ZERO BASIS IN THE TAXPAYER’S OWN STOCK OR DEBT OBLIGATIONS: DO THOSE INSTRUMENTS CONSTITUTE ‘PROPERTY’?

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Under current law, it is not entirely clear whether a transferor’s own note or stock constitutes “property” for purposes of section 351, and if so, whether the adjusted basis of that “property” is zero or its value on date of issue. In this report, Blanchard concludes that the better view is that a transferor’s own note or stock should not constitute “property” for purposes of section 351 and that any transferee corporation stock or other consideration (such as boot property or the transferee’s assumption of transferor liabilities) received by the transferor in exchange for its own obligation or stock should be viewed as received in a taxable “purchase” transaction. As such, the transferor should take a cost basis in any transferee corporation stock received in exchange for the transferor’s own note or stock, and the transferee corporation should take a cost basis in the transferor’s note or stock.

The author further suggests that, when the transferor transfers both its own stock or note as well as other property, and receives transferee corporation stock as well as other consideration in the exchange (such as the assumption of transferor liabilities or cash), the consideration transferred by the transferor in the exchange should be allocated among the consideration received by the transferor in the exchange based on the relative value or amounts of the consideration transferred and received. For example, if the transferor transfers real estate (value of $100 and basis of $10) and a transferor note worth $50 to Newco in exchange for Newco’s assumption of $60 of transferor business debt and Newco stock worth $90, the author suggests that the transferor’s $50 note should be allocated $20 (40 percent) to Newco’s assumption of transferor debt, in that the $60 debt assumption is 40 percent of the total consideration received from Newco of $150, and $30 (60 percent) to the Newco stock. That portion of the exchange would not fall within section 351, such that Newco takes a $50 cost basis in the transferor note, the transferor takes a $30 cost basis in one-third of the Newco stock issued in the exchange, and $20 of the transferor liabilities assumed by Newco are treated as assumed in exchange for $20 of the transferor note. The remainder of the exchange would fall within section 351, under which the transferor receives $60 in value of Newco stock plus $40 of debt assumption in exchange for real estate with a value of $100 and basis of $10. Accordingly, (i) the transferor should recognize gain under section 357(c) of $30 (the excess of the $40 of debt assumed in the section 351 exchange over the $10 basis of the property transferred in the section 351 exchange); (ii) the transferor takes a $30 cost basis in one-third of the Newco stock and a $0 section 358(a)(1) substituted basis in two-thirds of the Newco stock; (iii) Newco takes a $50 cost basis in the transferor note; and (iv) Newco takes a $40 section 362(a) basis in the real estate (transferor’s beginning basis of $10 plus the $30 of section 357(c) gain recognized by the transferor).

I. Introduction

This report was inspired by a recent article written by Prof. Stuart Lazar addressing the deceptively complex tax issues arising from the contribution by a taxpayer of its own debt obligation to a transferee corporation in an exchange that satisfies the requirements of section 351.1 The Lazar article should be mandatory reading for any

1Stuart Lazar, “Lessinger, Peracchi, and the Emperor’s New Clothes: Covering a Section 357(c) Deficit With Invisible (or Nonexistent) Property,” 58 The Tax Lawyer 41 (2004), hereinafter cited as the Lazar article. Another informative article on this topic, albeit much broader in scope, is Elliott Manning, “The

(Footnote continued on next page.)
tax practitioner faced with the prospect of a client wishing to engage in a section 351 exchange, not just because it is a clearly written discussion of the various tax issues that must be considered in that context, but primarily because it raises the bar for future policy deliberations regarding the kinds of items that should constitute “property” for purposes of section 351 as well as other nonrecognition provisions found in subchapter C.\(^2\)

Prof. Lazar has made a significant and quite welcome advance in the analysis of the proper characterization of transfers of a stock or debt “liability” of a transferee to a transferee corporation in an exchange otherwise qualifying for nonrecognition treatment under subchapter C. The Lazar article contains valuable insights into the various weaknesses in the current analysis by the Service and the courts, as set forth in Rev. Rul. 68-629,\(^3\) the Tax Court’s decision in Alderman,\(^4\) the Second Circuit’s decision in Lessinger,\(^5\) and the Ninth Circuit’s decision in Peracchi.\(^6\) Prof. Lazar also provides a useful way out of the muddled quicksand in which, thanks to the existing authorities, taxpayers currently are mired.

Part II of this report is a summary of the current state of affairs and offers a few observations on that unhappy state. Part III summarizes Prof. Lazar’s viable solution to the problem, offering a few additional observations and concluding remarks.

II. Characterization of Transferee Obligations

Prof. Lazar summarizes the state of the law as follows:

Prior to the Second Circuit’s decision in Lessinger v. Commissioner and the Ninth Circuit’s decision in Peracchi v. Commissioner, however, it appeared to be settled law that a contribution by a shareholder of his or her own promissory note was not considered a contribution of property with a tax basis that would prevent such shareholder from recognizing section 357(c) gain. The opinions issued by the circuit courts in Lessinger and Peracchi appear to have changed this result. Whether one agrees with the result that these two courts achieved, one cannot justify the analyses taken by these courts in reaching these results.\(^7\)

The “settled law” to which Prof. Lazar refers consists of Rev. Rul. 68-629 and the Alderman case,\(^8\) in which the IRS and the Tax Court conclude that, because the transferor incurs no cost in issuing its own obligation, the transferor has a zero basis in the obligation such that “the transfer of the [obligation] to the corporation did not increase the basis of the assets transferred and [hence] the liabilities assumed by the corporation exceeded the [transferor’s] basis in the assets transferred.”\(^9\)


1The Lazar article focuses only on transferor debt instruments contributed to a transferee corporation in a section 351 exchange for the purpose of avoiding gain under section 357(c). However, the points made by Prof. Lazar have broader application to other nonrecognition provisions found in subchapter C (such as sections 354 and 361) as well as to other instruments, such as transferor stock and derivatives (such as options) the value of which is measured by reference to transferor stock. Except as otherwise noted below, all “section” references are to the Internal Revenue Code of 1986, as amended or to the Treasury regulations issued pursuant to the code. A reference to the Service or the IRS is to either or both the Internal Revenue Service and the United States Department of the Treasury, as the context may require.

2Rev. Rul. 68-629, 1968-2 C.B. 154, in which the IRS concludes that a transferor has a zero basis in its own debt obligation and therefore does not reduce its gain recognition under section 357(c) by the principal amount of the obligation in cases in which the liabilities assumed by the transferee corporation exceed the aggregate adjusted basis of the other property transferred in the exchange.

3Alderman v. Commissioner, 55 T.C. 665 (1971), in which the Tax Court adopted the position of the IRS set forth in Rev. Rul. 68-629. See also Seggerman Farms Inc. v. Commissioner, 81 T.C.M. (CCH) 1543, Doc 2001-11802, 2001 TNT 81-17 (2001), aff’d 508 F.3d 803, Doc 2002-24075, 2002 TNT 207-5 (7th Cir. 2002) (even though transferors retained personal liability for the obligations to which the transferred property was subject by guaranteeing those obligations, they were required to recognize gain under section 357(c) to the extent the obligations exceeded the aggregate basis of the transferred property). The Tax Court in Seggerman Farms notes that liability as guarantor is secondary (that is, the guarantor has a claim against the principal debtor for reimbursement of any payments on the guaranteed debt), and, hence, is not an “economic outlay” for which the transferor receives basis. Seggerman Farms Inc. v. Commissioner, 81 T.C.M. (CCH) at 1546. There are also several cases decided in the subchapter S context in which the courts have concluded that an S corporation shareholder receives no increase in the basis of its S corporation stock or notes as a result of her guarantee of S corporation indebtedness. See, e.g., Doc v. Commissioner, 116 F.3d 1489, Doc 97-21668, 97 TNT 143-8 (10th Cir. 1997) (S corporation shareholder receives no stock basis for his guaranty of corporate debt); Hitchens v. Commissioner, 103 T.C. 711 (1994) (S corporation owed money to C corporation that in turn owed money to the principal shareholder of both corporations; to pay its debt, the S corporation assumed the C corporation’s obligation to the mutual shareholder without a release of the C corporation from liability to the shareholder; the Tax Court held the shareholder obtained no basis in the S corporation as a result of its assumption of the C corporation debt; however, the court notes that the shareholder would have obtained basis under an economically equivalent transaction (for example, if a novation had occurred, with the S corporation note being transferred to the shareholder by the C corporation in satisfaction of the C corporation’s debt)).


