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THE TOO OFTEN LATE ARRIVAL OF WISDOM, OR, WHAT TO DO WITH TRADE ACCOUNTS PAYABLE AND RECEIVABLE UNDER SECTION 357(c) OF THE INTERNAL REVENUE CODE OF 1954*

I. INTRODUCTION

Another chapter has been added in the continuing struggle of the Internal Revenue Service, the United States Tax Court, law review commentators, and cash basis taxpayers to arrive at a satisfactory definition of "liabilities" as that term is used in section 357 of the Internal Revenue Code of 1954.[1] The Tax Court, in the case of *Focht v. Commissioner*,[2] has now reversed itself, in a divided opinion, and forsaken its literal interpretation of the term "liabilities" in section 357, opting instead for the holding that an obligation, to the extent that its payment would have been deductible if made by the taxpayer, shall not, for the purposes of sections 357 and 358, be treated as a liability. This article seeks to integrate the new decision with its predecessors and to evaluate the chances of success of the solution it proposes.

The problem stems from a decision by Congress to encourage business activity by deferring recognition of gain at the time of incorporation.[3] Section 351 of the 1954 Code provides that there shall be no recognition of gain or loss when property is transferred

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* "Wisdom too often never comes, and so one ought not to reject it merely because it comes late." Justice Frankfurter in Henslee v. Union Planters Bank, 335 U.S. 595, 600 (1949), as quoted by Simpson, J., in his concurring opinion in Focht v. Commissioner, 68 T.C. 223, 238 (1977), *appeal docketed*, No. 78-1118 (3d Cir. Feb. 2, 1978).

1. See chronologically, Raich v. Commissioner, 46 T.C. 604 (1966); Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972), *rev'g* 30 T.C.M. (CCH) 1124 (1971); Thatcher v. Commissioner, 61 T.C. 28 (1973), *rev'd in part and aff'd in part*, 533 F.2d 1114 (9th Cir. 1976). *See also* Rev. Rul. 69-442, 1969-2 C.B. 53, Del Cotto, *Section 357(c): Some Observations of Tax Effects to the Cash Basis Taxpayer*, 24 BUFFALO L. REV. 1 (1974); Kahn and Oesterle, *A Definition of "Liabilities" in Internal Revenue Code Sections 357 and 358(d)*, 73 MICH. L. REV. 461 (1975); Roha, *Application of Section 357(c) of the Internal Revenue Code to a Section 351 Transfer of Accounts Receivable and Payable*, 24 CATH. L. REV. 243 (1975); Note, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154 (1967).

2. 68 T.C. 223 (1977), *appeal docketed*, No. 78-1118 (3d Cir. Feb. 2, 1978).

3. The predecessor of I.R.C. § 351 is § 202(c)(3) of the Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 230. The stated purpose behind the adoption of § 202(c)(3) was the facilitation of necessary business readjustments. S. Rep. No. 275, 67 Cong., 1st Sess. 11 (1921), *reprinted in* 1939-1 C.B. (part 2) 188-89.

to a corporation solely in exchange for stock or securities, provided that the transferors of such property are in control of the corporation immediately after the exchange.[4] Section 351 further provides that if other property or money is received in addition to stock or securities, gain may be recognized, but only to the extent of the total amount of such other property or money received.[5] The question soon arose whether the assumption of liabilities of the transferor by the transferee corporation constitutes "other property or money" for the purposes of gain recognition under section 351.

The United States Supreme Court answered this question in the affirmative in the 1938 case of *United States v. Hendler*.[6] Viewing the assumption of liabilities by the transferee corporation as the constructive receipt of money by the transferor, the Supreme Court reversed the lower court holding that the taxpayer was protected because there was no actual payment of money or other property.[7] "The Hendler Company was the beneficiary of the discharge of its indebtedness. Its gain was as real and substantial as if

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4. I.R.C. § 351 reads as follows:

§ 351. Transfer to corporation controlled by transferor

(a) General rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) Receipt of property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) Special rule.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

(d) Exception.—This section shall not apply to a transfer of property to an investment company.

5. For example, if A transfers appreciated property to a corporation in an exchange that qualifies for I.R.C. § 351 treatment and in return receives stock plus a machine with a fair market value of 50 and cash of 100, then gain to A can be recognized to the extent of 150.

6. 303 U.S. 564 (1938).

