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Tax Notes

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NEWS ANALYSIS: READING SECTION 357(C) OUT OF THE CODE.

Don't try this at home. That's how **Robert Wood** of Steefel, Levitt & Weiss interprets the taxpayer-favorable result in Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989), in his treatise Corporate Taxation: Complete Planning and Practice Guide. The result seems right, but it also seems too good to be true since section 357(c) does not permit it. If liabilities exceed asset basis on a section 351 transfer, Wood does not advise making up the difference with a shareholder note. If one's client is in this pickle, Wood observes, then the Lessinger result is comforting.

In Lessinger, the Second Circuit held that a shareholder's open account indebtedness to his sole proprietorship should have a basis equal to the amount promised on an incorporation transfer. The court reversed the Tax Court's holding (see 85 T.C. 824 (1985)), that section 357(c) literally requires gain recognition where transferred liabilities exceed the basis of transferred assets, because the shareholder has a basis of zero in his own obligation. This article considers transfers of shareholder obligations in section 351 transactions, and advocates a negative basis for the transferee shareholder instead of immediate taxation under section 357.

The government is hoping to develop a conflict among the circuits so that the Supreme Court can consider the Lessinger result. An example of conflict is Owen v. Commissioner, 881 F.2d 832 (9th Cir. 1989), in which the shareholder retained secondary liability for purchase debt on equipment transferred to a controlled corporation. (Owen is consistent with previous decisions of the Tax Court that section 357(c) says what it says.)

Circular Reasoning

That the Second Circuit's decision in Lessinger is the right result for the wrong reasons seems to be the prevailing view outside government. Certainly it is not possible to find the court's answer from sections 357, 358 or 362. The Second Circuit viscerally did not want to tax the hapless wholesaler of nuts and bolts on the transfer of a debt to his business that was enforceable against him by his creditors. Readers will recall that the Second Circuit similarly twisted section 357(c) to avoid an unjust result for a sympathetic taxpayer in Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972), and that it took the enactment of section 357(c)(3) to clean up the mess.

When the assets and liabilities of Lessinger's accrual method sole proprietorship were transferred to his pre-existing controlled corporation, liabilities exceeded assets by some

$197,000, the difference being booked as a receivable from Lessinger. Before the transfer, Lessinger's existing controlled corporation had advanced him a large sum, in small increments, to deal with liquidity problems in his sole proprietorship. Lessinger's factors demanded that he incorporate his sole proprietorship so that usury defenses to high interest charges could be avoided. Although no interest was payable on the shareholder debt, for which there was no payment schedule or formal document, it grew to $237,000, of which $145,000 was eventually repaid. Four years after this transfer, a bank compelled Lessinger to formalize his open account indebtedness to the corporation.

A big difference between the Tax Court and Second Circuit decisions was the Tax Court's feeling that the debt might be phony and the Second Circuit's view that it was enforceable. The Second Circuit made much of the fact that Lessinger was at all times on the hook for this debt, enforceable against him by the corporation and outside creditors. [P. 1557] Under New York law, the pre-existing corporation would not have been treated as assuming Lessinger's debt unless it made an affirmative effort to do so. Despite the numerous cases holding that continuing personal liability is immaterial to the operation of section 357(c), the Second Circuit focused on it. "As an empirical matter, creditor's releases may be hard to come by in the real world; thus, this line of reasoning may well read section 357(c) out of the Code," Lewis & Clark College professor of law John Bogdanski warned. (Bogdanski, "Shareholder Debt, Corporate Debt: Lessons from Leavitt and Lessinger," 16 J. Corp. Tax'n 348 (1990).)

The Second Circuit was loathe to reject the literal application of section 357(c) outright, though it seems to have rejected the IRS argument that the maker has a zero basis in his own obligation. Instead, the appeals court resorted to a reading of section 357(c) that Bogdanski variously describes as "preposterous" and "circular." The IRS argued that the shareholder's zero basis in his note would create a section 357(c) gain in the amount of the note, which gain would become part of the corporation's basis under section 362(a). Instead, the Second Circuit decided that the basis to which section 357(c) must be referring is the holder's basis in the note, which must be equal to the face amount, so that the holder would have no income when the note was paid.