6Lazar article at 43.

7See notes 3 and 4 supra. In the context of transferee stock, see Rev. Rul. 74-503, 1974-2 C.B. 117, in which the IRS concludes that a transferor has a zero basis in its own stock and therefore the issuance of that stock to a transferee corporation in a section 351 exchange results in the transferee taking a zero basis in the stock under section 362(a).

8Rev. Rul. 68-629, 1968-2 C.B. at 155. Similarly, the Tax Court stated, “Since the personal promissory note in the hands of the Aldermans had an adjusted basis of zero at the time of its issuance, no gain is realized by the Aldermans on the transfer to S corporation of the personal note.” (Footnote continued on next column.)
That “settled law” somewhat justifiably was tossed into chaos by the Lessinger and Peracchi appellate court decisions.10 In Lessinger, the Second Circuit reversed the transfer to Alderman Corp., the liabilities assumed...by the corporation exceeded the adjusted basis of the transferred property by $9,299.99. Such amount, under section 357(c), must be recognized as gain to the Aldermans. To conclude otherwise, as petitioner contends, would effectively eliminate section 357(c) from the Internal Revenue Code. It would be a relatively simple matter to execute a note so that the adjusted basis would always exceed liabilities.” Lessinger v. Commissioner, 55 T.C. at 665. The Tax Court’s concern in Alderman regarding a transferee’s ability to “game the system” (and avoid section 357(c) gain) by the simple expedient of issuing a note with an issue price equal to the excess of the liabilities assumed by the transferee corporation over the aggregate adjusted basis of the other property transferred may well be the primary concern of the Tax Court and IRS in taking the position that the transferor’s note constitutes property with a zero basis. At the heart of this concern must be the fear that, because the transferor may be positioned to control the transferee’s enforcement of the transferor’s note, treating the note as having a basis equal to its principal amount paves the way for indefinite deferral or avoidance of the transferor’s section 357(c) gain. For example, in GCM 33,937 (Sept. 30, 1968), which backs up Rev. Rul. 68-629, the IRS indicates some concern “about whether the note constitutes a future contract to make capital contributions, a present contribution to capital, or a present transfer in a section 351 exchange.” Lazar article at 62. Presumably, the IRS settles for treatment as a current transfer of property in a section 351 exchange to avoid the indefinite deferral or avoidance of the transferor’s section 357(c) gain that might result if the transaction were characterized as an obligation on the part of the transferor to make future capital contributions to the transferee corporation.

10See notes 5 and 6, supra. Query whether those cases also alter the treatment of a transfer of the transferor’s obligation to a partnership in exchange for a capital and profits interest in the partnership. See Rev. Rul. 80-235, 1980-2 C.B. 229, in which the IRS states, “the contribution of a partner’s written obligation, its personal note, to the partnership does not increase the basis of the partner’s interest under section 722 of the Code because the partner has a zero basis in the written obligation. Payments on the written obligation are added to the partner basis in the partnership as the payments are actually made.” See also reg. section 1.704-1(b)(2)(iv)(d)(2) (“if a promissory note is contributed to a partnership by a partner who is the maker of such note, such partner’s capital account will be increased with respect to such note only where there is a taxable disposition of such note by the partnership or where the partner makes principal payments on such note”). That position (which in effect treats the written obligation as a “subscription agreement” in which the partner has agreed to make future cash contributions to the partnership in exchange for the partnership interest) also prevents the partnership from recognizing gain on the receipt of principal payments on the obligation from the transferor/partner. The principal payments are not in satisfaction of a note, taxable under section 1271, but rather are in exchange for an interest in the partnership for which the partnership is entitled to nonrecognition treatment under section 721(a). However, under the IRS’s position, query whether the partnership takes a zero basis in the obligation under section 723 and therefore must recognize gain on a taxable sale of the transferor/partner’s obligation before its satisfaction by the obligor, albeit an arguably better view is that such a sale of the note merely accelerates the contribution of cash represented by (Footnote continued in next column.)

Tax Court’s decision and held that a transferor did not recognize section 357(c) gain in connection with the transferee corporation’s assumption of transferor liabilities in excess of the aggregate adjusted basis of the property (other than the transferor’s obligation) transferred in the section 351 exchange. To reach that conclusion, the Second Circuit first found that the Tax Court had improperly characterized the transferor’s note as “artificial” even though it “was not as well documented as a debt to a third party would be.”11 Next, the Second Circuit dismissed the Tax Court’s holding that, even if the transferor’s note were “true debt” for federal income tax purposes, that note had a zero basis in the transferor’s hands and, hence, did not assist the transferor in reducing his section 357(c) gain.

It is the Second Circuit’s second holding in Lessinger that is of primary interest. The court based its holding on three observations, one of which is insightful and helpful in advancing the analysis, the second of which is likewise helpful, and the third of which seems wrong.

The first observation is that the transferor’s own obligation is not property as far as the transferor is concerned.

“Basis” as used in the tax law, refers to assets, not liabilities. Section 1012 provides that “the basis of property shall be the cost of such property, except as otherwise provided.” Liabilities by definition have no “basis” in tax generally or in section 1012 terms specifically. ...The taxpayer could, of course, have no “basis” in his own promise to pay the corporation $255,000, because that item is a liability for him.12

The second observation is that the transferor’s obligation, while not constituting property in his hands that could have “basis,” did constitute property in the hands of the transferee corporation that had a basis equal to the transferee’s cost incurred in acquiring the obligation, which was the amount of the liabilities ($225,000) assumed by the transferee corporation in excess of the “subscription agreement” and therefore should be treated as an amount received by the partnership in exchange for a partnership interest that is entitled to nonrecognition treatment under section 721(a). Also, under the IRS’s position, because the transferor/partner receives no basis for his note before his making a principal payment, presumably he must recognize gain on a subsequent sale of his partnership interest prior to that time equal to the excess of his amount realized over his lower basis in his partnership interest. Presumably, the partner would be allowed a loss in a subsequent tax year if and when he makes a principal payment under the relation-back doctrine of Arrowsmith v. Commissioner, 344 U.S. 6 (1952). The Ninth Circuit in the Peracchi case declined to extend its holding to partnership transactions (Peracchi v. Commissioner, 143 F.3d at 487 n.16), and no discussion of the treatment of a partner’s obligation payable to his partnership is offered in the Second Circuit’s decision in Lessinger. Thus, it would appear that the only guidance in the partnership context remains Rev. Rul. 80-235 and reg. section 1.704-1(b)(2)(iv)(d)(2).

11Lessinger v. Commissioner, 872 F.2d at 525.
12Id. at 525.
adjusted basis of the other property received by the transferee corporation in the exchange.

