸ and rejecting conduct not undertaken for a business purpose.⁴⁹ In fact, there was no cash; the corporation may not have had cash that it could have loaned, and Sol may not have been able to borrow from another party.⁵⁰ The substance in *Lessinger* is the form: Sol promised to pay the corporation in the future.⁵¹

A variation of the cash analogy is the argument that the transferor should get the same result from issuing a note to the corporation as from borrowing the cash from a third person and contributing it to the corporation.⁵² This formulation shows that the heart of the cash analogy argument as applied to *Lessinger* is that a note should be treated the same as cash.⁵³ However, the two cases are not equivalent because in one the corporation has the cash and in the other it does not. There is, however, a possible equiva-

46. *Id.* at ¶ 1.05[2][b].

47. See *United States v. Morris & Essex R.R.*, 135 F.2d 711, 713 (2d Cir.), cert. denied, 320 U.S. 754 (1943).

48. For example, if a debtor purports to pay interest by borrowing an amount equal to the interest from the creditor and immediately paying this amount to the creditor as interest, the interest is not considered paid (and therefore is not deductible if the debtor uses the cash method of accounting) because the borrowing and payment change the form of the interest obligation without changing its substance. See *Rubnitz v. Commissioner*, 67 T.C. 621, 629 (1977).

49. See 1 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 4.3.5 (2d ed. 1990).

50. Cf. *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148 (1974) (refusing to treat a corporation's issuance of \$50 bonds for its stock (worth \$33) as if the corporation had sold the \$50 bonds for \$33 cash and used the cash to buy the stock, saying that this recharacterization "would require rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred").

51. A classic case in which the Supreme Court rejected the cash analogy is *Helvering v. Price*, 309 U.S. 409 (1940). A cash method taxpayer, who had made good on a guarantee by giving his note, deducted the note amount as a loss. The Fourth Circuit sustained the deduction, reasoning that giving the note was equivalent to borrowing and using the borrowed funds to pay cash and stating that transactions having identical business results should not have divergent tax treatment. *Price v. Commissioner*, 106 F.2d 336 (4th Cir. 1939), rev'd, 309 U.S. 409 (1940). The Supreme Court disagreed, properly so because such divergence does exist. "Deductions are regularly allowed for business expenses paid with borrowed funds, provided the funds are not borrowed from the person to whom payment is made . . ." 4 Bittker & Lokken, *supra* note 49, at ¶ 105.3.4, p. 105-60. See also *Don E. Williams Co. v. Commissioner*, 429 U.S. 569 (1977) (holding that giving a note to a qualified plan was not payment).

52. See Fleming, *supra* note 2.

53. Fleming, *supra* note 13, at 14 (describing the difference as "economically insignificant").

lence: that in both cases the corporation has not assumed Sol's debt, as discussed below.

C. *The Proper Justification*

1. *Overview.*—The correct analysis of *Lessinger* is that the transferor's obligation is not property for purposes of section 351 and that the obligation (or, more importantly, some more convincing contractual arrangement) is relevant to the section 357(c) computation *only* if it reduces the transferor's liabilities assumed or taken subject to.⁵⁴ If one piece of paper says the transferred property is subject to a \$100 liability of Sol Lessinger and another piece of paper says that Sol will pay that \$100 liability, there is in substance no debt assumption or taking of property subject to debt if Sol's obligation is bona fide. The important question is how to identify the cases to which this approach should apply. The most common fact patterns are described below.

2. *Transferor, who is personally liable on the debt, transfers property to the corporation subject to the debt, but is not released from personal liability; the corporation does not assume the debt.*—At least one case, *Owen v. Commissioner*,⁵⁵ holds that section 357(c) requires gain recognition on these facts because the corporation received property subject to debt. The court rejected the transferor's argument that section 357(c) only applies when the transferor realizes an economic benefit from the transfer.⁵⁶ While the transferor remained liable to the outside creditors, he made no promise *to the corporation* to pay the debt.

Whether a transfer is subject to debt should not be determined so mechanically. The determination should depend on whether, in light of all of the interrelated legal obligations, the parties intend to condition the corporation's ownership on its payment of the debt as it falls due. The corporation's assumption of or taking subject to the debt is evidence that the parties intended the corporation to pay the debt, and a court should require convincing evidence to justify the contrary conclusion that they intended the transferor to pay.

In *Owen*, the court states that it is not relevant whether the transferor realizes economic benefit from the corporation's assumption of or taking subject to the transferor's debt. This idea apparently derives from *Rosen v.*

54. This possibility is mentioned in passing, but not pursued, in *Brewer*, *supra* note 2, at 459. It was first discussed in detail in *Bittker & Eustice*, *supra* note 16, at ¶ 3.06[2], [4][b].

55. 881 F.2d 832 (9th Cir. 1989), cert. denied, 493 U.S. 1070 (1990).

56. *Id.* at 835.

Commissioner,⁵⁷ which involved an assumed recourse debt to which the transferred property was *not* subject. While the transferor intended that the corporation pay the debt from the proceeds of a stock offering, the offering never occurred, and the transferor ultimately paid the debt. The Tax Court stated: "Section 357(c) may even result in the realization of a gain for tax purposes where none in fact exists. However, the petitioner did not contend, and the court is loath to find, that the result exceeds the constitutional powers to tax vested in the Congress."⁵⁸ In a footnote, the court stated that in enacting section 357(c), "the Congress intended to deal with the case where the transferor takes the deduction for depreciation on account of assets purchased with borrowed funds and the transferee repays the loan. Its effect is analogous to other recapture provisions in the Code."⁵⁹

In *Rosen*, the corporation assumed the debts, and the intention was that the corporation pay the debts. Therefore, the discussion of whether the transferor realized economic gain at the time of the section 351 exchange is dictum. Furthermore, the legislative history cited in the footnote does not support the gratuitous statement that a transfer without gain can be taxed,⁶⁰ and the footnote itself states that the "transferee repays the loan," which surely results in economic gain.

Thus, *Rosen* does not stand for the proposition that section 357(c) applies without regard to whether the transferor enjoys economic benefit. At most, it refers to the rule (not there applicable) that under *Crane* and *Tufts*, a transferor's amount realized includes even nonrecourse purchase money debt to which property is actually subject upon disposition, regardless of economic benefit to the transferor.⁶¹

Similarly, the other cases cited by *Owen* do not support disregard of economic benefit. In *Smith v. Commissioner*,⁶² the court stated that section 357(c) applies whether or not the transferor is released from personal liability. The taxpayer in *Smith* transferred property subject to nonrecourse debt but agreed with the corporation that, as between them, he would be liable for the debt. Despite the undertaking, the corporation made some of the payments on the nonrecourse debt. The court discounted the transferor's undertaking and

57. 62 T.C. 11 (1974), *aff'd*, 515 F.2d 507 (3d Cir. 1975).

58. *Id.* at 19.

59. *Id.* at 19 n.3 (cites to 1954 code leg. history omitted).

60. S. Rep. No. 1622, 83d Cong., 2d Sess. 270 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4908; H. Rep. No. 1337, 83d Cong., 2d Sess. A129 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4266.

61. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1 (1947). Phantom gain can seem to result because the seller receives neither cash nor discharge of personal liability on debt.

62. 84 T.C. 889, 909 (1985), *aff'd*, 805 F.2d 1073 (D.C. Cir. 1986).

relied instead on a literal reading of "subject to," quoting a property law text for the proposition that "[g]enerally, a transfer subject to a mortgage is an agreement that, as between the transferee and the transferor, the debt is to be satisfied out of the land."⁶³ The opinion implies that the court thought that the parties intended that the corporation pay the debt, despite the transferor's undertaking to pay, and that the transferor merely indemnified the corporation.⁶⁴

The *Smith* opinion cites *Rosen*, discussed above, and *Alderman v. Commissioner*.⁶⁵ What the *Alderman* and *Smith* cases have in common is the transferor's promise to the corporation that the transferor will pay the debt and subsequent behavior contradicting that promise.⁶⁶ The court found that the transferor in *Alderman* gave her obligation to the corporation simply for the purpose of balancing the corporate balance sheet, and that during the succeeding eight years, the corporation paid all of the debt from its own funds and the transferor failed to pay her note.⁶⁷

Beaver v. Commissioner also evidences the Tax Court's skepticism of a transferor's claim to have retained liability on debts assumed or taken subject to by the corporation.⁶⁸ The case involved a recourse debt that was secured by transferred property and presumptively assumed by the corporation. The court found no evidence to support the taxpayer's contention that the debt was not assumed by the corporation.

These cases should not be read to hold that it is irrelevant whether the transferred property is in substance subjected to the transferor's debts. They should instead be taken as determinations that these transferors did not prove that they intended to stand for their debts. In the absence of proof by the taxpayer bearing the burden of proof, the courts have let stand the presumption that the owner of property subject to debt will pay the debt.