Until Lessinger, the principal case on the issue of shareholder debt and section 357(c) was Alderman v. Commissioner, 55 T.C. 662 (1971). There the taxpayer transferred all of the assets and liabilities of his sole proprietorship to a controlled corporation. Because the transferred liabilities exceeded the basis of the transferred assets by some $9,000, the taxpayer also transferred his note for some $10,000 to make up the difference and to give the corporation capital stock of $1,000. The IRS argued, as it did in Rev. Rul. 68-629, 1968-2 C.B. 154, that the taxpayer's basis in his own note was zero, and this zero basis became the corporation's basis under section 362. The Tax Court agreed, holding that the application of section 357(c) was "undisturbed" by the creation and transfer of the note. Otherwise, the court pointed out, section 357(c) would be effectively eliminated from the Code. "It would be a relatively simple matter to execute a note so that the adjusted basis [of assets] would always exceed liabilities," the court stated. (55 T.C. at 665.)

A useful comparison is Thatcher v. Commissioner, 533 F.2d 1114 (9th Cir. 1976), rev'g in part 61 T.C. 28 (1973), which involved a question that would now be governed by section

357(c)(3). The Ninth Circuit finessed the basis question by holding that accounts receivable should be valued at their face amount when transferred to a controlled corporation. The appeals court, following the lead of dissenting Tax Court Judge Hall, held that accounts receivable and accounts payable should be netted for purposes of determining section 357(c) gain. The netting was based on the notion that the transferor sold its receivables in exchange for the assumption of its liabilities. The partnership whose assets and liabilities were transferred in Thatcher was on the cash method. The Ninth Circuit's solution allowed the transferor to have a deduction for the payables that would offset the section 357(c) gain, along the lines of Pierce v. Commissioner, 326 F.2d 67 (8th Cir. 1964).

Because the Thatcher court was dealing with a cash method transferor with deductible accounts payable, it did not have to think about the basis that the transferor and the transferee should have in a receivable. Netting produces the same result as in Lessinger. As the discussion will show, Lessinger awards basis to the transferring shareholder too early.

Excess Loss Account

Section 357(c) was put in the law because Congress abhors the idea of a negative basis. (For a discussion and an argument that section 357(c) was overkill, see Cooper, "Negative Basis," 75 Harv. L. Rev. 1352 (1962).) What is wrong with a negative basis? Apparently the biggest fear in the section 351 setting is that tax on gain due to an excess of liabilities over assets will never be imposed, or will be deferred far into the future. The drafters of the Subchapter C Revision Act of 1985 suggested that section 357 be limited to debt used to purchase or operate the transferred assets. They appear to have believed that the principal abuse of section 351 would be "borrowing out," avoiding gain by mortgaging assets for an amount exceeding the transferor's basis.

The consolidated return rules allow negative basis; it is the most important feature of the investment basis adjustment rules governing an affiliated group member's basis in the stock of another member. Negative basis is a potential income item in the hands of the corporate shareholder. It is achieved under regulation section 1.1502-32(e) by creating an excess loss account in a corporate shareholder when certain items -- such as subsidiary distributions, earnings and profits deficits, net operating losses, and lower-tier negative basis adjustments -- reduce the parent's basis in the stock of the subsidiary below zero. The parent must include the excess loss account in income when it disposes of the stock of the subsidiary in any of the various ways described in regulation section 1.1502-19.

For instance, suppose a parent corporation owns all the stock of a first-tier subsidiary with a basis of $15, and the first-tier subsidiary owns all the stock of a second-tier subsidiary with a basis of $5, and the second-tier subsidiary owns all the stock of a [P. 1558] third-tier subsidiary with a basis of $10. The third-tier subsidiary has an earnings and profits deficit of $20 in year one. Under regulation section 1.1502-32(b)(2), the second-tier subsidiary reduces its basis in the stock of the third-tier subsidiary to zero, creating an excess loss account of $10. For the same reason, the first-tier subsidiary will get a zero basis in the stock of the second-tier subsidiary and an excess loss account of $15, and the parent will

reduce its basis in the stock of the first-tier subsidiary to zero and get an excess loss account of $5.

If the stock of the third-tier subsidiary becomes worthless in year two, it is considered a disposition, requiring the second-tier subsidiary to recognize its excess loss account of $10, creating $10 of earnings and profits in it. These earnings will reduce the first- tier subisidiary's excess loss account to $5. The parent's excess loss account will disappear, and it will have a positive adjustment of $5 to its basis in the stock of the first-tier subsidiary.