But the corporation should have a basis in its obligation from *Lessinger*, because it incurred a cost in the transaction involving the transfer of the obligation by taking on the liabilities of the proprietorship that exceeded its assets, and because it would have to recognize income upon Lessinger’s payment of the debt if it had no basis in the obligation.13

The Second Circuit’s third observation is that, for purposes of determining the transferor’s gain under section 357(c), the relevant basis is the transferee corporation’s total basis in the property acquired from the transferor, not the transferor’s total basis in the property transferred.14 Normally, by operation of section 362(a), the transferee’s basis in the acquired property is the same as the transferor’s basis (increased by any gain recognized by the transferor). However, when part of the property held by the transferee corporation after the exchange is a transferor obligation in which the transferee takes a cost basis, the transferee’s total basis in the property exceeds that of the transferor. Thus, because the transferee’s total basis in the property acquired from the transferor (including the transferor’s obligation) equaled the amount of the assumed liabilities, no section 357(c) gain was recognized by the transferor.

The Second Circuit’s first two observations seem right. It makes no sense to ask whether the transferor has basis in its own obligation because the item is not an asset in its hands. In fact, it’s just the opposite of an asset — it’s a liability. Consequently, the regime of sections 357(c) and 362(a) breaks down in determining the tax consequences to the transferor and transferee under the facts of *Lessinger* — it makes no sense to charge the transferor with section 357(c) gain on the exchange by arguing the transferor has a zero basis in an item that can have no basis to the transferor because the item simply isn’t an asset in the transferor’s hands, and it makes no sense to provide the transferee corporation with a zero basis in the transferor’s obligation using the same faulty logic. Because of this breakdown, it also makes perfectly good sense to provide the transferee corporation with a cost basis in the transferor’s obligation equal to the consideration paid by the transferee in exchange for the obligation, whether one views that consideration as the assumption of transferor liabilities or the issuance of transferee stock.15 Thus, the second observation of the Second Circuit makes perfectly good sense.

However, the Second Circuit’s third observation (that section 357(c) gain is measured by the excess of the liabilities assumed over the adjusted basis of the property in the hands of the transferee corporation) can’t be right. The transferee corporation’s basis in the property acquired from the transferor is determined under section 362(a) to be the basis of that property in the hands of the transferor, increased by any gain recognized by the transferor on the exchange. As such, if the transferor recognizes gain under section 357(c), the transferee’s basis in the property acquired is increased by that section 357(c) gain. Thus, if it is the transferee corporation’s property that is the measure of the transferor’s section 357(c) gain, then illogical circularity would exist in the statutory scheme — the section 357(c) gain would increase the transferee’s basis in the transferred property, which in turn would eliminate the section 357(c) gain, which in turn would reduce the transferee’s basis in the transferred property, which in turn would cause the transferor to recognize section 357(c) gain, and so forth. Accordingly, while many may agree with the Second Circuit’s conclusion that Mr. Lessinger recognized no section 357(c) gain on the exchange, few would subscribe to the basis for the conclusion.

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In *Peracchi*, the Ninth Circuit’s analysis in supporting the taxpayer’s avoidance of section 357(c) gain differs markedly from that of the Second Circuit in *Lessinger*. Unlike the Second Circuit’s observation that a transferor’s own obligation cannot be property in his hands that has basis, the Ninth Circuit in *Peracchi* seems to conclude that not only is the transferor’s obligation “property” in his hands, but it has a basis equal to the “cost” of issuing the obligation. The Ninth Circuit further notes that the transferor’s “cost” in the note hinges on “whether bankruptcy [of the transferee corporation] is significant enough of a reality to confer substantial economic effect on the contribution of the note to the corporation.”16 Because the transferee corporation’s bankruptcy risk was significant, the court concludes that the transferor’s cost basis in his own obligation was the face amount of the obligation and, hence, no section 357(c) gain was recognized by the transferor on the exchange.

The Ninth Circuit might have justified its holding (but didn’t) by reliance on reg. section 1.61-12(c)(1), which provides “An issuer does not realize gain or loss upon the sale or exchange of a security.”17

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1274 (issue price is the discounted present value of stated redemption price at maturity if the obligation has adequate stated interest).

16 *Peracchi v. Commissioner*, 143 F.3d at 493.

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13 *Id.*

14 *Id* at 526.

15 Assuming the transferor’s note is easier to value than the transferee stock or assumed liabilities, the transferee’s cost basis in the transferor’s note would be equal to its fair market or issue price under *Philadelphia Park Amusement Co. v. U.S.*, 126 F. Supp. 184 (Ct. Cl. 1954). Lazar article at 79 n.180. Generally, in the case of an obligation that is issued for nonpublicly-traded property, the issue price of the obligation is determined under either section 1273(b)(4) (issue price is stated redemption price at maturity if the obligation has adequate stated interest) or section 1222 (Footnote continued in next column.)
issuance of a debt instrument.” (Emphasis added.) “Realization” of gain or loss under section 1001 always occurs whenever a taxpayer disposes of property with a basis different from its amount realized. Thus, if a taxpayer’s own obligation is “property,” as seems to be the views of the Tax Court and Ninth Circuit in both the Alderman and Peracchi decisions, then this “property” must have a basis in the taxpayer’s hands equal to its fair market value, assuming reg. section 1.61-12(c)(1) is valid. Otherwise, the taxpayer would clearly realize gain or loss on the disposition of this “property.”

That justification of the Ninth Circuit’s holding is disingenuous. It is highly likely that the government, in drafting reg. section 1.61-12(c)(1), was simply expressing the view that income cannot be realized when an increase in the asset side of the taxpayer’s balance sheet is caused by an equal increase in the liability side of the balance sheet. It is hardly likely the government was thinking that a taxpayer’s obligation is “property” in his hands with a fair market value basis.

However, the justifications actually given by the Ninth Circuit are equally unsatisfying. The Ninth Circuit makes two arguments in support of its conclusion. First, the court argues that concluding that the Peracchis had a zero basis in their note results in the transferee corporation’s taking a zero basis in the note under section 362(a) and recognizing gain on a later sale or satisfaction of the note, which the Ninth Circuit understandably found incorrect. While that may well be a difficult position for the transferee corporation, it hardly justifies a nonsensical view that a transferor obligation constitutes “property” in his hands with a fair market value basis.

Second, the court makes a step transaction argument, the gist of which is summarized in the Lazar article as follows:

According to the Ninth Circuit, the Peracchis’ contribution of the note was indistinguishable from the situation in which either (1) the Peracchis borrowed cash from a bank in exchange for a note, contributed the cash to the corporation, and then caused the corporation to repurchase the note from the bank; or (2) the Peracchis exchanged their note for a promissory note from an unrelated party, contributed the third-party note to the corporation, and then caused the corporation to exchange such third-party note for the Peracchis’ promissory note. In both these cases, the court states that the corporation would wind up the owner of the Peracchis’ note without the recognition of section 357(c) gain by the Peracchis. The Ninth Circuit finds that the only difference between the transaction as set forth in Peracchi and those set forth in the court’s hypotheticals is “the valuation role implicitly performed by [a] third party.” The court uses circular reasoning to summarily dismiss a perceived attack that these hypotheticals are sham transactions [by arguing that, because a contribution of a shareholder note has “real economic effect,” the step-transaction doctrine should not apply to collapse the steps set forth in the hypotheticals].

That circular reasoning can hardly justify the Ninth Circuit’s holding.

The heart of the problem with the Ninth Circuit’s analysis is the mistaken notion that a transferor can take a cost basis in its own note. While it is black-letter law that a taxpayer can take a section 1012 cost basis in property purchased by him in exchange for his own note, that does not imply the taxpayer has full basis in the obligation. The reason the taxpayer takes a basis in property acquired in exchange for his obligation is not because he has exchanged a full-basis item of property (his note) for other property, but rather because the taxpayer’s incurrence of a liability to acquire property economically is no different from an outlay of cash in exchange for the property. In either case, the taxpayer’s financial picture is unchanged — if he pays cash, his net worth remains the same because he has merely substituted one asset for another, and if he issues a note, his net worth is unchanged because the liability side of his balance sheet offsets the increase in the asset side. Thus, at the heart of the Ninth Circuit’s opinion in Peracchi lies a misapprehension of the tax characterization of a transferee obligation.