What different facts should produce a different result? Even if transferred property is nominally subject to debt, the transferor can prevent the transfer from being considered made subject to the debt by making contractual arrangements with the outside creditor, as well as with the corporation, to pay the debt.⁶⁹ In other contexts in which tax results depend on whether

63. 84 T.C. at 909. See also *Crane v. Commissioner*, 331 U.S. 1, 14 (1947) (referring to "the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations").

64. 84 T.C. at 899, 907.

65. 55 T.C. 662 (1971). *Alderman* is cited in *Smith* at 84 T.C. 909.

66. See *Smith*, 84 T.C. at 909, n. 20 (suggesting that the outside creditor might have had a claim against the transferor, but not deciding that issue).

67. *Alderman*, 55 T.C. at 665.

68. 41 T.C. Memo (CCH) 52, 54, T.C. Memo (P-H) ¶ 80,429 (1980).

69. See generally Bittker & Eustice, *supra* note 16, at ¶ 3.06[4][b].

property is transferred subject to debt, authorities support the view that the phrase “subject to” is not to be interpreted literally to encompass every debt that nominally encumbers transferred property.⁷⁰ Parallel with that authority, a court can and should find that property transferred in a section 351 transaction is not subject to debt if all of the following conditions are met: (1) The transferor is personally liable to the outside creditor on the debts to which the transferred property is subject and does not cause the corporation to assume the debts; (2) the transferor negates any assumption that would occur presumptively under state law; and (3) the transferor affirmatively contracts with the corporation to pay directly to the creditor the debts to which the transferred property is subject and to exonerate the property from the burden of the debts, and the transferor performs that contract.

a. *Section 1001.*—Most importantly, the presumption of debt relief should be overcome if the circumstances prevent the debt from being included in the transferor’s amount realized for purposes of section 1001. This is so because section 357(c) was intended to apply only to those debts referred to in section 357(a),⁷¹ which provides that in an otherwise qualify-

70. Analogous issues arise under several provisions in addition to those discussed in the text. Section 1041(a) provides that exchanges between spouses are nontaxable and the basis of the property exchanged carries over to the spouse. Section 1041(e), added in 1986, provides that § 1041(a) does not apply when property subject to debt in excess of its basis is transferred to a trust; rather, the transferor recognizes the excess as income. The legislative history gives no clue to the intent behind § 1041(e). H. Rep. No. 426, 99th Cong. 1st Sess. 977 (1985). However, a companion amendment to § 453B(g) provides that the rule allowing installment obligations to be transferred from spouse to spouse without triggering gain recognition does not apply to a transfer to a trust. These two rules seem to reflect a view that the trust is not the spouse and simply seek to impose the normal recognition and application of § 1001. Thus, § 1041(e) does not prove that “subject to” debt must inevitably be realized by the property transferor.

Under § 956, U.S. shareholders of a controlled foreign corporation are taxed on any increase in the amount of the CFC’s undistributed earnings that is invested in U.S. property. The amount invested in property is its basis, reduced by liabilities to which it is subject. Apparently, the idea is that there has been no repatriation of the CFC’s earnings to the extent of the liabilities against the property. However, the regulations provide that the reduction is not allowed if the property is an obligation of a related person and the debt encumbering it is with recourse to the CFC. Temp. Regs. § 1.956-1(e)(5).

See also IRC § 312(c) (requiring that the reduction of corporate earnings and profits upon a distribution of property be offset by the amount of debt to which the property is subject); § 336(b) (presuming that the fair market value of property distributed in corporate liquidation is not less than the amount of any liability to which the property is subject).

71. *Focht v. Commissioner*, 68 T.C. 223, 233 (1977). See generally Douglas A. Kahn & Dale A. Oesterle, A Definition of “Liabilities” In Internal Revenue Code Section 357 and 358(d), 77 Mich. L. Rev. 461 (1975). In enacting § 357(c)(3), providing that items deductible on payment are not liabilities for purposes of § 357(c), Congress stated that it did

ing section 351 transaction, the transferee's assumption of a transferor's debts, or the taking of property subject to such debts, is generally not treated as a receipt of money or other property (boot) by the transferor. If a debt is not included in the amount realized under section 1001, it could not be subject to section 357(a) and hence should not be subject to section 357(c).

The regulations provide that the amount realized on a disposition of property includes any debt of the transferor that is "discharged" in the transaction.⁷² Moreover, "[t]he sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability)."⁷³ This sentence implies that if the other person does not agree to pay the liability, the debt is not included in the transferor's amount realized. There appears to be no authority to the contrary. Indeed, in the usual case, including the debt to which the property is subject as an amount realized would improperly double up the transferor's income. Assume *A* sells land worth \$100, subject to a \$60 recourse debt, to *B* for \$100 cash; *B* does not agree to pay the debt. If the debt were treated as discharged for purposes of section 1001, *A* would realize \$160. Clearly, *A* should be treated as realizing only \$100.⁷⁴

The application of this rule to a section 351 exchange is inherently more difficult because of the control relationship between transferor and transferee. Assume transferor *T* transfers land worth \$100, subject to a \$60 recourse debt, to newly organized *X Corp.* in exchange for *X* stock; the corporation does not agree to pay the debt. Whether the stock is worth \$100 depends on who is intended to pay the debt. This factual question cannot be answered from the objective facts of the case because the corporation does not pay a defined amount for the land. This difficulty of knowing whether debt to which the property is subject enters into the transferor's amount realized probably is the implicit reason why the Tax Court and the Service

not thereby limit the meaning of "liabilities" under § 357(a). S. Rep. No. 1263, 95th Cong., 2d Sess. 183, 185 (1978), reprinted in 1978 U.S.C.C.A.N. 6946, 6948. This statement is not inconsistent the view that "liabilities" should generally mean the same thing under § 357(a) and (c), but it probably reflects an intent to retain the greatest possible breadth for the nonrecognition rule of § 357(a).

72. Regs. § 1.1001-2(a).

73. Regs. § 1.1001-2(a)(4)(ii).

74. See Regs. § 15a.453-1(b)(3)(ii) (avoiding double counting in the wraparound mortgage case by giving the seller a basis in the wraparound mortgage that reflects the deemed assumed wrapped debt); *Stonecrest Corp. v. Commissioner*, 24 T.C. 659, 667-68 (1955) (applying § 453 to a wraparound mortgage and observing that the circumstance of controlling importance is whether the wrapped mortgage was considered in determining the purchase price), nonacq., 1956-2 C.B. 11.

in effect have adopted a presumption against the transferor in cases like *Lessinger*.

b. *Section 453*.—The next most important analogy is the treatment of wraparound mortgages in installment sales. A wraparound mortgage is a mortgage given by a buyer in exchange for property that is already subject to a mortgage. The seller agrees to pay the pre-existing wrapped debt, so that the buyer is not called on to pay twice. For example, property worth \$1,000, subject to a mortgage of \$400, might be sold for \$200 down and the buyer's wraparound note for \$800, with the parties agreeing that the seller will pay the wrapped mortgage as it comes due.

The installment sales regulations, like section 357(c), use the phrase "subject to." The gain reportable by an installment seller on receipt of an installment payment is the amount of the payment, multiplied by the "gross profit ratio," which is the ratio of the "gross profit" to the "total contract price."⁷⁵ The "gross profit" is the excess of the "selling price" over the seller's adjusted basis for the property.⁷⁶ The "selling price" includes any mortgage on the property, "whether assumed or taken subject to by the buyer."⁷⁷ The "total contract price" (the denominator of the gross profit ratio) is the selling price, reduced by most indebtedness "assumed or taken subject to by the buyer," except that the reduction for indebtedness cannot exceed the seller's adjusted basis for the property.⁷⁸

In applying these rules, the Tax Court has stated that the customary meaning of the phrase "subject to" excludes debt to which property is nominally subject but that the transferor agrees to pay.⁷⁹ The Court rejected an inflexible definition:

While in a sense every sale of mortgaged property is subject to a mortgage since the property remains liable to have the mortgage debt satisfied from it, we think the expression was used in the regulation in its customary meaning, to define the [actual as contrasted with the nominal] obligations of the

75. Regs. § 15a.453-1(b)(2)(i).

76. Regs. § 15a.453-1(b)(2)(v).

77. Regs. § 15a.453-1(b)(2)(ii).

78. Regs. § 15a.453-1(b)(2)(iii), (iv).

79. *Stonecrest*, 24 T.C. at 667 ("The expression means that the buyer has no personal obligation to pay the mortgage debt; that, as between seller and buyer, the seller has no obligation to pay the debt; and that the debt is to be satisfied from the property.").

parties to a sale of property with respect to the mortgage debt.⁸⁰

The Tax Court followed the Supreme Court's directive that the customary meanings of words used in the Code usually govern.⁸¹ The same customary meaning of "subject to" should also apply under section 357(c).