7. 91 F.2d 680 (4th Cir. 1937).

the money had been paid it and then paid over by it to its creditors."[8]

Displeased with such a result, Congress immediately responded in 1939 with the passage of section 112(k) of the Internal Revenue Code of 1939,[9] which provided that assumption of a liability or receipt of property subject to a liability by the transferee corporation would not be considered as money or other property for the purpose of determining gain. The House of Representatives report specifically referred to the *Hendler* decision and urged passage of the new provision on the ground that otherwise the nonrecognition treatment of corporate reorganizations would in effect be nullified.[10] The only limitation imposed on the new rule was

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8. 303 U.S. at 566; for a detailed analysis of *Hendler*, see Surrey, *Assumption of Indebtedness in Tax-Free Exchanges*, 50 YALE L.J. 1 (1940).

9. Int. Rev. Code of 1939, Ch. 1, § 112(k), 53 Stat. 870 (Now I.R.C. § 357(a) and (b)) reads as follows:

§ 112. Recognition of gain or loss

. . . .

> (k) Assumption of Liability not recognized.—Where upon an exchange the taxpayer receives as part of the consideration property which would be permitted by subsection (b)(4) or (5) of this section to be received without the recognition of gain if it were the sole consideration, and, as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as 'other property or money' received by the taxpayer within the meaning of subsection (c), (d), or (e) of this section and shall not prevent the exchange from being within the provisions of subsection (b)(4) or (5); except that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this section, be considered as money received by the taxpayer upon the exchange.

10. H.R. Rep. No. 855, 76th Cong., 1st Sess. 19 (1939), *reprinted in* 1939-2 C.B. 518-19 which states:

> The recent Supreme Court case of United States v. Hendler (303 U.S. 564 (1938)) has been broadly interpreted to require that, if a taxpayer's liabilities are assumed by another party in what is otherwise a tax-free reorganization, gain is recognized to the extent of the assumption. In typical transactions changing the form or entity of a business it is not customary to liquidate the liabilities of the business and such liabilities are almost invariably assumed by the corporation which continues the business. Your committee therefore believes that such a broad interpretation as is indicated above will largely nullify the provisions of existing law which postpone the recognition of gain in such cases. To enable bona fide transactions of this type to be carried on without the recognition of gain, the committee has recommended section 213 of the bill.

that if a tax avoidance purpose or the absence of a bona fide business purpose could be shown, the assumed liabilities would then be treated as money received by the taxpayer on the exchange.

In 1954, section 112(k) became section 357(a) and (b). A new provision, section 357(c)[11] was added to provide a further limitation on the basic rule. Section 357(c) sets forth the following test: If the amount of the liabilities assumed plus the amount of the liabilities

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11. I.R.C. § 357 reads as follows:

§ 357. Assumption of liability

(a) General rule.—Except as provided in subsections (b) and (c), if—

(1) the taxpayer receives property which would be permitted to be received under section 351, 361, 371, or 374 without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability,

then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351, 361, 371, or 374, as the case may be.

(b) Tax avoidance purpose.—

(1) In general.—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose,

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351, 361, 371, or 374 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) Burden of Proof.—In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

(c) Liabilities in excess of basis.—

(1) In general.—In the case of an exchange—

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D),

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) Exceptions.—Paragraph (1) shall not apply to any exchange to which—

(A) subsection (b)(1) of this section applies, or

(B) section 371 or 374 applies.

to which the property is subject exceeds the total adjusted basis of the assets transferred in a section 351 exchange, then gain shall be recognized to the extent of the excess amount. On its face, section 357(c), like other provisions of the code, presents an objective test that can be mechanically applied, rather than a subjective test such as that used in section 357(b).[12]

II. The Treatment of Trade Accounts Payable and Receivable Under Section 357(c)

It soon became evident, however, that the "objective" test set forth in the new section 357(c), if applied mechanically, could result in unjust consequences. In 1966, the Tax Court decided *Raich v. Commissioner*.[13] There, for the first time, the problem of a transfer by a cash basis sole proprietorship of accounts receivable and accounts payable to a corporation under a section 351 exchange was encountered head-on. The court held that trade accounts payable should be treated as liabilities within the definition of that term in section 357(c). Therefore, because of the zero basis treatment of accounts receivable for a cash basis taxpayer[14] and the lack of other assets transferred, the test in section 357(c) yielded a substantial gain. This holding, as the *Raich* court itself was aware, might well lead to unfair results. Probably to avoid personal liability, the taxpayer changed the form of his business from that of a sole proprietorship to a corporation. That apparently simple step resulted in a significant tax liability. The court observed that "the result reached may conflict with the well-established intent of Congress to foster tax-free business reorganizations."[15] However, since the term "liabilities" was not used as a term of art or further defined when adopted, the court felt bound by its plain meaning which