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The preceding discussion has focused exclusively on the issuance of a transferor note in an otherwise qualifying section 351 exchange. However, the same analysis applied by the IRS and Tax Court in this context has also been applied by the IRS in the context of a transferor’s issuance of its own stock to a transferee corporation, as set forth in Rev. Rul. 74-503. A commentator describes the ruling as follows:

[Rev. Rul. 74-503] involves treasury stock of a parent, stock which the parent transferred to a subsidiary and which the subsidiary planned to hold, at least for the time being, rather than use immediately as consideration in an acquisition of other property. The ruling states that Congress, in enacting section 1032(a), repudiated the Tax Court’s holding in Firestone Tire & Rubber Co. v. Commissioner that stock of a target acquired in reorganization in exchange for treasury stock of the acquiring corporation took a basis in the latter’s hands.

18Lazar article at 81, 82.
19See, e.g., Crane v. Commissioner, 331 U.S. 1 (1937); Holdcroft Transp. Co. v. Commissioner, 4 T.C.M. (CCH) 508 (1945), aff’d 153 F.2d 323 (8th Cir. 1946).
21Firestone Tire & Rubber Co. v. Commissioner, 2 T.C. 827 (1943), aff’d, reviewed (3 dissents), appeal dismissed (6th Cir. June 19, 1944).
equal to its basis for the treasury stock. Also repudiated, according to the ruling, is the conceptual underpinning of the Firestone case that treasury stock usually has a basis equal to its cost, the redemption price. That the stock transferred to the subsidiary was treasury rather than previously unissued stock is irrelevant, the ruling holds. With these conclusions there is no quarrel. The ruling continues, however, by holding that an issuer’s basis for its stock, whether treasury or newly issued stock, is zero and that the subsidiary in the ruling, which by statute took a carryover basis, therefore also had a zero basis for the stock it received. The ruling cites no authority for this statement; it does not even cite the property option ruling, Revenue Ruling 70-521,22 which at least is consistent on technical grounds with the zero basis holding. . . . This is an unsolved mystery.23

Thus, according to Rev. Rul. 74-503, if P issues its own stock to S in exchange for all the stock of S, (i) under section 362(a), S takes a zero basis in the P stock S receives in exchange for its own stock (because P has a zero basis in its own stock), and (ii) also under section 362(a), P takes a zero basis in the S stock received in exchange for the P stock (because S has a zero basis in its own stock).24

The IRS has reduced the detrimental impact of its zero-basis position in the context of transferor stock by adopting reg. section 1.1032-3. Reg. section 1.1032-3(b) permits an entity acquiring transferor stock to take a basis in the stock equal to its fair market value on the date of acquisition by treating the transaction “as if, immediately before the acquiring entity disposes of the stock of the issuing corporation, the acquiring entity purchased the issuing corporation’s stock with cash contributed to the acquiring entity by the issuing corporation (or, if necessary, through intermediate corporations or partnerships).”25 However, that favorable treatment under reg. section 1.1032-3(b) is severely limited by reg. section 1.1032-3(c) to cases in which (i) absent the special rule, the acquiring entity would take a basis in the stock determined under section 362(a) or section 723; (ii) the acquiring entity “immediately transfers” the stock to a person other than an entity from which the stock was directly or indirectly acquired;26 (iii) the person receiving the stock from the acquiring entity does not have a substituted basis in the stock under section 7701(a)(42) (for example, the stock is not used in a triangular reorganization described in reg. section 1.1032-2 in which the target shareholders take a basis in the stock determined under section 358(a)(1)); and (iv) “the issuing corporation stock is not exchanged for stock of the issuing corporation.” For example, if P contributes its own stock to S in a section 351 exchange and S retains the P stock for more than some minimal period of time, the favorable rule of reg. section 1.1032-3(b) will not apply to provide S with a basis in the P stock equal to its value on the date of contribution, nor will the rule provide P with a fair market value basis in the S stock it receives in exchange for the P stock, because S has not disposed of the P stock “immediately” after acquiring the P stock.

Like a debt obligation, a corporation’s own stock is not an asset in its hands, but rather is a form of “liability” that can be issued by the corporation in exchange for property or services without the issuer’s realization or recognition of income.27 Indeed, before the repeal of the stock for debt exception to debt discharge income, it was held that a corporation recognized no income on the issuance of its own stock in exchange for its outstanding debt because all that has occurred is the substitution of one “liability” for another.28 Thus, as in the case of debt instruments issued by the transferor in exchange for

23Manning article at 191.
24Section 358(a)(1) does not apply to determine P’s basis in the S stock because section 358(e) provides, “This section shall not apply to property [here, the S stock] acquired by a corporation [here, P] by the exchange of its stock or securities . . . as consideration in whole or in part for the transfer of the property to it.” However, the IRS ruled that section 362(a) does apply to determine the basis of P’s S stock, because P received the S stock (clearly “property” in the hands of P) “in connection with a transaction to which section 351 . . . applies,” and that S stock has a zero basis in the hands of S such that, under section 362(a), P likewise takes a zero basis in the S stock.
25Reg. section 1.1032-3(d) provides that the regulation also applies to “an option issued by a corporation to buy or sell its own stock.” See also reg. section 1.1502-13(f)(6), preventing members of a consolidated group from recognizing loss (but not preventing gain recognition) on dispositions of stock of the common parent as well as options to buy or sell the stock of the common parent.
26Although reg. section 1.1032-3(c)(2) states the acquiring entity must “immediately transfer the stock of the issuing corporation to acquire money or other property,” reg. section 1.1032-3(e), Exs. 4-9, expands the provision to also apply to compensatory transfers of stock and stock options in which the acquiring entity uses the issuing corporation’s stock or stock options to obtain services.
27As noted in the text above, reg. section 1.61-12(c)(1) provides “An issuer does not realize gain or loss upon the issuance of a debt instrument.” Section 1032(a) provides “No gain or loss shall be recognized to a corporation on the receipt of money or property in exchange for stock (including treasury stock) of such corporation.” The reason for those exceptions to income realization or recognition lies in the fact that the issuing corporation’s accretion on the asset side of its balance sheet is offset by an addition to the liabilities or shareholder’s equity side.
28Although the stock for debt exception has long since been repealed, there is a significant body of case law, decided before the repeal in 1993, holding that a corporation realizes no debt discharge income when it retires debt in exchange for its own stock, even if the stock’s fair market value is less than the adjusted issue price of the retired debt. One of the theories underlying that conclusion is that no gain would have been recognized by the corporation under section 1032 if it had originally issued the stock for the subscription price of the debt and, hence, no gain should be recognized when the debt is discharged with the stock. However, the principal theory is that stock, like debt, is a form of corporate “liability” and, hence, substituting stock for debt does not discharge a corporate liability. See, e.g., Capento Sec. Corp. v. Commissioner, 140 F.2d 38 (1st Cir. 1944), aff’d 47 B.T.A. 691 at 695 (1942), nonacq. (in addition to subscription theory, the court also reasons that (Footnote continued on next page.)
transferee stock, query whether it makes sense to view transferee stock as “property” transferred to the transferee corporation in exchange for its stock.

It is likely apparent by now that the author is not entirely in agreement with the view that the transferor’s own stock or debt constitutes zero-basis “property” for purposes of the nonrecognition provisions of subchapter C. In thinking about that question, it is helpful to recall that there is substantial precedent holding that the definition of “property” (at least for purposes of section 351) is extremely broad, covering a multitude of items (including leasehold interests and nonexclusive licenses of intangible assets) that typically would be viewed as an acceleration of ordinary income on a cash sale of the items and clearly would not qualify as capital assets or section 1231 property for tax purposes. However, in those cases, the item conveyed to the transferee corporation was not a “liability” of the transferor but rather was a carved-out, smaller interest in a larger item that clearly constituted “property” in the hands of the transferor for tax purposes.