In *Professional Equities, Inc. v. Commissioner*,⁸² a decision in which the Service subsequently acquiesced, the Tax Court held that wrapped debt should not be treated as assumed or taken subject to for purposes of determining the total contract price if the following conditions exist: The seller must contract with the buyer to remain liable on the wrapped debt, the buyer must rely solely on that promise for protection from the wrapped debt and must agree to pay the full purchase price to the seller, and the buyer must not serve as an agent for payment of the outside debt.⁸³ The Court found "no justification for reducing the sales price by the amount of any underlying mortgage in determining the 'contract price' in the denominator, since the buyer neither 'assumed' the underlying mortgage nor took 'subject' to it—the only circumstances set forth in the regulations for any such extraordinary reduction."⁸⁴ Further, "[t]he seller in a wraparound sale receives neither

80. *Id.* at 668. See *Voight v. Commissioner*, 68 T.C. 99, 111 n.6 (1977) (observing that a statement in the conveyance that the property is "subject to" debt is not dispositive for tax purposes).

81. *Stonecrest*, 24 T.C. at 666 (citing *Crane v. Commissioner*, 331 U.S. 1, 6 (1947)).

82. 89 T.C. 165 (1987) (holding Regs. § 15a.453-1(b)(3)(ii) invalid as inconsistent with § 453), acq., 1988-2 C.B. 1.

In *Professional Equities*, the court stated that where the seller's wrapped debt exceeds the property's basis, it might be reasonable to treat the excess as payment in the year of sale. 89 T.C. at 178 n.17. This statement has no application to the *Lessinger* scenario, but rather refers to the typical wraparound mortgage case where the buyer is giving debt that replicates the wrapped debt but is not being treated as payment in the year for installment sale purposes.

83. See *Republic Petroleum Corp. v. United States*, 613 F.2d 518 (5th Cir. 1980) (holding that buyer's payments on the wrapped debt were evidence of intent to assume); *Goodman v. Commissioner*, 74 T.C. 684, 713-14 (1980) (holding that the buyer took the property subject to the wrapped mortgage because it was obligated to make payments on the purported wraparound mortgage to a bank that applied part of the payment to the wrapped mortgage), aff'd without published opinion, 673 F.2d 1332 (7th Cir. 1981); *Voight v. Commissioner*, 68 T.C. 99, 113 (1977) (holding that the purchaser assumed a wrapped mortgage where it was intended to pay the wrapped debt directly to the outside creditor), aff'd, 614 F.2d 94 (5th Cir. 1980).

84. *Professional Equities*, 89 T.C. at 171. The opinion in *Stonecrest* contains extensive discussion of why the property should not be considered sold subject to the wrapped debt.

'current payment nor the practical benefit of current payment of the underlying debt.'⁸⁵

The Tax Court, in dictum in a footnote of a memorandum opinion, has rejected the analogy between section 357(c) and wraparound mortgages under section 453 on the ground that the latter merely deals with timing and not the amount of income.⁸⁶ This argument is unpersuasive. In both contexts, the question involves the meaning of the phrase "subject to," and the normal meaning should apply in both cases.⁸⁷ Furthermore, a crucial element of the wraparound mortgage treatment is that the seller/transferor's amount realized does not include both the wraparound mortgage and the wrapped mortgage.⁸⁸

c. *Section 752(c)*.—Another analogous provision, section 752(c), provides that in determining whether a partner's liabilities have increased or decreased, a liability to which property is subject shall be considered as a liability of the owner of the property. An increase in a partner's share of partnership liabilities is treated as a contribution to the partnership by the partner, and a decrease in liability share is treated as a distribution by the partnership to the partner.⁸⁹

Where a partner transfers property to a partnership subject to debt but (as among the partnership and the partners) remains ultimately responsible for paying the debt, the partnership is deemed to make a distribution to the partner in the amount of the debt, and the partner is deemed to make an equal contribution, with the result that there is no net contribution or distribution.⁹⁰ Where a partnership transfers property subject to debt to a person who is not a partner but retains liability for the debt, there is no authority on whether the transaction should have the effect of reducing partnership liability and causing

85. *Professional Equities*, 89 T.C. at 179 (quoting *Hunt v. Commissioner*, 80 T.C. 1126, 1142-43 (1983)). See also Regs. § 1.1274-5(c) (providing that for purposes of the OID rules a wraparound mortgage is not treated as an assumption).

86. *Owen v. Commissioner*, 53 T.C. Memo (CCH) 1480, 1484 n.19, T.C. Memo (P-H) ¶ 87,375 (1987).

87. In *United Pac. Corp. v. Commissioner*, 39 T.C. 721, 728 (1963), the court states: Respondent argues that "the purchaser can realistically be regarded as having assumed the mortgage on the property at the time of the sale for Federal tax purposes regardless of recitals in the agreements." In the absence of any compelling reasons, we cannot accept this invitation to "realism" which involves a distortion of the agreement of the parties, and which also ignores the established distinctions in real property law in this area which were pointed out in the *Stonecrest* case.

88. See *Hunt v. Commissioner*, 80 T.C. 1126, 1144 (1983) (stating that even the Commissioner presumably would not require multiple recognition of the same gain).

89. IRC § 752(a), (b); Regs. § 1.752-1(b), (c).

90. Regs. § 1.752-1(g).

a deemed distribution to partners. However, the leading commentators have stated that no reduction should occur if, under section 453, the property would not be treated as transferred subject to the debt.⁹¹

d. *Section 1031(d)*.—A final Code analogy involves section 1031, under which a taxpayer can exchange property for property of like kind without recognition of gain or loss and with a carryover of the basis of the exchanged property to the acquired property. Under section 1031(d), “where as part of the consideration” in a like kind exchange the other party acquires the taxpayer’s property subject to debt, the debt amount is treated as money received (boot), and the taxpayer recognizes gain equal to the lesser of the boot or the gain inherent in the exchanged property.⁹² The Service has ruled, however, that a taxpayer can avoid having the debt amount treated as boot by issuing a note to the other party to the exchange for the amount of the debt to which the transferred property is subject.⁹³ In so ruling, the Service necessarily determined that the note offset the debt, eliminating it from the “subject to” category, and that the other party did not in substance assume the burden of the debt.

3. *Transferor is personally liable and remains personally liable; the corporation assumes the debt*.—These appear to have been the facts in *Alderman, Lessinger, and Rosen*.⁹⁴ Also, because of a presumption under the laws of some states that such assumption automatically occurs on the incorporation of a proprietorship or partnership, several other reported cases involve the same facts.⁹⁵ Normally, the most reasonable conclusion is that the parties intended the most recent undertaking (by the corporation) to be controlling as between them, particularly if the creditors were informed of the assumption.

91. William S. McKee, et al., *Federal Taxation of Partnerships and Partners* ¶ 7.01[2] (2d ed. 1990).

92. If the property received in the exchange is also subject to a mortgage, the mortgages are usually netted, and the taxpayer is treated as receiving or giving boot equal to the net decrease or net increase in mortgage liability resulting from the exchange. Regs. § 1.1031(d)-1(c).

93. Rev. Rul. 79-44, 1979-1 C.B. 265.

94. *Alderman v. Commissioner*, 55 T.C. 662 (1971); *Lessinger v. Commissioner*, 85 T.C. 824, 837 n.8 (1985), rev’d, 872 F.2d 519 (2d Cir. 1989); *Rosen v. Commissioner*, 62 T.C. 11 (1974), aff’d, 515 F.2d 507 (3d Cir. 1975).

95. *Christopher v. Commissioner*, 48 T.C. Memo (CCH) 663, T.C. Memo (P-H) ¶ 84,394 (1984) (Oklahoma law presumes that the successor of an unincorporated entity assumes the entity’s debt); *Beaver v. Commissioner*, 41 T.C. Memo (CCH) 52, 54, T.C. Memo (P-H) ¶ 80,429 (1980) (Ohio law presumes that liabilities follow incorporated assets).

Sol Lessinger attempted to reverse the corporate assumption by creating a book receivable. The Tax Court found for the government on two grounds: that Sol's obligation had a zero basis—the ground that has received the most notoriety—but also that the receivable from Sol was too artificial to warrant recognition for tax purposes. The court found that under state law, the corporation's assumption of Sol's debts occurred five months before the entry of a simple "loan-receivable-SL" on the corporate books. Sol did not execute a note or pay any interest. According to the court, the entry did not create a "bona fide asset of the corporation."⁹⁶

On facts as dubious as those in *Lessinger*, courts have found that purported borrowings by shareholders from their corporations were dividends.⁹⁷ Similarly, *Lessinger* at the Tax Court level should be viewed as a failure of proof that Sol retained the liability. The facts were somewhat better for the taxpayer in *Alderman* because the transferor gave a written note.⁹⁸ However, although the corporation paid the creditors, the transferor failed to service the note for at least eight years after the exchange, providing ample basis for the Tax Court's refusal to give effect to the note.⁹⁹

Perhaps, a court would find for the taxpayer on facts involving a tightly documented arrangement whereby the corporation formally assumes the debt for some valid business reason but the transferor contracts with the corporation to actually pay the debt as it becomes due and does so, as discussed in Part IV.C.5 below. The cumbersomeness of such a scheme belies its wisdom as well as its bona fides. The corporation should not assume the debt if the parties intend that transferor will pay it.

