Dealing with Liabilities Excess of Basis Under Section 351

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Section 351 has long been one of the most used nonrecognition provisions in the Code, shielding from gain recognition asset transfers to corporations where a controlling stock interest is taken back by the transferors. In fact, the provisions of Section 351 are thought to be so easily satisfied that it is unusual to seek an advance ruling on a Section 351 transfer. And, it is fairly atypical to seek a ruling even where the Section 351 transfer is part of a larger transaction (a spinoff under Section 355 for example) that will itself be the subject of a ruling.

A transfer of appreciated assets to a corporation in exchange for the recipient corporation's stock, is

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eligible for nonrecognition treatment under Section 351 as long as the transferors of property to the corporation are in control of the corporation immediately after the transfer. One of the few traps in Section 351 relates to liabilities. Still, the fact that the transferred property is encumbered by liabilities does not deprive the transferor of tax-free treatment unless the liabilities were created on the eve of the transfer **and** the proceeds of the borrowing and the obligation to repay the loan are separated as a result of the incorporation. In that event, Section 357(b) will likely apply to treat the debt assumption as the receipt of "boot." Where boot is received in a Section 351 transaction, a transferor's realized gain is recognized in an amount not exceeding the amount of the boot.

Liabilities Assumed

Where the sum of the liabilities assumed and those to which the transferred property is subject exceed the adjusted basis of the property transferred, Section 357(c) provides that the excess is a taxable gain. This determination is made on a transferor by transferor basis. (See Rev. Rul. 66-142.) The character of the gain depends on the character of the assets transferred. A transferor may seek to avoid this unhappy result by contributing to the corporation his personal promissory note in an amount equal to the shortfall.

However, the IRS has ruled that this strategy is ineffective. See Rev. Rul. 68-629. According to the IRS, the transfer of one's note does not increase the basis of the assets conveyed to the corporation because the basis of property is its cost and a taxpayer incurs no cost in making a note.

A Note of Courage

There are indications that this somewhat harsh rule may be changing. A recent Ninth Circuit decision provides a glimmer of hope, standing in direct conflict with the IRS' approach. *Peracchi v. Commissioner*, 81 A.F.T.R.2d ¶98-654 (9th Cir. 1998) stands for the proposition that a shareholder's note (assuming it is worth approximately its face amount) has a basis equal to its face amount and can therefore mitigate a Section 357(c) gain.

In *Peracchi*, the court focused on the possibility that the transferee (the holder of the transferor's note) might go bankrupt. If this event transpired, the note would attain great significance because the presence of the note would allow the transferee's creditors to reach the personal assets of the transferor. Where the risk of bankruptcy is important enough to be recognized (the court found that Mr. Peracchi's transferee was an operating business that was subject to more than a "non-trivial" risk of bankruptcy), the transferor should get a basis in the transferred note.

The note was considered to represent a new and substantial increase in the transferor's investment in the corporation and it was entirely proper for the transferor to enjoy a basis step-up sufficient to eliminate the spectre of Section 357(c). The court found support for its approach in other parts of the law which it interpreted to mean that a shareholder's economic exposure (even though not accompanied by an economic outlay) is the ultimate measure of the shareholder's investment.

Nothing New?

Although *Peracchi v. Commissioner* has prompted a good deal of commentary, and does squarely hold that a shareholder who engages in a Section 351 exchange with his controlled corporation can avoid gain recognition under Section 357(c) by contributing his note along with encumbered property. Yet, at least one other case deserves mention. Nearly ten years ago, the Second Circuit, in a much publicized decision, had concluded that the basis to which Section 357(c) refers is the corporation's basis in the contributed note, and not the shareholder's basis in the note and his property. See *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989).

One of the factors that the court in *Peracchi* scrutinized was the real economic significance of the note. It was important to the court that the note had independent significance apart from the Section 351 exchange. Had the note from the shareholder not been given as part of a Section 351 exchange, then its potential real economic significance would justify giving the shareholder a Section 1012 cost basis in the stock received. However, if that same Section 1012 basis treatment were to apply in conjunction with a Section 351 exchange, the note could not be treated as property exchanged under Section 351.

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"Exchanged basis" (not cost basis) in stock is what is obtained in a Section 351 exchange. Thus, Section 357(c) would still apply to require recognition of any debt encumbering the property (but not including the note) in excess of the property's basis.

Treating the contribution of the note as part of a Section 351 exchange would preclude application of the normal cost basis rules. The normal view would be that a maker has no basis in his own note. This notion is cast aside in the *Peracchi* case, where the court felt strongly that a shareholder note given in a Section 351 exchange should result in a cost basis in the stock obtained. After all, this is the result that occurs when a person's promissory note is used in a purchase. The note provides basis in the purchased assets. On the other hand, one can think of circumstances in which a note does not provide basis. Thus, a partner's note will not create basis in a partnership interest. See Revenue Ruling 80-235, 1980-2 C.B. 229.

Good or Bad?

Some commentators have been highly critical of the *Peracchi* case, saying that the Ninth Circuit has created basis where there really should be none. The court has also been accused of violating the terms of Congress' pronouncements in Sections 351, 357(c) and 358. (For one criticism, see Cummings, "Ninth Circuit Avoids *Lessinger* Misstep, but Makes Another," *Tax Notes*, May 11, 1998, p. 781.)