Consequently, that precedent does not require the characterization of a transferor “liability” as property for purposes of the nonrecognition provisions of subchapter C.

III. The Characterization That Should Apply

A. Transferor Debt

Prof. Lazar concludes that the better policy answer under section 351 is that the issuance of a debt obligation of the transferor to the transferee corporation should not be viewed as a transfer of property for purposes of section 351.

For the Second Circuit [in Lessinger] to have been consistent in its analysis, it would have had to conclude that the note was not property in the Lessingers’ hands, that the note was not transferred to the corporation as part of a section 351 transaction, and that section 1012, and not section 362, was interest in real property owned by taxpayer constituted a transfer of property for purposes of section 721(a). The Zachary facts arose before the enactment of section 636(a), which now characterizes a production payment carved out of a larger interest in mineral property owned by the transferor as indebtedness of the transferor. Thus, today the Zachary case would present the same issues addressed in Rev. Rul. 68-629, Alderman, Lessinger, and Peracchi.

However, Rev. Rul. 64-56, 1964-1 C.B. 133, in analyzing whether a license of intangible property owned by the transferor to the transferee corporation constitutes a transfer of “property” for purposes of section 351, states: The transfer of all substantial rights in property of the kind hereinafter specified will be treated as a transfer of property for purposes of section 351 of the Code. The transfer will also qualify under section 351 of the Code if the transferred rights extend to all of the territory of one or more countries and consist of all substantial rights therein, the transfer being clearly limited to such territory, notwithstanding that rights are retained as to some other country’s territory.

Rev. Rul. 71-564, 1971-2 C.B. 179, expands on Rev. Rul. 64-56, noting that to qualify as “property,” the license must constitute an unqualified transfer in perpetuity of an exclusive right” in the intangible asset, and that a “secret” loses its status as “property” once it ceases to be “protectible under the applicable law of the country in which the rights have been granted to the transferee.” Those rulings indicate that, at least in the context of intangible property, the IRS may take the position that unless the interest conveyed to the transferee corporation would result in sale or exchange treatment to the transferor if the exchange had been taxable, the interest will not qualify as “property” for purposes of section 351. However, in FSA 1998481 (Oct. 7, 1998), the IRS notes that a court would very likely hold that section 721 covers a transfer of nonexclusive rights to intangible property to a partnership and recommends accepting the taxpayer’s position on that question. Also, that position seems contrary to the conclusions reached in LTR 8225069 and LTR 199915040, cited in the preceding footnote, regarding carveouts of long-term leasehold interests from real estate leases.
the applicable section for determining the corporation’s basis in the note. In that case, the corporation’s basis in the note would be equal to the fair market value of the property received.\textsuperscript{31}

Prof. Lazar also states that the “exclusion of the note from the definition of property, consistently applied, would have required the Second Circuit to conclude that section 357(c) was applicable to the Lessingers’ transaction” because “[i]f the corporation’s issuance of stock in exchange for the note were treated as a separate transaction, the issue of the note’s basis, as well as the question of in whose hands do we compute such basis, would have been irrelevant in determining whether the Lessingers transferred an amount of liabilities in excess of the adjusted basis of the transferred assets.”\textsuperscript{32} Finally, Prof. Lazar observes:

As a result of the decisions issued by the Second and Ninth Circuits, it is incumbent upon Congress to amend section 351(d) to provide that stock issued in exchange for a shareholder promissory note shall not be considered issued in exchange for property. In addition, Congress should require that any stock that is not issued in exchange for property should be treated as issued in a separate transaction. This would allow taxpayers to bifurcate transactions in which assets and liabilities are contributed to a corporation into (1) stock for property exchanges covered by section 351, and (2) other taxable exchanges. Those “other taxable exchanges” would allow taxpayers that transfer a note to the corporation to receive a basis in stock received in exchange therefor; while, at the same time, allowing the corporation to receive an immediate basis in the note.\textsuperscript{33}

It is easy to agree with Prof. Lazar’s first conclusion — that a transfer of the transferor’s own obligation to a transferee corporation in an exchange otherwise satisfying the requirements of section 351 should not be treated as a transfer of property for purposes of that provision. Both common sense and tax policy considerations support that conclusion. Common sense dictates the result because, as the Second Circuit notes in Lessinger, it makes no sense to inquire into the transferor’s basis in a transferor “liability” insofar as a taxpayer may have basis for federal income tax purposes only in an “asset.”\textsuperscript{34}

As far as tax policy goes, the principal concern of the IRS and Tax Court in concluding the transferor takes a zero basis in his own obligation for purposes of section 357(c) appears to be that it is too easy for a controlling shareholder to obtain basis and avoid gain (or perhaps even create a loss) by the simple expedient of issuing his own obligation to his controlled corporation.\textsuperscript{35} However, that concern is better addressed by a careful examination of the instrument to determine whether its issuance should be recognized for tax purposes.\textsuperscript{36} If it is determined that the controlling shareholder’s note should be recognized as a debt instrument for federal income tax purposes, that should be the end of this inquiry. Otherwise, that “creation of basis” concern forces a nonsensical position that “true debt” of the transferor constitutes zero-basis property in the hands of the transferor,\textsuperscript{37} which yields not only a strained result in cases in which a note is issued to avoid section 357(c) gain, but can also produce inconsistent results in other cases.\textsuperscript{38} Accordingly,

obligation realizes no income because the increase in the asset side of the taxpayer’s financial statement is offset by an increase in the liability side of the balance sheet.\textsuperscript{39}

\textsuperscript{31}Lazar article at 79.

\textsuperscript{32}Lazar article at 79, 80. Prof. Lazar also points out that “such an approach provides for a more rational determination of the shareholder’s basis in the stock received in the transaction,” which likewise would be a section 1012 cost basis equal to the value of the stock. Id.

\textsuperscript{33}Lazar article at 91.

\textsuperscript{34}Lessinger v. Commissioner, 872 F.2d at 525. True, as noted above, reg. section 1.61-12(c)(1) states, “An issuer does not realize gain or loss upon the issuance of a debt instrument,” which could be read as requiring the conclusion that a note constitutes “property” with a fair market value basis in the hands of the issuer. However, as also noted above, the better view of this regulation is that the government is simply stating that a taxpayer acquiring property in exchange for a taxpayer (Footnote continued in next column.)

\textsuperscript{35}See, e.g., Alterman Foods Inc. v. U.S., 505 F.2d 873 (5th Cir. 1974), affirmin 73-2 U.S. Tax Cas. (CCH) para. 9792, rehearing denied 509 F.2d 576 (5th Cir. 1975) (characterizing advances made by subsidiaries to a parent corporation that were characterized as debt on the parent’s books as dividends because (i) there was no written instrument, no fixed maturity date, no repayment schedule, no provision for interest rates or payments, and no collateral posted in the event of nonpayment; (ii) prior repayments were later offset by additional loans back to the parent; and (iii) the only source for repayment of the alleged subsidiary loans was via distributions on the equity held by the parent in the subsidiaries).