4. *Transferor is not personally liable but the transferred property is subject to a debt.*—Section 357(c) appears to apply to this case also because the normal presumption is that the corporation will pay the debt to which the property is subject.¹⁰⁰ However, the transferor could probably avoid section

96. *Lessinger*, 85 T.C. at 837 n.8.

97. See generally Bittker & Eustice, *supra* note 16, at ¶ 8.05[6].

98. *Alderman*, 55 T.C. at 662-63.

99. *Alderman* is the fountainhead of the Tax Court's view that a transferor's obligation should be treated like zero basis property under § 357(c). Its authority is somewhat undermined by the fact that it relied on the Tax Court's earlier decision in *Raich* for the proposition that § 357(c) should be literally interpreted. *Id.* at 665 (quoting *Raich v. Commissioner*, 46 T.C. 604, 608 (1966)). The Tax Court subsequently reversed *Raich* in *Focht*, adopting a nonliteral interpretation excluding from the scope of "liabilities" the payables of a cash method transferor. *Focht v. Commissioner*, 68 T.C. 223, 229 (1977), acq., 1980-2 C.B. 1.

100. *Smith v. Commissioner*, 84 T.C. 889 (1985), *aff'd*, 805 F.2d 1073 (D.C. Cir. 1986). See also *Crane v. Commissioner*, 331 U.S. 1, 14 (1947) (stating that the owner of property mortgaged at less than its value will treat the liability as his own).

357(c) by contracting with the corporation to pay the creditor, as in the wraparound mortgage case under section 453.

The case that came closest to addressing this issue was *Smith*.¹⁰¹ The Tax Court took a simplistic approach to the "subject to" question, citing only the general presumption that the parties must have agreed that the nonrecourse debt was to be satisfied out of the security. It expressed doubt about the bona fides of the transferor's undertaking to pay the debt by analogizing it to the "pre-incorporation paper transaction" of the *Alderman* case.¹⁰² The court did not consider the possibility of treating the debt as a wrapped mortgage, but wraparound mortgage treatment as under section 453 was probably precluded by the facts. The court viewed the transferor's undertaking more as an indemnity than a reservation of primary liability on the debt, and the corporation actually made some of the payments on the debt. Thus, *Smith* does not preclude a different result on better facts that properly support application of the wraparound mortgage approach.

While the wraparound mortgage approach can apply to nonrecourse debt under section 453 without the seller undertaking personal liability to the outside creditor,¹⁰³ transferors in section 357(c) transactions might consider taking that additional step to stifle possible doubts about the bona fides of the retention of liability. In section 453 cases, those doubts are diminished by the existence of the wraparound mortgage itself because the amount of that mortgage usually supplies ample proof that the buyer did not also intend to pay the wrapped debt.¹⁰⁴ In section 357(c) transactions, the consideration received by the transferor is stock, not a wraparound mortgage. The same preclusive evidence might exist if the stock of the corporation has an ascertainable value apart from the debt assumption. However, where the transferee is a closely held corporation, the value of its stock is likely to depend on whether the parties intend that the corporation pay the debt, and not vice versa. Therefore, a formal assumption of the debt by the transferor to the creditor should serve the same evidentiary purpose.¹⁰⁵ Furthermore, a transferor undertaking personal liability to the outside creditor has a much

101. *Smith*, 84 T.C. at 889.

102. *Id.* at 909.

103. See *United Pac. Corp. v. Commissioner*, 39 T.C. 721 (1963).

104. See *Stonecrest Corp., v. Commissioner*, 24 T.C. 659, 667 (1955) ("It has been stated that in determining whether or not a transfer is subject to a mortgage, 'A circumstance which is usually of controlling importance in this regard is whether the mortgage was considered in adjusting the purchase price'"), nonacq., 1956-2 C.B. 10.

105. Support for this approach is found in the regulations governing partnership capital accounts, which permit a partner's capital account to be increased by the partner's assumption of a partnership debt only if the partner assumes a direct personal obligation to the outside creditor, the creditor knows it, and, as between the partner and the partnership, the partner is ultimately liable. Regs. § 1.704-1(b)(2)(iv)(c).

stronger technical argument because that moves the debt from the nonrecourse to the recourse category vis a vis the creditor,¹⁰⁶ and the discussion above concerning recourse debt should apply.¹⁰⁷

That transferors know how to take such contractual precautions (albeit too late) is evidenced by the *Owen*¹⁰⁸ and *Smith*¹⁰⁹ cases, where the shareholders attempted after the fact to create (and backdate) personal liability to the outside creditors and obtain release of security interests. Even Sol Lessinger's obligation was ultimately conveyed to the outside creditor. These transferors' problems lay not in zero basis but in their failure to prove their intent to pay.

5. *Transferor Notes*.—In the foregoing discussion, the principal technique advocated for avoiding the impact of section 357(c) is transferor retention of direct liability on debts relating to the transferred property. It is possible, in theory, for direct liability to be retained by the transferor using the corporation as the transferor's paying agent. Perhaps this approach should be permitted when there is a business purpose for using it.

For example, in many cases, the assumed debts are those of a business being incorporated in the section 351 transaction, and the transferor wants to retain liability for only the amount by which the debts exceed the basis of the transferred assets. For the transferor to retain direct liability for only such a specific amount might be very inconvenient for the transferor and the corporation if it requires, for example, that each party pay portions of particular debts. It might also be confusing to creditors who deal with the business both before and after the incorporation. An appropriate solution to

106. See *Bressi v. Commissioner*, 62 T.C. Memo (CCH) 1668, 1672, T.C. Memo (P-H) ¶ 91,651 (1991) (defining "nonrecourse" to mean that the lienor may look only to the property and cannot look to the debtor).

107. Regulations § 1.1001-2(a)(4)(i) states that the sale of property subject to nonrecourse debt discharges the transferor from the liability, which is therefore included in the amount realized on the sale. This regulation should be read no more literally than § 15a.453-1(b)(3)(ii). The regulation examples make clear that it applies the "subject to" concept. Regs. § 1.1001-2(c) exs. 2, 4, 6. If recourse debt encumbering property can be eliminated from the "subject to" category by failing to have the buyer to assume it, nonrecourse debt should have the same treatment. *Tufts* stands for the proposition that recourse and nonrecourse debt should receive the same treatment under § 1001 (although recourse debt discharge can be bifurcated between discharge of indebtedness and sale proceeds, while nonrecourse debt cannot). *Tufts v. Commissioner*, 461 U.S. 300, 311-12, reh'g denied, 463 U.S. 1215 (1983). See Marvin A. Chirelstein, *Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts* 270 (6th ed. 1991) ("In effect, borrowing with personal liability and borrowing without personal liability are to be treated alike for" purposes of § 1001).

108. *Owen v. Commissioner*, 881 F.2d 832 (9th Cir. 1989), cert. denied, 493 U.S. 1070 (1990).

109. *Smith*, 84 T.C. at 889.

these business problems may be for the transferor to make a personal promise to pay the corporation an amount equal to the excess debt and to have the corporation make all payments to the outside creditors.

Should the transferor be treated as retaining liability for the desired amount if, at the time of the incorporation, the transferor issues a note to the corporation for the amount, the note requires payments roughly parallel to the corporation's obligations under the assumed debts, and the transferor is punctilious in meeting obligations under the note? It seems harsher to deny effect to this arrangement than was the Tax Court's action in *Lessinger*. Nevertheless, it is a borderline, facts dependent case that tests the bounds of the techniques advocated above.

V. AN OBLIGATION GIVEN WITH A SECTION 351 EXCHANGE CAN BE CHARACTERIZED AS A PURCHASE MONEY OBLIGATION TO MAKE A CONTINGENT CONTRIBUTION TO CAPITAL

A. Overview

Having shown how the section 357(c) problem can be resolved without according basis to the section 351 transferor's obligation, we turn to the broader issue of the basis effects of that obligation, outside the narrow scope of section 357(c). To do so, we must focus on the difference between acquisitions of property by purchase and acquisitions in nonrecognition, substituted basis exchanges.

A purchase transaction is one in which property is acquired in a way that obtains for the purchaser a "cost" basis for the property under section 1012.¹¹⁰ A purchase can be accomplished by the acquiror paying cash, giving a purchase money obligation, exchanging property for property in a taxable transaction, or recognizing the value of the acquired property as income.¹¹¹ For example, property received as compensation for services takes a basis equal to the gross income recognized on the property's receipt (often called a tax cost basis).¹¹² Conversely, in a nonrecognition, substituted basis exchange, the basis in the acquired property is either the exchanged basis of property transferred by the taxpayer or the transferred basis of the other party to the exchange for the property received.¹¹³

We have seen above that an obligation issued by the transferor in a section 351 exchange transaction should not be considered property given in

110. See IRC § 338(h)(3) (defining purchase in this manner for purposes of the § 338 election); § 1033(a)(2)(A)(ii) (defining purchase in this manner for purposes of § 1033).