Allowing a shareholder of a controlled C corporation to have negative basis and requiring him to keep an account for it would result in a good deal of deferral for owners of closely held businesses, which are the majority of corporations. Owners typically die holding their stock, which then takes a stepped-up basis in the hands of their heirs under section 1014. If they sell their stock or liquidate the corporation, it happens once in a lifetime. An excess loss account concept for these businesses would be costly in terms of revenue, since section 357(c) allows the tax to be collected up front, and difficult to administer, given the government's admitted troubles auditing closely held businesses.

This is not an argument for section 357(c), but just points out that its policy -- good or bad -- resists change. Ironically, a negative basis for Lessinger might have helped the IRS. Lessinger's corporation became insolvent five years after the transfer. The IRS might invoke its section 1311 power -- oops, wrong year -- to tax Lessinger on gain from the forgiveness of the remaining unpaid portion of the shareholder debt.

Subchapter S Analogy

The concept of excess loss accounts is not too complicated for the majority of closely held corporations. Shareholders who elect subchapter S status for their corporations buy into a set of complicated basis rules. Section 1367(a)(1) requires S corporation shareholders to increase the basis in their stock by the amount of income passed through to them, as though the income had been distributed and then contributed to capital. Section 1367(a)(2) requires shareholders to reduce the basis in their stock -- but not below zero -- by their share of the corporation's deductions, losses, and distributions of previously taxed income. If the shareholder's stock basis is zero, additional basis reductions for distributions of earnings are applied against shareholder loans. Beyond that, excess losses cannot be used on the shareholder's return according to section 1366(d)(1), but can be carried forward until basis against which they can be used is restored.

Basis in their stock and debt is extremely important to shareholders of S corporations, because it determines the extent to which losses can be passed through currently under section 1366(d). Shareholder guarantees of the debt of S corporations pose questions similar to those posed by Lessinger, and the weakness of the Second Circuit's reasoning is shown by an analysis of the developments in subchapter S law. A basis increase for a shareholder guarantee of a loan to an S corporation requires an "economic outlay" on the part of the shareholder under Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983).

In Selfe v. Commissioner, 778 F.2d 769 (11th Cir. 1985), the taxpayer personally guaranteed and secured a corporate debt of her thinly capitalized S corporation, taking the position that she could raise her basis in her S corporation stock by the full amount of the debt under Plantation Patterns v. Commissioner, 462 F.2d 712 (5th Cir. 1972), cert. denied 409 U.S. 1076 (1972). The district court below agreed with the government that any basis increase should occur only when the shareholder/ guarantor is called upon to pay the corporate debt. The Eleventh Circuit reversed, holding that a basis increase is permitted where the facts show that the shareholder borrowed the funds and advanced them to the corporation. Applying a debt/equity analysis instead of an economic outlay analysis, the appeals court was willing to treat a shareholder guarantee as the equivalent of an equity investment where the lender looks to the shareholder as the primary obligor. (Don't try this at home either, Wood advises.)

The Fourth Circuit reached the opposite conclusion in Estate of Leavitt v. Commissioner, No. 88-3129 (4th Cir. 1989). The shareholders, each of whom had a $10,000 basis in the stock of an S corporation whose liabilities exceeded its assets, personally guaranteed a $300,000 loan to the corporation. The loan was formally a loan to the corporation, which made the interest and principal payments; yet the shareholders, relying on Selfe, argued that it was the equivalent of a contribution of capital on their part. Affirming the Tax Court, the Fourth Circuit saw no economic outlay by the shareholders; guarantees, unaccompanied by further acts, were not enough. Like the Tax Court, the Fourth Circuit thought a debt/equity inquiry unnecessary until the economic outlay question was resolved.

The cases can be reconciled in that the posture of Leavitt was different than that of Selfe. In Selfe, the [P. 1559] court rejected a motion for summary judgment pending a further inquiry into the facts; whereas in Leavitt, the Tax Court had made complete factual findings that did not support the taxpayer's argument. Leavitt argues for treating Lessinger's transfer of his debt as incomplete until he pays it or the corporation discharges it or sells it. Lessinger's corporation endorsed the formal note to a bank as collateral for a loan four years after the transfer. This was probably not enough to give Lessinger basis for the note under the economic outlay test. The result under this reasononing would be the same as giving Lessinger a negative basis, because any action that would give him basis under an economic outlay test also would trigger an excess loss account.