\textsuperscript{36}Another perfectly reasonable alternative (certainly far more preferable than the zero-basis view) would be to adopt the “open transaction” position in the corporate context that the IRS seems to have adopted in the partnership context, discussed at note 10 supra, and treat the note as in effect a “subscription agreement” under which the transferor will make future contributions of property in exchange for transferee stock issued at inception. However, that approach produces other troubling issues, such as what happens if, before any principal payments are made on the transferor’s note, the transferee corporation sells the transferor’s note or the transferee sells his transferee corporation stock. Furthermore, it seems somewhat strained to view a negotiable promissory note or marketable bond of the transferor as a subscription obligation for transferee stock already issued to the transferor. Nevertheless, if the government were to reverse its existing zero-basis position and provide guidance on the tax consequences to the transferee and transferee corporation, clearly this approach makes a great deal more sense than its current zero-basis approach. In the meantime, it appears the only other viable approach available to taxpayers, and supported by existing authority, is that advocated by Prof. Lazar. That approach also seems viable in the context of a transfer of P stock to S in exchange for all the S stock, whereas the “open transaction” view, which would require an even more strained characterization of the P stock as some form of subscription obligation, does not seem to fit this case at all.

\textsuperscript{37}For example, suppose P owns all the stock of S, an existing operating subsidiary of P. It is well-established that if S issues its own obligation to P as a dividend, (i) the amount of the (Footnote continued on next page.)
from the standpoint of both common sense and tax policy, Prof. Lazar’s conclusion — that a transfer of the transferor’s own obligation to a transferee corporation in an exchange otherwise satisfying the requirements of section 351 should not be treated as a transfer of property for purposes of that provision — seems correct.

However, one might voice some disagreement with his remaining points — namely, that section 357(c) still applies if the liabilities assumed by the transferee corporation (within the meaning of section 357(d)) exceed the aggregate basis of the other property transferred, and that an amendment to section 351(d) is required to exclude transferor debt from the definition of “property” for purposes of section 351. On the latter point, it would appear that the Second Circuit’s observation in Lessinger, to the effect that Mr. Lessinger’s own note can hardly be said to be an item of property (at least as far as Mr. Lessinger is concerned), arguably provides sufficient basis for concluding that section 351 does not apply to a transfer of his own note to the transferee corporation. While it would be very helpful if Congress decided to step into the fray and amend section 351(d) to so provide, there is no reason that the IRS or a later court considering the question could not bring reason to the debate and hold that section 351 does not apply to a transfer of the transferor’s own obligation to the transferee corporation.

Not only is that conclusion supported by at least a portion of the Second Circuit’s reasoning in Lessinger, but it is also supported by key provisions in subchapter C. For example, section 362(a) requires the transferee corporation in a section 351 exchange to take a basis in the transferred property equal to the transferor’s basis in the property, increased by any gain recognized by the transferor on the exchange. Similarly, section 358(a)(1) provides that the transferor’s basis in nonrecognition property (such as stock of the transferee corporation received in a section 351 exchange) “shall be the same as that of the property exchanged,” increased by any gain recognized by the transferor and decreased by any “other property” received by the transferor. As discussed above, while the transferor’s own note clearly constitutes property in the hands of the transferee corporation, it is not property in the hands of the transferee and cannot possibly have a tax basis in the hands of the transferor. As such, the key for determining both the adjusted basis of the note in the hands of the transferee corporation under section 362(a) and the adjusted basis of the transferee stock in the hands of the transferee under section 358(a)(1) is missing. Doubtless, that is because Congress never considered whether an item might be property in the hands of the transferee corporation but not property vis-à-vis the transferor. Nevertheless, the statutory dilemma is resolved by limiting the definition of “property” for purposes of sections 351, 358, 361, and 362 to items constituting “property” (or items carved out from a larger interest constituting “property”) in the hands of the transferor. Accordingly, there seems to be sufficient

40An objection might be raised under current law that this goes too far and, contrary to the authorities cited at notes 29 and 30 supra, treats zero-basis, carved-out interests in larger property rights such as nonexclusive licenses of intangible property, as not constituting “property” for purposes of section 351. However, whether or not those carved-out interests constitute “property” under current law should not depend on whether they have a zero basis for federal income tax purposes. Rather, the determination should hinge on whether they constitute assets in the hands of the transferor and, hence, can have any basis at all under current law. Also, it is not at all clear that those carved-out interests have a zero basis in cases in which the transferor has a positive basis in the larger property right. See, e.g., reg. section 1.61-6(a) (“[w]hen part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part’’); Hunter v. Commissioner, 44 T.C. 109 (1965) (sale of remainder interest subject to life estate requires taxpayers to allocate basis between interest sold and interest retained based on relative values and report gain equal to excess sales proceeds over basis allocated to interest sold); Columbia Oil & Gas Co. v. Commissioner, 118 F.2d 459 (1941) (seller of oil leases who retained a production payment in the leases was required to allocate its basis between the sold leases and retained production payment based on their relative fair market values); Commissioner v. P.G. Lake Inc., 356 U.S. 260 (1958) (disposition of carved-out production payment from working interest in mineral property is an acceleration of ordinary income without reduction for any portion of taxpayer’s basis in the mineral property); Stranahan v. Commissioner, 472 F.2d 864 (1973), rev’d 30 TCM (CCH) 1078 (1971) (sale of right to receive dividends on stock retained by taxpayer is an acceleration of ordinary income); TAM 8499018 (Sept. 2, 1980) (pre-1982 sale of interest coupons on bonds retained by taxpayer results in ordinary income; no allocation of taxpayer’s basis in the bonds between coupons and bonds under reg. section 1.61-6(a)); TAM 8827002 (Footnote continued on next page.)
basis in current law for concluding that the transferor’s own note is not “property” for purposes of section 351. Regarding Prof. Lazar’s point that the transferor’s note should be realized as issued solely as exchange for transferee stock, it is difficult to understand why transferee stock should be distinguished from other consideration received from the transferee corporation (such as cash or liability assumption) in determining the consideration received by the transferee in exchange for his own obligation. There is substantial support for the position that a transferee corporation’s acquisition of property (such as the transferor’s note) in exchange for the assumption of transferor liabilities (even a contingent liability or liability that otherwise would become deductible on accrual and economic performance) does not result in income to the transferee corporation but instead must be viewed as a purchase of the property in exchange for adequate consideration in money or money’s worth (namely, the assumed liability).41 Also, the IRS takes the position that, in cases in which a taxpayer transfers an executory obligation to perform services, not a property or liability that otherwise would become deductible (such as the transferor’s note) in exchange for the assumption of transferor liabilities (even a contingent liability assumption) in determining the consideration received by the transferor in exchange for his own obligation, there is no gain or loss to the transferor.42

The issue is illustrated by the following examples:

Example 1 (Section 351 exchange with boot). A (an individual) transfers the assets of a sole proprietorship (aggregate value of $1,000 and basis of $400) plus an A promissory note (issue price and value of $500) to Newco, a newly formed corporation, in exchange for (i) all the common stock of Newco, its only class of stock, worth $1,000, (ii) $500 of cash borrowed by Newco from an unrelated bank. Newco assumes no A liabilities under section 357(d). Section 351 applies to the exchange of property for Newco stock and cash.

Example 2 (Section 351 exchange with liability assumption). A (an individual) transfers the assets of a sole proprietorship (aggregate value of $1,000 and basis of $400) plus an A promissory note (issue price and value of $500) to Newco, a newly formed corporation, in exchange for (i) all the common stock of Newco, its only class of stock, worth $1,000, plus (ii) Newco’s assumption under section 357(d) of $500 of liabilities that have arisen in the conduct of the business of the sole proprietorship. Section 351 applies to the exchange of property for Newco stock and liability assumption.