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12. *See* I.R.C. § 731(a)(1), where, in the case of a partnership distribution to a partner, no gain is recognized unless the amount of money received exceeds the adjusted basis of the partner's interest in the partnership. *See also* I.R.C. § 733, which would indicate that gain is so recognized to avoid the problem of a negative basis. Section 733 provides that "in the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) . . . ." The dearth of legislative history indicating congressional intent behind adoption of I.R.C. § 357(c) will be discussed *infra* note 30 and accompanying text.

13. 46 T.C. 604 (1966).

14. Ezo Prods. Co. v. Commissioner, 37 T.C. 385 (1961). *See also* 46 T.C. at 610 where it is stated that "accounts receivable in the hands of a cash basis taxpayer have a basis of zero." (footnote omitted).

15. *Id.* at 611.

would necessarily include debts such as trade accounts payable.[16]

The Tax Court and the Internal Revenue Service continued in their course of literal interpretation but were presented with two serious setbacks. The first came in a decision handed down by the Court of Appeals for the Second Circuit, *Bongiovanni v. Commissioner*.[17] There, the court reversed a memorandum opinion of the Tax Court on the theory that the term "liabilities" as it was used in section 357(c) was not meant to include mere accounting liabilities but rather "what might be called 'tax' liabilities, *i.e.*, liens in excess of tax costs, particularly mortgages encumbering property transferred in a Section 351 transaction."[18] The Court of Appeals for the Ninth Circuit in *Thatcher v. Commissioner*[19] agreed with the result in *Bongiovanni* but disliked the ad hoc method by which it was reached. Therefore it adopted Judge Hall's dissenting opinion from the Tax Court's consideration of *Thatcher*: trade accounts payable are to be viewed as liabilities so that gain will be immediately recognized under section 357(c), but an offsetting deduction may be available when the payables are paid.[20]

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16. For an apparent stage whisper by the Internal Revenue Service to taxpayers in the predicament of Mr. Raich, *see* Rev. Rul. 69-442, 1969-2 C.B. 53 at 54 where it is stated:

> The IRS will apply section 357(c) of the Code to other situations involving similar facts [in reference to the *Raich* case] inasmuch as such section literally applies and the legislative history clearly supports the application of that section under such circumstances. However, the Service wishes to point out that the trade accounts receivable would not have a zero basis if the taxpayer had been on the accrual method of accounting prior to the transfer of the business under section 351 of the Code.

In other words, the easiest way to avoid the whole problem is to simply switch from a cash basis method of accounting to an accrual basis method of accounting and forget the definitional subtleties of "liabilities" as it is used in § 357(c). This is certainly a pragmatic approach but not of much assistance to those taxpayers who have already erred. *See* notes 32 & 44 *infra*.

17. 470 F.2d 921 (2d Cir. 1972), *rev'g* 30 T.C.M. (CCH) 1124 (1971).

18. 470 F.2d at 924.

19. 533 F.2d 1114 (9th Cir. 1976), *rev'g in part and aff'g in part* 61 T.C. 28 (1973). It should be noted that the course of literalism was not without its unwilling followers, as witnessed by the five dissents in the *Thatcher* Tax Court opinion.

20. 533 F.2d at 1117-18. Judge Hall's approach views the transfer of both the receivables and the payables to the corporation as a sale, payment of the payables representing the consideration given for the future receipt of income from the receivables. Thus, if *A* transfers 100 of receivables and 75 of payables and an asset with a basis of 20, the § 357(c) gain (liabilities assumed of 75 minus basis of assets transferred of 20) would be 55. However, as the receivables are greater in amount than the § 357(c) gain, if the transferee corporation makes actual payment of the payables in the year of the exchange, the proposed deduction would be available to offset the entire § 357(c) gain. Such an approach retains the broad meaning of "liabilities" while lessening somewhat the harsh results of the *Raich* rule.