It is not a complete answer to these complaints that Peracchi could have structured the transaction to avoid this entire controversy. As one observer pointed out, Mr. Peracchi could have contracted with the corporation to pay to the secured creditor directly the debts to which the transferred property was subject. Plus, he could have exonerated the property from the burden of the debts. This, seemingly, would have prevented the issue from arising in the first place.

Yet, not all commentators have been negative about the *Peracchi* case. In fact, some commentators have pointed out that the underpinning of the *Peracchi* case and the Ninth Circuit's decision was the genuine indebtedness of the note. The Tax Court had viewed the note as a sham. When the matter reached the Ninth Circuit, the Ninth Circuit acknowledged that Mr. Peracchi had paid imperfect attention to his obligations under the note. Still, a casual payment history did not mean that the note was not genuine. The Ninth Circuit said it was important to look at the face of the note and to consider whether Peracchi's legal obligation was illusory.

The Ninth Circuit found that it was not illusory, noting that the IRS had stipulated that:

- Peracchi was creditworthy;
- the note bore a market rate of interest and had a fixed term;
- the IRS was not arguing that the note was worth anything other than its face value;
- there was no suggestion that the corporation could not have borrowed against it or sold it to raise cash; and
- the note was fully transferable and enforceable by third parties.

From these factors, the Ninth Circuit concluded that the contribution of the note was not a bailout transaction, in which Peracchi had paid cash and transferred the economic risk of loss to lenders. Instead, he remained fully liable for $1.06 million, which surely neutralized any tax avoidance motive. Although recognizing that there was bailout potential in a circumstance such as this, the Ninth Circuit directed the IRS to look for lack of business purpose. The IRS in *Peracchi* had already stipulated that the contribution of the realty to the corporation had a business purpose. Thus, the Service was estopped to argue a lack of business purpose in order to find tax due under Section 357(b).

Interestingly, the question has been raised whether *Peracchi* applies equally to C corporations and S corporations. The *Peracchi* case involved a note contributed to a C corporation. There are suggestions in the opinion that a C corporation does not funnel losses to the shareholder, while an S corporation does. Implicitly, the scrutiny on contributed promissory notes may be greater in the S corporation context.

No Mistake

As one observer noted, for almost 30 years,

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practitioners have planned around Section 351 transfers by contributing high-basis, low-value property in order to increase the aggregate tax basis, more on a par with the debt that posed a risk of "boot" classification in the transaction. Controlling shareholders were often told to add cash to the transaction even if it had to be borrowed.

Peracchi holds that a personal note will avoid the Section 357 liability. Although it is premature to suggest that the IRS would be willing to concede the point, this is at least good news. Certainly wherever personal notes are used, their formalities and payment terms should be strictly observed if the taxpayer wants to avoid having a fight over the validity of the debt. (For discussion, see Raby and Raby, "'Sorcery' Creates Tax Basis from 'Piece of Paper,'" *Tax Notes*, May 18, 1998, p. A73.)

Read narrowly, the *Peracchi* case stands for the proposition that a transferor's note (with a value approximating face) has a cognizable basis (so its transfer can eliminate a potential Section 357(c) gain) in cases where the risk of the transferee's bankruptcy is more than remote. The practical effect of this holding: gains otherwise taxable at the time of incorporation can now be deferred until such time as the transferor disposes of the transferee's stock in which the former has a zero basis.

Accelerating Losses

Certain liabilities are entirely disregarded in determining whether a taxpayer has a prohibited excess of liabilities over asset basis. Such liabilities are those whose payment would give rise to a tax deduction. (See Section 357(c)(3).) Moreover, in Rev. Rul. 95-74, the IRS expanded the exemption to encompass liabilities whose payment would not be deductible but, instead, would give rise to capital expenditures. In addition, the IRS concluded that the transferee would step into the transferor's shoes with respect to these inchoate deductions and capital.

> ***Example:*** Assume a corporation transfers assets with a basis and value of $100 to Newco in exchange for all the latter's stock. There are contingent environmental liabilities associated with the assets that will ripen into deductible items and capital expenditures totaling $90. Arguably, Newco's stock is worth roughly $10, but, because the liabilities are disregarded, the corporation's basis for Newco's stock is unaffected by their presence. (Normally, in a Section 351 transaction, the transferor's basis in the transferee's stock is reduced by the sum of the liabilities that the transferee corporation assumes). Thus, a sale of the Newco stock will yield an immediate capital loss of $90 that the transferor can apply to offset capital gains.

Last Word

The effect of this maneuver is to accelerate tax deductions because the deductions associated with the environmental problem (which the capital loss replaces) may not ripen for an extended period of time. Moreover, the purchaser of Newco should not be disadvantaged. When the environmental liabilities ripen, Newco will be entitled to the same mix of tax deductions and capital expenditures that the seller would have enjoyed had it retained the subject properties. Thus, this strategy appears to be a very good deal. The seller accelerates tax deductions that are fully available to the buyer at the time the underlying contingent obligations mature. ■

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