111. See generally Cummings, *supra* note 32, at 118-22.

112. Regs. § 1.83-4(b)(1).

113. See IRC § 7701(a)(42) (defining "substituted basis property").

that exchange. The alternative is to treat the obligation as a purchase money obligation. Indeed, obligations issued for stock outside section 351 are treated as purchase money obligations, as discussed below in Part V.B. When the obligation is given with a section 351 exchange, it also can and probably should be treated as given in a type of purchase in which the usual basis acquired by a purchase money obligation is deferred until payment because the obligation is viewed as contingent.

The commentators' dislike of zero basis for the transferor's obligation stems principally from the absence of purchase treatment of the transaction. Without purchase treatment, phantom gain is built into stock acquired for an obligation in a section 351 exchange, and phantom gain is also built into the obligation in the corporation's hands.¹¹⁴ Assume *T* receives 100 shares of *X* Corp. stock in exchange for *T*'s \$100 note. If the obligation is section 351 "property" with a zero basis and a value of \$100, *T* has a zero basis for the stock and will recognize \$100 of gain on selling it for \$100. *X* holds *T*'s obligation with a zero basis and will recognize \$100 of gain on factoring it for \$100.

While this double phantom gain could be eliminated by according basis to the obligation in the obligor's hands equal to the face amount, more fundamentally, this potential gain flows from the failure to treat the issuance of the obligation as a purchase. The reasons for that failure have not been made clear, and therein lies the root of most of the confusion about the *Lessinger* case.

B. *Treatment of Obligations Issued for Stock Outside Section 351*

A transferor who is not a controlling person under section 351 takes a cost basis for stock purchased in exchange for the transferor's obligation, and the corporation's basis for the obligation equals the value of the stock given.¹¹⁵ Should these purchase rules also apply when the obligation is

114. Thus, Brewer focused on problems "outside the section 357(c) context." Brewer, *supra* note 2, at 459.

115. There is little direct authority on non-351 obligation-for-stock exchanges. Under general tax principles on purchase money debt, the shareholder should take a cost basis equal to the amount of the note because there is no reason to treat newly issued stock differently from any other type of property. See *Parker v. Delaney*, 186 F.2d 455, 458 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951); *Mayerson v. Commissioner*, 47 T.C. 340, 351-52 (1966). The loss limitations, discussed *infra* Part V.C.2, necessarily imply that the stock has basis and that this basis could be deducted as a loss but for the limitations. Indirect authority appears in G.C.M. 33937 (Sept. 30, 1968), stating that an obligation to make future payments can affect the basis of stock acquired in recognition transactions.

General tax principles may be less helpful in determining the corporation's basis for the shareholder's obligation because the issuance of the stock is a nonrecognition transaction

given by a section 351 transferor?

When appreciated property is transferred in exchange for stock in a section 351 transaction, the property's basis, not its fair market value, becomes the corporation's basis for the property and the shareholder's basis for the stock received in exchange.¹¹⁶ Basis is not stepped up to include gain realized in the exchange because that gain goes unrecognized under the good graces of section 351; the section 351 nonrecognition rule justifies not treating the section 351 exchange as a purchase. However, the nonrecognition rule of section 351 is not the source of the nonrecognition enjoyed by an obligor who issues a note for value. Rather, the obligor depends on the more general rule that no gain or loss is realized upon issuance of an obligation.¹¹⁷

Consequently, there appears to be no reason inherent in the gain-or-loss deferral/carryover basis system of sections 351, 358, and 362 for denying a cost basis to a section 351 controlling transferor for stock received in exchange for the transferor's note. Furthermore, there are special rules that apply to purchases of stock by exchange of obligation that prevent certain abuses. After reviewing these loss limitation rules, we return in Part V.C below to section 351 and show that it can be viewed as precluding the normal purchase treatment of a transferor's obligation, but for another reason.

There are other rules that deny the use of a cost basis for stock acquired in exchange for an obligation, but they seem to have little pertinence to the *Lessinger* context. First, when a cash method taxpayer issues a note in a purchase of stock outside section 351, the taxpayer is not allowed to deduct a worthless stock loss on account of basis acquired with that obligation until

for the corporation. IRC § 1032. The limited authority on the issue indicates that a corporation's basis for property received in exchange for stock equals the stock's fair market value unless the stock is issued in a transaction (such as a § 351 exchange) for which special basis rules are provided. *ITT Corp. v. United States*, 963 F.2d 561 (2d Cir. 1992); *FX Sys. Corp. v. Commissioner*, 79 T.C. 957, 963 (1982); Rev. Rul. 56-100, 1956-1 C.B. 624.

Article 833 of Regulation 62 under the Revenue Act of 1921 allowed notes given for stock to be considered as tangible property of the corporation for purposes of computing "invested capital" under the excess profits tax; because increasing "invested capital" also increased a deduction based thereon, many shareholders treated their notes as invested capital. See, e.g., *Ehret Magnesia Mfg. Co. v. Lederer*, 273 F. 689 (E.D. Pa. 1921).

The paucity of authority on the consequences of purchasing stock for notes may stem from the fact that in many states, corporations were historically barred from issuing stock for notes, a limitation that has eased in recent years. See *Graves, Inc. v. Commissioner*, 202 F.2d 286 (5th Cir. 1953) (concerning a Mississippi statute that precluded the issuance of stock for debt); Model Business Corp. Act Ann. § 6.21 (1984); 4 William M. Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations* § 1599 (perm. ed. rev. vol. 1985).

116. IRC §§ 358(a), 362(a).

117. Brewer, *supra* note 2, at 460.

it is paid.¹¹⁸ However, where the stockholder uses the accrual method, worthless stock deductions have been allowed before the shareholder paid the purchase debt to the corporation.¹¹⁹

Second, the Service and the courts have rejected efforts by shareholders of S corporations to obtain additional basis in their stock by contributing their obligations to the corporations or buying more stock for their purchase money obligations.¹²⁰ The primary reason for this rejection has been that Congress requires an "investment" in the S corporation in order to support a loss deduction, and no investment is made by virtue of a shareholder's obligation, even the obligation of an accrual method shareholder.

It appears that both the stock loss cases and the S corporation loss cases ultimately derive from application to cash method taxpayers of the principle that a loss cannot be deducted until it is sustained.¹²¹ Where no net loss on stock is involved, however, as where basis simply reduces a larger amount realized, this principle apparently has not inhibited the utilization of basis acquired with a purchase money obligation. Furthermore, when stock

118. Rev. Rul. 74-80, 1974-1 C.B. 117. This rule reflects the principle of *Helvering v. Price*, 309 U.S. 409, 413 (1940), that a cash method taxpayer's issuance of a note is not payment sufficient to support a deduction (upon a guarantee, in that case); rather, the deduction is delayed until the note is paid. Courts have applied this principle to deny cash method shareholders any deduction for worthless stock bought from other shareholders for debt, until the debt is paid. See *Tams v. United States*, 33 F. Supp. 764, 770 (S.D. W.Va. 1940); *Miniger v. Denman*, 15 A.F.T.R. (P-H) 593 (N.D. Ohio 1930); *Boyer v. Commissioner*, 14 T.C. Memo (CCH) 350, T.C. Memo (P-H) ¶ 55,105 (1955); *Larkin v. Commissioner*, 46 B.T.A. 213 (1942); *Estate of Spruance v. Commissioner*, 43 B.T.A. 221, 229 (1941), acq., 1941-1 C.B. 10, rev'd on other grounds sub nom. *McKnight v. Commissioner*, 127 F.2d 572 (5th Cir. 1942).

119. *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939); G.C.M. 33937 (Sept. 30, 1968) (agreeing with *Sobel*).

120. *Perry v. Commissioner*, 54 T.C. 1293 (1970), aff'd, 27 A.F.T.R.2d (P-H) 1464 (8th Cir. 1971) (denying additional basis even if the shareholder is on the accrual method, due to the peculiar requirements of § 1374); Rev. Rul. 81-187, 1981-2 C.B. 167 (referring to the shareholder's zero basis). Cf. *Wilson v. Commissioner*, 62 T.C. Memo (CCH) 1122, T.C. Memo (P-H) ¶ 91,554 (1991) (ruling that a shareholder acquired no stock basis when another S corporation owned by him distributed to him the note of the S corporation whose losses the shareholder wanted to deduct; the note represented no additional investment); *Griffith v. Commissioner*, 56 T.C. Memo (CCH) 220, T.C. Memo (P-H) ¶ 88,445 (1988) (disregarding journal entries substituting the shareholder as creditor of the S corporation; the entries lacked economic substance); Rev. Rul. 80-236, 1980-2 C.B. 240 (collapsing the steps of a convoluted loan transaction when the shareholder made no economic advance to the S corporation and so got no basis increase). For related efforts to obtain basis by guaranteeing corporate debt, see generally James S. Eustice & Joel D. Kuntz, *Federal Income Taxation of S Corporations* ¶ 9.05[2][i] (3d ed. 1993).