The Zero Basis Conundrum

In Lessinger, the IRS put a lot of effort into questioning the reality of the shareholder debt. There is a better way to address the same concern, which is for the government to take the shareholder's word for it that the debt is real but to give him basis for it only when affirmative action is taken. If the shareholder pays his own debt, he gets basis; if his controlled corporation pays it, he has a dividend that could be considered contributed to capital. The only problem with this method from the government's standpoint is that it does not get the tax up front.

University of Miami professor of law Elliot Manning presents a compelling argument for

delayed recognition of basis. He argues that the IRS argument that an issuer has a zero basis in its own obligations is fundamentally flawed. An issuer's own obligations should not be treated as property to the issuer, although they should always be treated as property to the holder. Rather, treatment of the issuer should depend on its relationship to the holder. Where the issuer of debt is a shareholder and the holder is a controlled corporation, Manning notes, nonpayment is a legitimate concern and the IRS' principal concern. (Manning, "The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries," 39 Tax L. Rev. 159 (1984).)

The relationship between the issuer and the holder was the root of the government's concern in Don Williams v. Commissioner, 429 U.S. 569 (1977), in which an accrual basis corporation sought to deduct a contribution made to its qualified plan in the form of a negotiable, secured, interest-bearing demand note. The IRS had conceded that a similar note from a third party would have qualified for the deduction. Justice Blackmun, writing for the majority, denied the deduction on the ground that although the note had value to the holder, which could sell it easily, it had no value to the maker. Justice Stewart, dissenting, found this reasoning absurd; absent a compelling argument for benefit security, the Court was not justified in putting an accrual method taxpayer on the cash method for this purpose. In Lessinger, the taxpayer argued that there was no rational distinction between a controlling shareholder and any other debtor of an accrual basis corporation.

Regarding the Lessinger situation, Manning would treat the shareholder's issuance of debt to a controlled corporation as an open transaction until the debt is paid or otherwise disposed. When the debt is paid, both parties should treat the payment as a contribution to the capital of the corporation. Manning finds precedent for open transaction treatment in Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972), where a corporation assumed and later paid a shareholder liability. The appeals court found that the shareholder had no income when the corporation assumed the liability, but had a dividend when the corporation discharged it. (Manning notes that Maher is wrong insofar as it states that the shareholder's secondary liability matters.)

New York University professor of law James Eustice finds the fly in this ointment. What is the transferee's basis in the shareholder note if stock basis for the shareholder is delayed? Even if the issuer's own paper is not property in his hands, it is property in the hands of the holder, who has to have a basis for it. Bogdanski points out that Manning's open transaction treatment is fine as long as the transferee corporation continues to hold the shareholder note.

But what if the transferee sells it? The transferee has to somehow become entitled to a basis equal to the face value of the note so that it will not have income on a sale or other disposition. For this reason, Bogdanski argues that given section 357(c)'s purpose of preventing negative basis the shareholder should have a cost basis equal to the face amount for the note because he has incurred a real cost in creating in the corporation a right to collect from him. Bogdanski's solution gives the shareholder basis too early. The safest course for Federal coffers -- short of retaining section 357(c) and its harsh results -- is not to give the shareholder basis for his own obligation right away.

Is there a way to get the right result in Lessinger without making a mess of the basis rules of sections 358 and 362? No -- moreover, the Don Williams decision [P. 1560] also would get in the way. It would be untenable to give the transferee a corresponding zero basis because it would have income when the debt is paid, with no corresponding increase in the shareholder's basis in his stock. Don Williams points out the dichotomy between the small cost a note has to the issuer and the great value that it has to the holder. The basis rules cannot deal with this dichotomy unless the transferee's basis is disconnected from the transferor's basis in the case of the transferor's own obligation.

The basis rules should be amended to give the shareholder who transfers liabilities exceeding assets a zero basis in his stock and an excess loss account that would be triggered by certain events. This treatment would not have to be confined to instances where the excess liabilities were attributable to shareholder debt, although the government might want to continue to apply section 357(c) to prevent "borrowing out" given the Crane rule. The transferee corporation would get a disconnected basis equal to the face amount of shareholder debt (which may have to be adjusted for discount debt, for example). This would complicate the tax code, but judicial efforts to ameliorate section 357(c) complicate the law in a less constructive way because they produce uncertainty.

-- Lee A. Sheppard

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