In both examples, the approach indicated in the Lazar article presumably would treat A as receiving half the Newco common stock (worth $500) in exchange for her promissory note (also worth $500). As such, the first example produces $500 of gain to A under section 351(b) (the lesser of (i) the $500 cash received by A from Newco, or (ii) the $600 gain realized by A on the transfer of the sole proprietorship assets to Newco), and the second example produces $100 of gain to A under section 357(c) (the excess of (i) the $500 of sole proprietorship liabilities assumed by Newco under section 357(d), over (ii) the $400 aggregate adjusted basis of the sole proprietorship assets).45

Mar. 30, 1988 (pre-1982 separation of interest coupons from bonds, followed by sale of stripped bonds, requires basis allocation under reg. section 1.61-6(a)). Thus, a conclusion that an instrument constituting a “liability” in the hands of the transferor does not constitute “property” for purposes of section 351 should have no impact on whether other interests, carved out of an item that is clearly “property” in the hands of the transferor, constitute “property” for purposes of section 351.

41See, e.g., Oxford Paper Co. v. U.S., 86 F. Supp. 366 (S.D.N.Y. 1949), aff’d 194 F.2d. 190 (2d Cir. 1952) (in which $100,000 cash, $6,000 in stock of another corporation, a plant and a leasehold interest were transferred to the buyer solely exchange for the plant, stock, and cash, such that no gross income was recognized by the buyer; the appeals court agreed that the buyer did not recognize gross income in connection with the transaction); Rev. Rul. 55-675, 1955-2 C.B. 567 (following Oxford Paper in concluding that cash received in exchange for an agreement to pay rent owed under an assigned lease requiring above-market rent, is in the nature of a loan repaid by the assignee’s payment of above-market rent); LTR 2003/2013, Doc 2003-1123, 2003 TNT 8-36 (Sept. 30, 2002) (concluding that Oxford Paper and Rev. Rul. 55-675 are the general rule; thus, a buyer does not recognize income on the receipt of liquid assets in a trust fund designated to satisfy future nuclear decommissioning costs assumed by the buyer). But see James M. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964) (the court notes in dicta that the buyer of periodical assets is required to include in income an amount equal to an unearned subscription reserve assumed by buyer under the theory that the buyer received assets from the seller equal in value to the value of the reserve); Rev. Rul. 71-450, 1971-2 C.B. 78 (same). Perhaps the Pierce case can be distinguished from the other authorities on the grounds that an “unearned subscription reserve” constitutes an executory obligation to deliver periodicals to subscribers in the future, similar to an executory obligation to perform services, not a financial obligation (that is, an obligation to pay money) such as rent or nuclear decommissioning costs.


43Likewise, under this approach, (i) Newco takes a section 362(a) basis in the sole proprietorship assets of $900 in the first example (the sum of A’s $400 basis in those assets plus the $500 of section 351(b) gain recognized by A), and (ii) Newco takes a section 362(a) basis in the sole proprietorship assets of $500 in the second example (the sum of A’s $400 basis in those assets plus the $100 of section 357(c) gain recognized by A). In both examples, Prof. Lazar’s approach would provide Newco with a $500 cost basis in the A note under section 1012. Also, his approach would (i) provide A with a $900 basis in the Newco common stock in the first example under sections 1012 (giving

Footnote continued on next page.)
However, allocating A’s promissory note exclusively to the Newco stock received in the exchanges described in the preceding examples does not seem to be supported by the authority described above. A better approach would be to allocate the A’s promissory note ratably between all the consideration received by A from Newco based on the relative value or amounts of that consideration. Under that approach, because two-thirds of the total consideration A receives from Newco is Newco common stock, A should be treated as issuing her $500 promissory note to Newco in exchange for $333.33 in value of Newco common stock (two-thirds of the $500 value of her note) and $166.67 in cash or liability assumption (one-third of the $500 value of her note). Thus, in the first example, A should be viewed as transferring her sole proprietorship assets to Newco in exchange for $666.67 in value of the Newco stock and $333.33 of cash, resulting in section 351(b) gain to A of $333.33, and, in the second example, A should be viewed as transferring her sole proprietorship assets to Newco in exchange for $666.67 in value of Newco stock and $333.33 of liability assumption, resulting in no section 357(c) gain to A because the liabilities assumed in the section 351 exchange ($333.33) do not exceed the aggregate basis of the sole proprietorship assets ($400).

The correctness of allocating A’s promissory note between the total consideration A receives from Newco becomes apparent if the amounts of the consideration are switched, with A receiving $500 in value of Newco common stock and $1,000 of cash or liability assumption from Newco in exchange for A’s $500 promissory note and the assets of her sole proprietorship. If A were viewed as acquiring only Newco stock in exchange for her $500 promissory note in those altered cases, and if it is proper to treat that stock as not issued in exchange for property for purposes of section 351, then A would not be viewed in either case as transferring property to Newco in exchange for Newco stock and therefore would engage in a fully taxable sale of her sole proprietorship assets to Newco in exchange for cash or the assumption of liabilities. However, by allocating all the consideration received by A from Newco ratably between her promissory note and sole proprietorship assets, the risk that section 351 would not apply to her transfer of property to Newco is avoided in all but those unusual cases in which the boot or liability assumption exceeds 90 percent of the total consideration issued by Newco in the exchange.

46The IRS’s position is that section 351 applies to a transfer of property in exchange for stock if (i) the transferor (or group of transferees) has section 368(a)(c) control of the transferee corporation immediately after the exchange (even if the bulk of the transferee corporation’s stock held by the transferor or transferor group was not received in exchange for property), and (ii) the value of the transferee corporation’s stock received in exchange for the property equals or exceeds 10 percent of the total value of the transferee corporation’s stock held by each transferor. See, e.g., reg. section 1.351-1(a)(1)(ii) (an “accommodation transferor” is not treated as transferring property for purposes of section 351); Estate of Kambor v. Commissioner, 469 F.2d 219 (1st Cir. 1972) (same); Rev. Rul. 79-194, 1979-1 C.B. 145 (Situation 1) (an integrated retransfer of stock of the transferee corporation to another member of the control group does not break control where the other member of the control group was not an “accommodation transferor” of property to the transferee corporation); Rev. Proc. 77-37, section 3.07, 1977-2 C.B. 568 (for ruling purposes, a shareholder of the transferee corporation will not be treated as an “accommodation transferor” if the shareholder transfers property in exchange for stock having a fair market value equal to at least 10 percent of the value of the stock already owned by the shareholder). Under the altered facts of the two examples, one-third of the total consideration received by A from Newco consists of Newco common stock worth $500, and two-thirds of the total consideration received by A from Newco consists of cash or liability assumption in the amount of $1,000. As such, under the approach suggested in the text, A would be viewed as issuing her $500 note to Newco in exchange for $166.67 in value of Newco common stock (one-third of $500) and $333.33 of cash or liability assumption (two-thirds of $500). Thus, (i) in the first altered example, A is viewed as transferring the assets of her sole proprietorship to Newco in exchange for Newco stock worth $333.33 and cash in the amount of $666.67, resulting in A’s recognizing section 351(b) gain of $600 (the lesser of (a) the $666.67 cash deemed received in exchange for the sole proprietorship assets, or (b) the $600 of gain realized on the exchange [which is the excess of (1) the sum of the $666.67 cash and $333.33 in value of Newco common stock deemed received in exchange for the sole proprietorship’s assets, over (2) the $400 adjusted basis of the sole proprietorship’s assets]); and (ii) in the second altered example, A is viewed as transferring the assets of her sole proprietorship to Newco in exchange for Newco stock worth $333.33 and liabilities assumed with respect to those assets in the amount of $666.67, resulting in section 357(c) gain of $266.67 (the excess of (Footnote continued on next page.)
To summarize, the author believes the Lazar article comes very close to getting the tax consequences right whenever the property transferred by a taxpayer to a corporation consists of not only items that are property in the hands of the transferor, but also a note or other obligation of the transferor that constitutes a “liability” of the transferor and therefore should not be viewed for purposes of section 351 as a transfer of property to the transferee corporation. The only rather minor tweaks to Prof. Lazar’s analysis that seem appropriate are (i) congressional action in amending section 351(d) to exclude a transferor obligation from the scope of property transfers covered by section 351, while quite helpful, arguably is not required because there is sufficient basis in existing law (primarily, the observation by the Second Circuit in Lessinger and the language of sections 358(a)(1) and 362(a)) and common sense for reaching the conclusion that a transfer of the transferor’s own obligation to a transferee corporation in exchange for transferee stock, boot, or liability assumption is not a transfer of property governed by section 351 and its satellite provisions; and (ii) the transferor’s own obligation need not be viewed as issued solely in exchange for transferee stock, but rather should be viewed as issued in exchange for a portion of all the consideration received from the transferee corporation, including boot and liability assumption, perhaps allocating the transferor obligation among the various pieces of consideration received from the transferee corporation based on their relative values or amounts. It is the author’s hope that the IRS and courts addressing the issue in the future will consider Prof. Lazar’s helpful insights, perhaps even paying some attention to the additional points set forth above.