III. THE *FOCHT* CASE

In the *Focht*[21] case the court faced the same situation encountered in *Raich*, *Bongiovanni*, and *Thatcher*: the transfer of trade accounts receivable and payable along with other assets by a cash basis taxpayer in a section 351 exchange. The zero basis of the receivables combines with the liability status of the payables to produce a gain that may be recognized under section 357(c).[22] The majority opinion in *Focht* began with a consideration of the all-inclusive Tax Court treatment of liabilities in *Raich* and *Thatcher*. It noted that more equitable results could not be reached in those cases because there was no satisfactory rationale for giving liabilities a more limited meaning. The court then turned to the methods used in *Bongiovanni* and *Thatcher* to nullify the effects of section 357(c) with respect to trade payables, concluding that "it is time for us to reconsider"[23] the question.

The nub of the majority argument, based upon the legislative history of section 357(c) and the judicial decisions surrounding it, is that section 357(c) was not meant to apply to those liabilities, the payment of which would have been deductible by the transferor.[24] The court reasoned that narrowing the definition of "liabilities" is required by the interaction of the *Hendler*[25] case, the adoption of section 112(k), and the subsequent Supreme Court case of *Crane v. Commissioner*,[26] which held that assumption of a mortgage by a buyer of real property was to be included as part of the amount realized on the exchange by the seller. In *Hendler*, the only liabilities in question were mortgage bonds. Interest and merchandise accounts, both deductible items, were ignored by the Court. Similarly, the Court in *Crane* did not consider the interest due on the mortgage and unpaid at the time of the transfer to be an amount realized by the transferor.[27] Since deductible liabilities

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21. 68 T.C. 223 (1977), *appeal docketed*, No. 78-1118 (3d Cir. Feb. 2, 1978).

22. For the exact figures in the instant case, *see id.* at 225. The total assets transferred amounted to $77,704.10, of which $42,237.10 represented accounts receivable, while the total liabilities assumed equalled $88,979, with $73,729 constituting accounts payable. The adjusted basis of the assets so transferred was $35,467. Thus, the Commissioner determined that ordinary gain under I.R.C. § 357(c) was recognized in the amount of $53,512.

23. *Id.* at 229.

24. It is interesting to note that the court indicated as general support for its new interpretation of § 357(c) the arguments developed in a law review article. *Id.* at 229 n.12 where Kahn and Oesterle, *supra* note 1, is cited.

25. 303 U.S. 564 (1938).

26. 331 U.S. 1 (1947).

27. *Id.* at 4 n.6 where the Court stated: "The Commissioner explains that only

were excluded from the amount realized in *Hendler*, and since section 112(k) was enacted in response to the *Hendler* decision, it follows that the meaning given liabilities in *Hendler* must have been incorporated into that section. The *Focht* court viewed the subsequent decision in *Crane* as a clear and approving enunciation of the principles first recognized in *Hendler*.[28]

The cornerstone of the opinion, then, is that section 112(k), now section 357(a) and (b), purposely used the term "liabilities"[29] in a restricted sense. The court next turned its attention to the lack of express legislative intent to use a broader definition when section 357(c) was adopted, interpreting this silence to mean that section 357(c), in the contemplation of Congress, was to operate only as a limitation on section 357(a). Therefore, as section 357(a) does not apply to liabilities, the payment of which would be deductible, neither should section 357(c). The court reasoned that Congress adopted section 357(c) in response to the unsatisfactory operation of the subjective test set forth in section 357(b): "[O]ne can speculate

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the principal amount, rather than the total present debt secured by the mortgage, was deemed to be a measure of the amount realized, because the difference was attributable to interest due, a deductible item."

The apparent logic of the exclusion of interest from the amount realized is that it is unnecessary because of the wash that will later result. *See* Kahn and Oesterle, *supra* note 1, at 468. If interest were included in the amount realized, that inclusion would only be offset later by the deduction allowed because of its actual payment. I.R.C. § 163.

28. "Implicit in this conclusion [that the Supreme Court in *Hendler* would have allowed the Hendler Co., the transferor, a deduction for interest paid by Borden, the transferee, on the mortgages Borden assumed] is the view that *Hendler* foreshadowed *Crane*'s exclusionary treatment of assumed deductible liabilities, an exclusion we now find incorporated into sections 357 and 358." 68 T.C. at 234 (citations omitted).