121. See *Perry*, 54 T.C. at 1297. See also IRC § 165(a); Regs. § 1.165-1(b), (d)(1) ("economically genuine realizations of loss").

bought with a purchase money obligation is sold at a loss but is not worthless (obviously necessitating the seller to remain liable for the obligation and the obligation not to encumber the stock), the regulations themselves provide that a loss is sustained.¹²² Thus, it appears that the treatment of worthless stock losses is nearly "unique."¹²³

These rules relating to worthless stock losses and S corporation stock basis prevent abuses normally perceived to accompany purchase treatment of the acquisition of stock for an obligation outside section 351. Are there other issues that are peculiar to a section 351 setting?

C. Issues Peculiar to Section 351 Controlling Shareholders; Treating Transferor's Obligation as Contingent Debt

1. *Overview.*—The Service has decided that a shareholder should not be able to obtain basis by issuing an obligation to a corporation that the shareholder controls for section 351 purposes.¹²⁴ It has extended this rule to a partner's issuance of an obligation to a partnership,¹²⁵ although such an obligation can indirectly provide basis, as discussed below. The Service justifies these results on the ground that the obligation is property with a zero basis. The Tax Court has agreed.¹²⁶ We already have seen that the zero basis property rationale is illogical. Nevertheless, it well may stand because it has a literal appeal and its dangers can be planned around, as discussed in Part IV above. The intriguing question is what valid source, if any, can be found for the view that the obligations should not supply basis?

At least in the section 351 case, it must be that an obligation given to a controlled entity should not generate basis until paid (at which time basis arises under the rules for capital contributions) because the obligation is contingent on a future choice whether and when to pay the obligation. The reality of this contingency has not been examined.

2. *Section 351 Transferor.*—The Service early recognized the difficult issues attending the treatment of shareholder obligations issued in

122. Regs. § 1.1001-1(a). Cf. *Page v. Rhode Island Hosp. Trust Co.*, 88 F.2d 192 (1st Cir. 1937) (rejecting government's argument that sale of stock is sufficient to identify time of loss where substance of transaction was not purchase and sale of stock but rather was a liability of the taxpayer to his broker.)

123. G.C.M. 38003 (July 10, 1979).

124. See Rev. Rul. 68-629, 1968-2 C.B. 154 (implying this result by effectively treating the transferor's obligation as § 351 property with a zero basis).

125. Rev. Rul. 80-235, 1980-2 C.B. 229.

126. For the rule in partnership cases, see *Bussing v. Commissioner*, 88 T.C. 449, 463-64, Supplemental Opinion, 89 T.C. 1050 (1987); *Oden v. Commissioner*, 41 T.C. Memo (CCH) 1285, T.C. Memo. (P-H) ¶ 81,184 (1981), *aff'd*, 679 F.2d 885 (4th Cir. 1982).

connection with section 351 transactions. Therefore, it perhaps wisely chose to address those issues as vaguely as possible in Revenue Ruling 68-629,¹²⁷ the starting point for the Service's and Tax Court's current views on basis for obligations transferred to corporations and partnerships. That Ruling was guided by General Counsel Memorandum 33937.¹²⁸ The G.C.M. is fascinating in the concerns it reveals and the mental gymnastics it employs to reach the result that the transferor's obligation does not reduce the section 357(c) gain recognition.

The G.C.M. expressed concern about characterizing the transferor's obligation as a contract calling for future contributions to capital and about identifying the amount of stock basis acquired by transferor for his obligation. The G.C.M. implied that the obligation could be a current contribution to capital, but the authors of the G.C.M. apparently feared that characterization of the obligation as a current or future contribution to capital might somehow preclude calling the obligation "property" (with a zero basis) that was transferred as part of the section 351 transaction.

Nevertheless, neither the G.C.M. nor Revenue Ruling 68-629 calls the obligation "property." Rather, the G.C.M.'s conclusion springs from the assertion that the transferor could not obtain immediate stock basis for the obligation *because* it was given in a nonrecognition transaction. The G.C.M. acknowledged that a transferor can obtain stock basis by issuing an obligation in a recognition transaction (see section B above) or by a contribution to capital of an item in which the transferor has basis (such as the cash payment of the obligation), but asserted that *Crane*¹²⁹ did not apply to provide basis for an obligation given in a nonrecognition transaction.

The necessary implication of this assertion is that it is impossible to separate a controlling shareholder's obligation from a related section 351 exchange. Assuming that impossibility, the Service must have felt compelled to deal with the obligation within the rules for section 351 exchanges, and the only pigeonhole available was to treat the obligation as property with a zero basis. In effect, that is what Revenue Ruling 68-629 did in stating, "Since the taxpayer incurred no cost in making the note, its basis to him was zero. Therefore, the transfer of the note to the corporation did not increase the basis of the assets transferred."¹³⁰

In other contexts, contemporaneous purchase and nonrecognition transactions are given separate significance for basis purposes. For example, the regulations under section 1031 provide that the basis of property acquired

127. 1968-2 C.B. 154.

128. G.C.M. 33937 (Sept. 30, 1968).

129. *Crane v. Commissioner*, 331 U.S. 1 (1947) (confirming that basis is obtained by a purchase money obligation).

130. 1968-2 C.B. 154, 155.

in a like kind exchange is increased by any consideration given in addition to the like kind property transferred in the exchange.¹³¹ This surely means that if an obligation is given as boot in a section 1031 exchange, the obligor's basis in the property received is increased by the amount of the obligation. The fact that a like kind exchange is occurring at the same time cannot prevent the acquisition of *Crane* basis. Under the regulations, a taxpayer who pays cash boot in a like kind exchange takes a basis for the property received equal to the sum of the money and the basis of the exchanged property, and *Crane* teaches that for the purpose of determining basis, the issuance of a note is equivalent to a payment of money.

Thus, contrary to the implicit reasoning of the G.C.M., it cannot be the nonrecognition feature of the section 351 exchange that precludes purchase treatment for the obligation; basis can only be precluded by the relatedness of the parties to the obligation (usually absent from the like kind exchange). What has the relationship between obligor and obligee to do with acquiring purchase money basis? Normally, a purchase money obligation fails to produce basis in the property acquired only if the obligation is contingent.¹³² Likewise, this is the only logical ground on which the normal credit for purchase money obligations can be denied in cases under section 351. The relationship between the obligor and obligee evidently calls into question the unqualified duty of the obligor to pay. However, the government and the Tax Court not only have failed to articulate this ground, they also have failed to justify it.

Only by recognizing this ground and confronting the issue of its propriety can one assess the basis consequences that have been provided under the zero basis rubric. Obviously, the degree of contingency in section 351 cases varies widely as the facts shift from a 100% shareholder's obligation to the obligation of a 10% shareholder who happens to contribute the obligation as part of a section 351 exchange along with a controlling group of shareholders.¹³³ In view of the difficult factual issues presented, it is perhaps reasonable to presume that all section 351 transferors can give only contingent obligations to their corporations.

131. Regs. § 1.1031(d)-1(a) (referring confusingly to § 1016 rather than § 1012). Revenue Ruling 79-44, 1979-1 C.B. 265, which deals with the receipt of a note in a § 1031 exchange, does not discuss the obligor's basis.

132. See, e.g., *Albany Car Wheel Co. v. Commissioner*, 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964). The contingent debt issue has been developed in cases involving nonrecourse debt in an amount that exceeds the value of the security. E.g., *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976). The concept is also applied in the partnership area. Regs. § 1.752-2(b)(4).

133. Section 351 applies if property is transferred "by one or more persons" in exchange for stock and these persons "are in control" of the corporation immediately thereafter. See *Bittker & Eustice*, *supra* note 16, at ¶ 3.08.

That presumption may be further justified by a fear that the transferor has not added value to the corporation equal to the *Crane* basis that would result from treating the obligation's issuance as a purchase. Assume *T* transfers property to newly organized *X Corp.* in exchange for all *X* stock and the corporation's assumption of liabilities of *T* in an amount exceeding the basis of the transferred property by \$25; in an effort to avoid gain recognition under section 357(c), *T* simultaneously issues a \$25 note to the corporation. If the note is worth \$25, it increases the value of the stock by \$25, and the gain built into the transferred property is preserved in the relationship between the zero basis for the stock and the stock value. However, if the note is worth only \$15, transferor's built-in gain on the property transferred is not preserved.

Others have argued that such an obligation necessarily has full value because in corporate extremis the corporation's creditors could enforce the obligation.¹³⁴ This argument is analogous to the rule that a partner's obligation to his partnership can produce basis in his partnership interest where there is partnership debt to outside creditors who could force the partner to pay if all partnership assets become worthless, as discussed in Part V.C.3 below. While there is also the possibility of the shareholder being ultimately forced to pay, it is more likely that the obligation will languish in the corporation for years.