B. Transferor Stock

Turning to another form of transferor “liability,” namely the transferor’s own stock or options to buy or sell its own stock, it is interesting that the same degree of commentary has not been devoted to the zero-basis issue involving transferor stock and options. Perhaps the reason for the lack of attention to that issue lies in the $666.67 of liabilities assumed by Newco under section 357(d) over the $400 aggregate adjusted basis of the transferee’s sole proprietorship assets.


The IRS’s partial solution to the problem in the form of reg. section 1.1032-3, briefly discussed above.

One of the conditions for application of reg. section 1.1032-3(b) is the provision in reg. section 1.1032-3(c)(1) to the effect that, absent the application of reg. section 1.1032-3(b), the acquiring entity would take a carryover basis in the issuing corporation’s stock under section 723 or section 362(a). Presumably that “carryover basis” is zero under the rationale of Rev. Rul. 74-503. Thus, if a court were to conclude that transferee stock is not “property” for purposes of section 351, such that the transferee takes a fair market value (or section 1012 cost) basis in the stock, the IRS would have done a meaningful thing in issuing reg. section 1.1032-3. That would be a rather bitter pill for the IRS to swallow. Query whether it is a pill that need be swallowed.

Section 1032(a) provides that no gain or loss is recognized by a corporation on the receipt of property or services in exchange for its own stock. The use of the term “recognized” in the context of section 1032 reflects pre-1954 precedent, such as Firestone Tire & Rubber Co. v. Commissioner,48 in which the courts held that a corporation may take a basis in its own stock reacquired from its shareholders and therefore recognize gain or loss on a subsequent sale of those shares, provided they were not retired before the later sale. In other words, it appears that the courts viewed an issuer’s own stock as “property” in its hands, such that issuers were in the favorable position of repurchasing their own stock and then reselling the repurchased shares at a loss if the stock price went down or issuing new shares without gain recognition if the stock price went up. Section 1032 was enacted in 1954 to prevent that “gaming” of the system, making it clear that no gain or loss is “recognized,” regardless of whether the shares sold are newly issued or repurchased shares that were not retired.

By contrast, reg. section 1.61-12(c)(1) provides that no gain or loss is realized on the issuance of the taxpayer’s own obligation. Unlike the issuer’s own stock, there is no precedent in the context of the issuer’s own obligations indicating that an issuer recognizes gain or loss on a resale of debt instruments previously repurchased by the issuer. Thus, historically there are grounds for concluding that stock may be viewed as “property” in the hands of its issuer, whereas debt may not be viewed that way.

However, the pre-1954 courts permitted an issuer of stock to acquire property in exchange for its equity (Footnote continued in next column.)
without gain or loss realization if the issuer used newly issued shares, rather than previously reacquired shares that were not retired. The enactment of section 1032 was designed in part to provide the same tax consequences in connection with the issuer’s resale of reacquired and unretired shares as applies in connection with the issuer’s sale of newly issued shares (in other words, after 1954, an issuer’s reacquired and unretired shares are the same kind of acquisition currency as its newly issued shares). As a consequence, notwithstanding the use of “recognized” rather than “realized” in the context of section 1032, the better view seems to be that an issuer’s stock constitutes a form of “liability” of the issuer that should not be treated as “property” in its hands.50

No doubt the issuance of reg. section 1.1032-3 and the historical precedent briefly discussed above make it more difficult for a court or the IRS to conclude that a corporation’s issuance of its own stock to a transferee corporation is not a transfer of “property” to which section 351 can apply. Nonetheless, the same considerations requiring a change in the treatment of transferor debt instruments conveyed to a transferee corporation (namely, that it makes no sense to treat the debt obligation as having a zero basis in the hands of the issuer) seem to have equal application to newly issued transferor stock before and following the enactment of section 1032 and to reacquired and unretired transferor stock after the enactment of section 1032. Thus, notwithstanding the higher stakes in the context of transferor stock, consistent treatment of transferor stock and debt seems appropriate.

C. Concluding Remarks

For many years, there has been an aura of illogic surrounding the federal income tax consequences flowing from a taxpayer’s transfer of its own debt instrument or stock to a transferee corporation in exchange for the transferee corporation’s stock and other consideration (particularly the transferee’s assumption of transferor liabilities that exceed the aggregate adjusted basis of the other property transferred). Before the decisions of the Second Circuit in Lessinger and the Ninth Circuit in Peracchi, administrative and judicial precedent indicated that the transferor’s own note or stock constitutes “property”, that has a zero basis in the hands of the transferor, yielding strange and unjustifiable federal income tax consequences to both the transferor and transferee corporation. That position has puzzled both commentators and taxpayers, principally because it makes little sense to view a taxpayer’s own obligation or stock as an asset in its hands that has a zero basis.

Two courts of appeals, the Second Circuit in Lessinger and the Ninth Circuit in Peracchi, have correctly divined the inappropriate tax consequences produced by that rather nonsensical view of those transferor “liabilities” as constituting zero basis “property” in the hands of the transferor and, in the context of transferor notes conveyed to a transferee corporation in a section 351 exchange in which the transferee corporation assumed transferor liabilities in excess of the aggregate adjusted basis of the other property conveyed to the transferee corporation, have attempted to craft an approach that avoids the inappropriate tax consequences. One can only applaud those efforts as well-intentioned approaches to reaching a more rational federal income tax characterization of what is occurring in this context.

Fortunately, other knowledgeable tax experts have also devoted a fair amount of intellectual capital to the issues presented by an issuance of notes of the transferor to the transferee corporation in a nonrecognition transaction. This author believes that the most insightful article on this conundrum written to date is the Lazar article, in which Prof. Lazar concludes that the better practical and policy approach is not to treat a transferor’s own obligation issued to a transferee corporation in a transaction otherwise qualifying for nonrecognition treatment under section 351 as a transfer of “property” for purposes of that section, but to split the obligation out from the other property transfers and treat it as a “taxable” purchase of the consideration received from the transferee corporation.

The author has three minor “enhancements” to Prof. Lazar’s points that seem worth mentioning. The first is that his overall conclusion that Congress should amend section 351(d) to make it clear that a transfer of a transferor obligation is not a transfer of “property,” while helpful, is not necessary. There appears to be sufficient authority under current law for the IRS or a court to reach that conclusion. The second is that the transferor’s note need not be allocated exclusively to transferee stock, but rather should be allocated among all the consideration received by the transferee from the transferee corporation (including boot and liability assumption) based on the relative amounts of that consideration. The third is that, while the issue is clearly more difficult in the context of transferor stock, there is no convincing reason for not extending the general premise of “nonproperty” to transferee stock, such that a transferor’s transfer of its own stock (or an option to sell or purchase the transferor’s own stock) to the transferee corporation is not treated as a transfer of “property” to the transferee corporation.

89Id.
50Sec note 28 supra.