The court's reasoning appears more than a little tenuous, however, as it is based on the arguable assumption that what was more clearly stated in *Crane* (deductible liabilities are not to be treated as part of the amount received) was also inferred in *Hendler*. If it cannot be shown that *Hendler* used a special meaning of the term "liabilities," the link with the adoption of § 112(k) is broken. *Crane* was decided subsequent to the adoption of § 112(k) and its holding therefore could not have had any influence on congressional deliberations with respect to that section. The Kahn and Oesterle article, *supra* note 1, at 473, acknowledges this distinction but concludes that even if *Hendler* did not use the same reasoning as *Crane*, the *Crane* opinion by itself should be sufficient authority to so limit the definition of "liabilities."

29. It should be pointed out that the provisions of § 112(k) were adopted simultaneously with a section mandating a complimentary adjustment in basis to the stock received by the transferors in a § 351 exchange. Liabilities assumed were not to be used in determining gain but were to be included within the purview of the phrase "other property or money" for basis calculations. *See* Int. Rev. Code of 1939, Ch. 1, § 113(a), 53 Stat. 872 (now I.R.C. § 358(d)).

that Congress was dissatisfied with the operation of what is now section 357(b) (the tax-avoidance safeguard to section 357(a)) because it was too subjective and dependent upon a determination of a taxpayer's motive."[30]

The result under the majority opinion is that trade accounts payable will not be treated as liabilities for the purposes of section 357(c). Their payment would yield a resulting deduction under section 162 as a business expense. Therefore, they are not within the scope of section 357(a), as that scope is defined by legislative history and intent.

To fully appreciate the import of this decision, and its underlying rationale, an example is helpful. Assume *A* is a sole proprietorship on the cash basis method of accounting, with tangible assets of 60 (with an adjusted basis of 40), accounts receivable of 50, and accounts payable of 50. If *A* were to first liquidate the payables and receivables and then incorporate, he would realize ordinary income of 50, offset by a section 162 deduction of 50, with net income of zero. Under section 351, no gain would result upon incorporation. The pent-up gain of 20 (the appreciation of the assets from 40 to 60) would be preserved through the use of transfer basis because under section 358 the stock received by *A* would have a basis of 40 and a fair market value of 60. If *A* subsequently sold his stock, he would realize a gain of 20.

30. 68 T.C. at 235. There have been several theories advanced with respect to the legislative intent behind the adoption of § 357(c). The unworkability of the test in § 357(b) is one of them. A second theory is that illustrated by the examples used in the House and Senate committee reports and in the accompanying Treasury regulations. Such examples involve mortgages on real property in amounts greater than the adjusted basis of the lands involved. Recognition of gain on the assumption of those mortgages under § 357(c) is seen as a recapture provision for the depreciation that has been taken on the borrowed funds. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 270 (1954) *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4908; H.R. Rep. No. 1337, 83d Cong., 2d Sess. A129 (1954) *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4267; Treas. Reg. § 1.357-2(a). *See also* Del Cotto, *supra* note 1, at 6 for a discussion of the recapture theory. A third theory proposes that § 357(c) was adopted to solidify prior administrative practices into law. *See* Easson v. Commissioner, 33 T.C.963, 971 (1960), *rev'd*, 294 F.2d 653 (9th Cir. 1961); Rosen v. Commissioner, 62 T.C. 11, 19 n.3 (1974). Finally, the theory with the most adherents is that § 357(c) was enacted to avoid the possibility of a negative basis. *See* Cooper, *Negative Basis*, 75 HARV. L. REV. 1352 (1962); Commissioner v. Easson, 294 F.2d 563 (9th Cir. 1961). The *Easson* case is interesting in that the Tax Court, in applying § 112(k) of the 1939 Code in a situation subsequent to the adoption of the 1954 Code, reached the same result that would have been dictated by § 357(c) on the ground that if the excess between liabilities and basis was not taxed at that point, it might never be taxed. The court of appeals reversed, using a negative basis theory, citing Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950) (Magruder, C.J., concurring) as authority. *See* 294 F.2d at 658. *See also* note 12 *supra*.