Should a section 351 transferor's obligation be considered bona fide because the Service can treat it as a distribution if it is not properly serviced? A corporation's loan to a shareholder is treated as a constructive distribution (dividend) to the borrower only if, when the loan is made, there is no genuine expectation of repayment (as may be evidenced by the fact that it is not serviced and collected in a reasonable commercial manner by the corporation)¹³⁵ or if the obligation is forgiven in a later year.¹³⁶ The issue of whether a shareholder loan is made with a genuine expectation of repayment is no different than whether a section 351 transferor's obligation is contingent (except for the fact that in the section 357(c) cases the purpose for the obligation was tax avoidance or deferral). Therefore, we return again to the question: Why should a controlling shareholder's obligation be viewed more skeptically in the context of a section 351 exchange than where the shareholder simply borrows money from the corporation? Logically it should not, though perhaps the following explanation provides a contrary view.

134. See Sheppard, *supra* note 2, at 1556.

135. See, e.g., *Alterman Foods, Inc. v. United States*, 505 F.2d 873 (5th Cir. 1974); *Tollefsen v. Commissioner*, 52 T.C. 671, 678 (1969); *Ackerman v. Commissioner*, 18 T.C. Memo (CCH) 715, T.C. Memo (P-H) ¶ 59,164 (1959); *Roschuni v. Commissioner*, 29 T.C. 1193 (1958); *Baird v. Commissioner*, 25 T.C. 387 (1955).

136. See *Bartel v. Commissioner*, 54 T.C. 25 (1970).

According basis to property purchased with an obligation is a triumph of substance over form. For example, a cash method buyer has paid nothing in the form required by the cash method of accounting, but, in substance, the buyer has paid by obligating himself to pay. It is a familiar concept that only unrelated parties are permitted, on occasion, to reject the form and rely on the substance of their transactions.¹³⁷ In the section 351 setting the parties are, by definition, related. Therefore, perhaps they should not be allowed to reject the form of their transactions and must be treated as if no payment is made by transfer of the obligation.

This limitation on basis acquisition is not applied to other related party acquisitions (save the partnership case, discussed below) because normally the seller recognizes gain that offsets the basis acquired by the buyer.¹³⁸ However, in the case of a corporate stock issuance, section 1032 prevents the corporation's recognition of gain or loss upon issuance of its own stock. Furthermore, as a practical matter of administration, the section 351 exchange provides an occasion when shareholder notes can and perhaps should be examined carefully because both parties are receiving generally tax-beneficial treatment.

Thus, while it is fairly clear that the section 351 transferor's obligation should be treated as an obligation given in a section 1012 purchase transaction in connection with the section 351 exchange, perhaps these various factors justify treating the obligation as contingent. If so, it is proper to use Prof. Manning's approach of treating the transferor's obligation as an open transaction wherein the transferor obtains stock basis when the obligation is paid.¹³⁹ This approach seems reasonable because it is consistent with the principle that a loss should be deductible only when sustained, with the Service's implied view that later payment of the obligation produces basis,¹⁴⁰ with the apparent treatment of contingent purchase money obligations,¹⁴¹ and with the delayed basis apparently allowed for partner obligations to partnerships.¹⁴²

137. See, e.g., *Bartels v. Birmingham*, 332 U.S. 126 (1947) (treating a party denominated by the contract as employee as an independent contractor); *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939) (treating sale-leaseback as a mortgage).

138. The recognition of a loss upon a sale to a related party can be limited. IRC § 267; *Higgins v. Smith*, 308 U.S. 473 (1940).

139. Manning, *supra* note 21, at 195.

140. G.C.M. 33937 (Sept. 30, 1968).

141. See *Albany Car Wheel Co. v. Commissioner*, 40 T.C. 831, 841 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964) (stating, in dicta, that payments on contingent obligations may be taken into account when accrued).

142. See *Bussing v. Commissioner*, 88 T.C. 449, 463-64 (1987); Rev. Rul. 80-235, 1980-2 C.B. 229.

In view of the fact that the treatment of later payment of contingent obligations has not been fully worked out,¹⁴³ it is not surprising that the Service has guided the matter into the relatively safe (but ill-fitting) harbor of zero basis property under section 351. It might be said that the fit is "close enough for government work"¹⁴⁴ if it is made clear that later payment of the obligation produces stock basis and that the corporation is protected from unsuspected gain on the obligation.

As to the treatment of the corporation holding the transferor's obligation, contrary to the fears of the Second Circuit in *Lessinger*,¹⁴⁵ the phantom gain concerns should be manageable. If the obligation is viewed as a contingent promise to make a capital contribution, sections 118 and 1032 should protect the corporation from recognizing income on collecting the obligation. While the corporation might recognize gain in the unlikely event that it sells the obligation,¹⁴⁶ the Service may provide relief, as it has in the cases of parent stock received by a subsidiary in a triangular reorganization and used by the subsidiary in compensating employees.¹⁴⁷

Though it might be too complicated to effectuate, the proper view is that at the time of factoring, the previously contingent capital contribution has been made certain due to the substitution of the independent creditor. The partnership capital account regulations adopt this approach to account for contributed obligations.¹⁴⁸ As a result, not only should the shareholder then acquire basis in that amount, but the corporation should then obtain basis in the obligation in that amount, and should recognize gain or loss only to the extent the amount realized differs from the amount of the note.¹⁴⁹ This

143. See 2 Bittker & Lokken, *supra* note 49, at ¶ 41.2.2; Alfred O. Youngwood, *The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions*, 44 *Tax Law.* 765 (1991). The scant authority in the corporate area includes *Whiting v. Commissioner*, 47 T.C. Memo (CCH) 1334, T.C. Memo (P-H) ¶ 84,142 (1984) (holding that a reduction in the amount of shareholders' unpaid subscription did not produce discharge of indebtedness income).

144. *Associated Industries of Missouri v. Lohman*, 114 S. Ct. 1815, 1820 (1994) (citing a dissenting state court judge's characterization of the majority's reasoning).

145. *Lessinger v. Commissioner*, 872 F.2d 519, 525 (2d Cir. 1989).

146. This eventuality is not entirely speculative, as evidenced by Rev. Rul. 74-80, 1974-1 C.B. 117, involving such factoring.

147. Rev. Rul. 57-278, 1957-1 C.B. 124 (involving a triangular C reorganization in which the parent contributed its stock to a subsidiary which transferred the stock to the target for its property; if the stock had been treated as property other than the subsidiary's stock under the normal rules, the subsidiary would have recognized gain upon its exchange for value); Rev. Rul. 80-76, 1980-1 C.B. 15 (involving a parent that directly owned at least 80% of the vote and value of the subsidiary's stock and stating that no gain is recognized upon transfer of the parent's stock "[b]ecause section 83 applies").

148. Regs. § 1.704-1(b)(2)(iv)(d)(2).

149. Cf. Prop. Regs. § 1.453-1(f)(3)(ii) (basis step-up to corporation delayed until transferor reports boot gain under § 453). See generally *Cummings*, *supra* note 32, for the view

approximates the result that would follow if the corporation simply were given basis in the obligation upon its receipt equal to the value of the stock issued, which presumably would equal the value of the obligation. However, that approach is not consistent with the tax logic of the corporate entity; the corporation should derive basis in property acquired from a shareholder (controlling or not) only to the extent the shareholder also obtains basis in the corporation's stock.¹⁵⁰

However, if the transferor's obligation is in such form as to reduce the amount of debt assumed or taken subject to for purposes of section 357(c), as discussed in Part IV, the obligation cannot also be treated as a contingent purchase money obligation. Rather, it simply reduces the reduction of stock basis that otherwise would be caused by section 358(d). The note should not be an independently transferable asset of the corporation, any more than is the installment seller's duty to pay the wrapped mortgage. Therefore, its basis to the corporation should be irrelevant.

3. *Partner Transferor.*—The foregoing has proposed that the section 351 transferor's obligation should perform one of two functions: (1) reduce the amount of debt assumed or taken subject to by the corporation or (2) serve as a shareholder's contingent obligation to make a capital contribution. How do these functions match up with analogous situations in the partnership area, where the basis rules are defined in more detail? They match up surprisingly well, so long as the fundamental differences between corporations and partnerships are observed.

The Service and the Tax Court have imported into the partnership area the zero basis property approach applied to section 351 transactions, holding that a partner's issuance of an obligation to a partnership does not directly produce basis in the partner's partnership interest.¹⁵¹ This, however, is not the end of the basis story.

The obligation can indirectly increase the basis of the partner's interest through the rule of section 752(a), which treats a partner's assumption of partnership recourse debt as a contribution of money by the partner. Under section 722, the basis of the partner's interest is increased by a contribution of money. If the partnership is indebted to outside creditors (or owns property

that the corporation clones the shareholders' basis; thus when the shareholder obtains basis, the corporation should do likewise. See also Luxemburger & Lange, *supra* note 31, at 10-11 (recommending the same results for a partnership's factoring of a contributed obligation).