If, however, *A* chooses to transfer the unliquidated payables and receivables to his corporation in addition to the tangible assets, far different consequences result. Prior to *Focht*, section 357(c) would dictate immediate recognition of 10 worth of gain, as the liabilities assumed (accounts payable of 50) exceed the adjusted basis of the assets transferred (tangible assets, basis 40; receivables, basis 0) by 10. The basis of the stock received by *A* would be zero. Under section 358, the basis of the stock is calculated by subtracting from the adjusted basis of the assets transferred (40) the amount of the liabilities assumed (50) and then adding the amount of the gain recognized (10). So, 40 − 50 + 10 yields the zero figure. If *A* were to then sell his stock, he would recognize a gain of 60. Thus, under the second approach, *A*'s total gain is 70, while under the first approach, it is only 20 and it is totally deferred as *A* will not even recognize the 20 gain until the stock is sold.[31] In the second situation, precisely the result that section 112(k) sought to prevent occurs. *A* is being penalized for failing to liquidate his assets and liabilities prior to incorporation. An obstacle is thus placed in the way of those who seek to make smooth business readjustments.

One clear solution to the problem posed by the above examples is to liquidate payables and receivables prior to incorporation. A change from the cash basis method of accounting to the accrual method will also avoid the extra taxation.[32] But for those who blunder ahead unknowingly, like Focht, Thatcher, and Bongiovanni, the statutory framework has now been adjusted to ameliorate the harshness of section 357(c). Under the *Focht* rule, accounts payable will not be considered as a liablity under either section 357 or section 358 and therefore no gain will be recognized under section 351. The stock received by the transferor will have a transferred basis, thus preserving the pent-up gain caused by the appreciation of tangible assets.

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31. The 70 gain figure can be seen as composed of the 20 gain from the appreciation of the assets and the 50 of income from the receivables. However, the wash that occurs if the payables and the receivables are liquidated prior to incorporation does not result in situation two because payment of the payables by the transferee corporation yields a deduction against ordinary income, not a reduction of basis. Thus, after incorporation in situation two, receipt of the receivables and payment of the payables will produce no income for the corporation, *see* note 35 *infra*, but the zero basis of the stock will at some time produce a gain of 60. *A* is recognizing the 50 amount of gain as represented by the receivables twice in situation two, once as ordinary income and a second time as gain from the sale of the stock.

32. If the taxpayer were on an accrual method of accounting, the receivables would not have a zero basis and the § 357(c) calculation would not have to be made. *See* note 16 *supra*.

However, to completely equalize the tax consequences between a pre-incorporation liquidation and a post-incorporation liquidation of accounts payable and receivable by a cash basis taxpayer, one further step has to be taken. Final resolution of the problems created by section 357(c) demands that the question of who will be credited with the income from the receivables and the deduction from the payables be answered. In the above example, the transferee corporation should realize 50 of income when the accounts receivable are collected and a corresponding deduction of 50 should result when the payables are paid. In such a way, the results of pre-incorporation and post-incorporation liquidation, as shown by the two examples above, would be identical and the unequal treament of the ill-advised cash basis taxpayer would be eliminated.

The majority opinion, however, does not attempt to decide what will occur when the payables are paid and the receivables are received. The court merely acknowledged the issue, stating that it need not decide the tax consequences to the transferee when it pays the assumed liabilities.[33] In an attempt to guide future analysis the court cited the Supreme Court case of *Magruder v. Supplee*[34] in a footnote accompanying that statement. *Magruder* held that when real property is conveyed, the grantee cannot, on the strength of the allocation of costs at the closing, deduct real estate taxes that were not assessed to her. Real estate taxes are only deductible by the party against whom they were levied. Such a reference suggests that the payment of trade accounts payable can only be deducted by the party who incurred them, *i.e.*, the transferor. Aside from upsetting the delicate balance of prior judicial and administrative treatment,[35] such an allowance would again

33. 68 T.C. at 238.

34. 316 U.S. 394 (1942). The rule of *Magruder* was subsequently modified by statute. *See* I.R.C. § 164(d) which provides for the allocation of real estate tax deductions based on the date of sale of the property.

35. *See* Thatcher v. Commissioner, 61 T.C. 28 (1973), where the Tax Court in its statement of facts noted that when the accounts payable were paid by the transferee corporation, a deduction was taken and allowed. Further, the income from the accounts receivable was also claimed by the transferee corporation. *Id.* at 31. The findings of fact were not disturbed by the circuit court of appeals in its reversal of the Tax Court. Thatcher v. Commissioner, 533 F.2d 1114, 1116 (9th Cir. 1976).

Granting both the income and the deduction to the transferee corporation in a § 351 exchange raises two serious questions: assignment of income; and the non-transferability of deductible obligations. Under assignment of income principles, where one earns income or otherwise creates the right to receive and enjoy it, that person should not be able to avoid taxation by an assignment to a mere collector or conduit. Helvering v. Horst, 311 U.S. 112 (1940). However, there are strong policy reasons in § 351 exchanges for not applying these principles. *See* Hempt Brothers, disturb the equities achieved by excluding payables from the operation of sections 357 and 358. If the deduction were allowed to the transferor and the income credited to the transferee, the wash that should result will not occur because the corporation and the sole proprietor are two separate taxpayers. To achieve tax equity between the incorporation of a cash basis sole proprietorship and an accrual basis sole proprietorship without prior liquidation of payables and receivables, both the income from the receivables and the deduction from the payables should be granted to the transferee corporation.

Two other criticisms of the majority's opinion in *Focht*, taken from Judge Hall's vigorous and sometimes caustic dissent, should also be considered.[36] First, the opinion now casts doubt on the meaning of the word "liabilities" wherever it appears in the complex framework of the Internal Revenue Code.[37] Yet, she contends, the

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Inc. v. United States, 354 F. Supp. 1172 (M.D. Pa. 1973), *aff'd*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974), where the court held that transferred accounts receivable from a partnership to a corporation should be taxable to the corporation due to the overriding purpose of § 351 to facilitate business readjustments. Moreover, assignment of income has generally been used by the Service only when a tax avoidance motivation is present. *See, e.g.*, Brown v. Commissioner, 115 F.2d 337 (2d Cir. 1940); Commissioner v. Griffiths, 103 F.2d 110 (7th Cir. 1939), *aff'd*, 308 U.S. 355 (1939); Weinberg v. Commissioner, 44 T.C. 233 (1965), *aff'd per curiam sub nom.* Commissioner v. Sugar Daddy, Inc., 386 F.2d 836 (9th Cir. 1967), *cert. denied*, 392 U.S. 928 (1968). A finding then, that accounts receivable can be credited as income to the transferee corporation in a § 351 exchange, as they were in *Thatcher*, is not inconsistent with prior case law and administrative practice of the IRS.

The non-transferability of deductible items is a harder question to resolve. There is strong authority for the proposition that when a taxpayer assumes the liabilities of another, he or she cannot subsequently deduct payments made in satisfaction of those liabilities. Magruder v. Supplee, 316 U.S. 394 (1942). See especially Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946) where the court stated that "there is no justification for a ruling that the petitioner [transferee corporation] could deduct from the gross income of its business, expenses or losses attributable to the operation of the business by its predecessor." *Id.* at 325. The non-transferability of deductible items can be viewed as a necessary corollary to the assignment of income rationale in that it is a method of preventing sham transactions with a sole motivation of tax avoidance. It follows that it is proper for a court to conclude, as was done in *Hempt Brothers*, that the overriding policy reasons behind § 351 require granting the deduction to the transferee corporation when no tax avoidance motivation is present.

36. See the enthusiastic concurring opinions of Judges Simpson and Wilbur in Focht v. Commissioner, 68 T.C. 223 (1977), *appeal docketed*, No. 78-1118 (3d Cir. Feb. 2, 1978). See quote from Judge Simpson *supra* note prior to note 1. Judge Wilbur especially waxes poetic, quoting from John Chipman Grey, Thucydides, and Santayana in applauding the retreat from literalism.

37. By her count, 400 times throughout the code. 68 T.C. at 244 (Hall, J., dissenting).

statutory history relied upon by the majority to effect such possible sweeping uncertainty is far from conclusive. Congress never specifically stated that the term "liabilities" is only to be given effect according to the terms of *Hendler* and *Crane*. That inference of legislative intent is followed by the court's assumption that "liabilities" was meant to have the same meaning in section 357(a), (b), and (c). The sub-sections, it must be remembered, were adopted fifteen years apart and in response to different situations. The plain meaning of "liabilities," as the *Raich* court recognized,[38] includes trade accounts payable; any other conclusion rests upon a stretching of clear statutory language.[39]

Second, the majority opinion, in attempting to lessen the harshness of accounting on the cash basis method, has disturbed some of the fundamental mechanics of that method. In excluding the value of assumed trade payables from the transferor's gain recognition at the time of incorporation, a deduction for payment of those payables is in effect being received at that time.[40] A basic assumption of the cash basis method is that items are not deductible until paid and income is not credited until received.