150. The "basis cloning" policy is fully developed in Cummings, *supra* note 32, at 126-41.

151. See, e.g., Rev. Rul. 80-235, 1980-2 C.B. 229; Bussing v. Commissioner, 88 T.C. 449, supplemental opinion, 89 T.C. 1050 (1987); Oden v. Commissioner, 41 T.C. Memo (CCH) 1285, T.C. Memo (P-H) ¶ 81,184 (1981), *aff'd*, 679 F. 2d 885 (4th Cir. 1982).

that is subject to debt), the partner's obligation may increase the basis of the partner's partnership interest basis through sections 752(a) and 722. Assume one of several general partners issues a note to the partnership, and the partnership borrows money from an outside creditor secured in part by a pledge of the partner's note. To the extent of the amount of the note, the partner shoulders the "economic risk of loss" with respect to that outside debt because the partner may be required to pay the note in order to repay the loan. The partner is therefore treated as contributing money to the partnership in that amount.¹⁵² In contrast, a partner's issuance of a note to the partnership does not increase the partner's economic risk of loss if no legal arrangement, such as a pledge to an outside creditor, makes the partner ultimately liable to pay the note without right of contribution from other partners.¹⁵³

The example of a partner note pledged to secure a partnership debt might appear to be similar to the facts of the *Lessinger* case, and the basis result might appear to support the Second Circuit's result. In the partnership example, the partner's obligation to pay the pledged note is not considered so contingent as to prevent the acquisition of basis, despite the many and very real contingencies that may protect the partner from having to come out of pocket. For example, the partnership might pay its debt from other funds and not demand payment of the partner's note. Does the partnership example therefore prove that the approach suggested above for section 351 cases is wrong?

It does not. Because the partnership is viewed as an aggregation of its partners for many tax purposes, the partner's obligation should be viewed as no more contingent than is, for example, a property purchaser's obligation to pay purchase money debt. That the debt may be repaid from future income from the property, rather than from other funds of the purchaser, is not relevant to the basis arising from the purchase money obligation.¹⁵⁴ Similar-

152. See Regs. § 1.752-2; William S. McKee, et al., *Federal Taxation of Partnerships and Partners* ¶ 8.03[6] ex. 10 (2d ed. 1990); see also Regs. § 1.752-1(g) ex. (where partner remains liable on recourse debt to which contributed property is subject, and partnership does not assume the debt, the debt has no impact on the partner's basis in his partnership interest because the subject-to-debt is offset by the partner's debt assumption).

153. See Regs. § 1.752-2(h)(2), (4).

154. Cf. *Pritchett v. Commissioner*, 85 T.C. 580 (1985) reviewed, rev'd in part and remanded in part, 827 F.2d 644 (9th Cir. 1987) (the Tax Court called a limited partner's obligation to make an additional capital contribution "contingent" for purposes of determining the partner's amount "at risk" because the use of partnership income to pay partnership debt might preclude a capital call). The Tax Court has retreated from its position in *Pritchett*. See *Bennion v. Commissioner*, 88 T.C. 684 (1987); *Melvin v. Commissioner*, 88 T.C. 63 (1987); *Gefen v. Commissioner*, 87 T.C. 1471 (1986). Commentators have noted that no partner could be at risk with respect to partnership recourse liability if the *Pritchett* decision's reasoning is correct. McKee, et al., *supra* note 153, at ¶ 10.06[2][b].

ly, in the partnership example, that partnership debt may be paid from partnership income, rather than by enforcing the contributing partner's note, does not preclude the issuance of the note from creating basis.

A corporation, in contrast, is not an aggregate of its shareholders for tax purposes. Corporate debt is not the debt of shareholders, much to the relief of shareholders. Furthermore, there is no mechanism by which a shareholder's obligation to the corporation could produce a fluctuating basis in the stock as can occur under the partnership basis rules of section 752, which can result in continuous adjustment of outside basis as inside partnership debt fluctuates.

The insulation of shareholders from liability on corporate debt is modified by a special contractual arrangement whereby a shareholder retains liability on debt that otherwise would have become corporate debt. These arrangements that future Sol Lessingers might make were discussed in Part IV above. Absent such an arrangement, the section 351 transferor is in the same posture as the partner who issues a note to a partnership that owes no outside debt with respect to which the partner has the economic risk of loss. In both cases, the obligation should be viewed as contingent if it is not to give rise to basis.

In one sense, this contingency is more easily presumed in the controlling shareholder case than in the partnership case because, under section 721, a control relationship is not a condition of nonrecognition for a transfer of property by a partner in exchange for a partnership interest. On the other hand, a partner can obtain basis in his partnership interest by indirect liability for partnership debt to outsiders who can be expected to enforce their rights as arms length creditors; where such creditors and such liability are absent, why should the partnership be expected to enforce a partner's contribution of his obligation? In such case, the partner's obligation also may properly be presumed to be contingent.

VI. LEGISLATIVE OR ADMINISTRATIVE SOLUTIONS?

A legislative solution for the *Lessinger* problem could be pursued, but it does not seem nearly as necessary as was the enactment of section 357(c)(3). Before its enactment in 1978, in many incorporations of cash method businesses, the transferors of zero basis accounts receivables were surprised to find themselves taxed under section 357(c) because their corporations had assumed liabilities in excess of the basis of the property transferred. Courts devised various remedies for this "trap for the unwary,"

but a legislative solution was desirable, given the volume of cases in which the trap could be sprung and the uncertainty of the judicial remedies.¹⁵⁵

The *Lessinger* problem seems both less common and less of a trap than the problem of incorporating zero basis receivables. The problem arises only where the transferor has enjoyed a benefit of the type section 357(c) is intended to recapture—a prior borrowing against the transferred property in an amount exceeding the property's basis or depreciation exceeding the taxpayer's investment in the property. As to being trapped, the transferors in the *Lessinger* and *Alderman* cases gave their obligations to the corporations after they became aware of the potential of gain recognition under section 357(c). In the case of recourse debtors transferring property subject to that debt, any concern about their being trapped is attributable to section 357(c) itself, and not to the *Lessinger* problem. Some transferors may be unwary, as when they are liable on recourse debt and do not cause the corporation to affirmatively assume the debt, but the corporation is deemed to do so under state corporate law. It is likely in most such cases that absent some other facts to the contrary, there was an intent to have the corporations pay the debts, and so the presumption is justified.

Proponents of a legislative solution would likely seek a netting of the transferor's obligation against debt assumed or taken subject to by the corporation. Such a result is questionable because it either must ignore concerns about bona fides and permit all such obligations to offset debt assumed or must define the quality of the obligation needed to be bona fide. So far, both Congress and the Treasury have been reluctant to define bona fide debt, and this seems an inappropriate place to force that issue.

A partial administrative solution seems more appropriate. The Service could begin by clarifying or augmenting Revenue Ruling 68-629 to shift the focus away from zero basis in the transferor's obligation. Instead, guidance should address the issue of when debt has been assumed or taken subject to. It could provide that for purposes of section 357(c) (and section 358(d)), there is no assumption of liabilities unless, under state law, the outside creditors could hold the corporation liable. More importantly, it should provide that where debt is not assumed but transferred property is encumbered, the property is considered not subject to debt under the same circumstances that wrapped debt is not considered taken subject to for purposes of section 453, in light of the Service's acquiescence in *Professional Equities*.¹⁵⁶

While a wrapped mortgage may be either recourse or nonrecourse for purposes of section 453, it seems that for purposes of section 357(c) the

155. See S. Rep. No. 1263, 95th Cong., 2d Sess. 183-85 (1978), reprinted in 1978 U.S.C.C.A.N. 6761, 6946-48.

156. *Professional Equities, Inc. v. Commissioner*, 89 T.C. 165 (1987), acq., 1988-2 C.B. 1.

transferor might also be required to have personal liability on the debt to the outside creditor. The reason for this added strictness is the lack of objective evidence, in the form of cash and wraparound note given by the corporation, that the corporation has paid full value for the transferred property without also intending to pay the debt.

As to the deeper basis questions attending a section 351 transferor's obligations, if transferors are not to obtain basis therefor until paid (and even the Second Circuit in *Lessinger* did not indicate otherwise), the Code ideally should declare that rule. Legislative history should base the rule on a legislative presumption of contingency of a purchase money debt. The corporation should be accorded a basis in the obligation equal to its face amount upon factoring. Lacking legislation (as Congress surely has weightier concerns, both in the Code and outside), the Treasury should be able to reach the same results by regulations.

VII. CONCLUSION

Zero basis is not a hoax, it is the truth. An obligation is not property in the maker's hands, and the maker has no basis for it. A maker obtains basis by issuing an obligation, but does not have basis in the obligation. In any event, the solution to the section 357(c) problem of transferors like Sol Lessinger lies not in supplying a jury-rigged basis to the obligation, but rather in supplying facts that better prove an intention that the transferor retained liability on his debts. The solution to the dual built-in gain problem spawned by the spurious zero basis property approach is to cast it aside and to recognize the section 351 transferor's obligation for what it must be: a purchase money obligation that is presumed to be contingent.