To alleviate these problems, Judge Hall urges the adoption of the solution she first proposed in her dissent in *Thatcher*: that "liabilities" should be given its natural meaning and gain recognized accordingly at the time of incorporation.[41] She would, however, allow the transferor a deduction (to the extent that section 357(c) makes the exchange taxable) on the actual payment of the liabilities involved. In this way, payables are netted against receivables with

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38. 46 T.C. 604 (1966). *See* note 16 *supra* and accompanying text.

39. In her dissent Judge Hall strenuously stated: "It has been said, with more than a grain of truth, that judges in tax cases these days tend to consult the statute only when the legislative history is ambiguous . . . . What is wrong with reading the statute?" 68 T.C. at 244.

40. Note the strict treatment of assumption of liabilities in previous cases. Rosen v. Commissioner, 62 T.C. 11 (1974), *aff'd*, 515 F.2d 503 (1975), where, even though the transferor remained personally liable on the liabilities involved, the court still held that the assumption involved was income to the transferor. *See also* Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972), *rev'g* 55 T.C. 441 (1970), for an entirely different treatment of assumption of liabilities in the dividend area. There it was held that if a corporation assumes a personal liability of a shareholder and that shareholder remains secondarily liable, a dividend will not occur until the liability is actually paid. The justification for such differing treatment is that corporate formation calls for an immediate calculation of gain, because of the attendant administrative difficulties in determining whether liabilities are ever paid, while the dividend area is more conducive to a "wait and see" approach. *See also* Rev. Rul. 77-360, 1977-42 I.R.B. 6.

41. 61 T.C. 28, 43 (1973) (Hall, J., dissenting).

only the excess being taxed, and the statutory definition of "liabilities" as it appears in sections 357 and 358 and all the other code sections is left intact.[42] This solution was later adopted by the Ninth Circuit Court of Appeals in reversing the Tax Court decision.[43]

Judge Hall's criticisms of the majority opinion are certainly well-taken. However, one must keep in mind the strong policy reasons that support the results reached by the majority opinion in *Focht*. The thrust behind section 351 and the congressional response to the *Hendler* decision is that incorporation is not a time for gain recognition unless actual money or property is received. A sole proprietorship should be able to incorporate without incurring a huge tax liability when all that is actually happening is the transfer of an ongoing business to a corporation. Judge Hall's netting process only succeeds in negating a section 357(c) gain when payables and receivables are both present in comparable amounts and when the payables are actually paid within the year of the transfer. Under the majority's treatment of "liabilities" in section 357, however, the trap for cash basis taxpayers created by the *Raich* rule is eliminated and the policy of not hampering necessary business readjustments is consequently furthered in a more far-reaching manner than that advocated by Judge Hall.

IV. Conclusion

One small anomaly in the code, the trap for cash basis taxpayers in section 357(c), has produced torrents of commentary and semantic arguments and sent armies of judges and lawyers deep into the archives to uncover a satisfactory justification for the desired result. The easiest and most workable solutions, however, still seem to be either a change from a cash basis method of accounting to an accrual method,[44] or a withholding of equal amounts of trade payables and receivables. But both of these solutions anticipate recognition of the problem before it arises. Since many taxpayers

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42. *Id.*

43. *See* note 20 *supra*.

44. *See* note 16 *supra*. A change from a cash basis method of accounting to an accrual method is at present complicated and time-consuming. *See* I.R.C. § 446 where it is provided that in order to change accounting methods, a taxpayer must secure the consent of the Internal Revenue Service. *See also* Treas. Reg. § 1.446-1(e)(3)(i) which provides that the taxpayer must file an application with the Commissioner of Internal Revenue within 180 days after the beginning of the taxable year in which it is desired to make the change.

will continue to be caught unaware, the *Focht* solution certainly goes a long way towards reaching tax equity. To completely alleviate the disparity in tax treatment between a cash basis taxpayer who liquidates accounts receivable and accounts payable before incorporation and one who does not, however, the question of who is to recognize the subsequent income and deduction from the accounts payable and accounts receivable must be answered. If both of these items are credited to the transferee corporation, in the absence of a tax avoidance motivation, total equity will be achieved in a manner consistent with the basic policy of section 351 to facilitate necessary business readjustments.[45]

Sally S. King

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45. *See* note 35 *supra*.