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Determining the Character of Section 357(c) Gain

FRED B. BROWN*

I. Introduction

Under section 351, a person transferring property to a controlled corporation generally recognizes no gain or loss on the transaction;¹ thus, such transfers are generally free of federal income tax. An exception to tax-free treatment is contained in section 357(c), which generally provides that a transferor in a section 351 transaction recognizes gain to the extent that any liabilities assumed by the corporation on the transfer exceed the transferor's aggregate adjusted basis in the assets transferred.² Over the last few decades, tax scholars have devoted a significant, and possibly inordinate, amount of attention to the issue of whether a shareholder can avoid section 357(c) gain by contributing her own promissory note to a corporation.³ While this issue

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¹ See I.R.C. § 351. All section references are to the Internal Revenue Code of 1986 as amended (the Code).

² See I.R.C. § 357(c). In addition to its application in the section 351 setting, section 357(c) also applies to divisive D reorganizations. See I.R.C. § 357(c)(1). For a discussion of this aspect of section 357(c)'s application, see *infra* note 35.

³ See, e.g., Jerred G. Blanchard, Jr., *Zero Basis in the Taxpayer's Own Stock or Debt Obligations: Do Those Instruments Constitute 'Property'?*, 106 TAX NOTES (TA) 1431 (2005); John A. Bogdanski, *Closely Held Corporations*, 16 J. CORP. TAX'N 348 (1989); John A. Bogdanski, *Section 357(d)—Old Can, New Worms*, 27 J. CORP. TAX'N 17 (2000); Kenneth P. Brewer, *The Zero Basis Hoax*, 63 TAX NOTES 457 (1994); Jasper L. Cummings, Jr., *Zero Basis Hoax or Contingent Debt and Failure of Proof? Sorting Out the Issues in the Lessinger Case*, 2 FLA. TAX REV. 283 (1994); J. Clifton Fleming, Jr., *The Highly Avoidable Section 357(c): A Case Study in Traps for the Unwary and Some Positive Thoughts About Negative Basis*, 16 J. CORP. L. 1 (1990); Susan Kalinka, Peracchi: *What is the Right Result?*, 80 TAX NOTES 1615 (1998); Stuart Lazar, Lessinger, Peracchi, and the Emperor's New Clothes: *Covering a Section 357(c) Deficit with Invisible (or Nonexistent) Property*, 58 TAX LAW. 41 (2004); Richard M. Lipton & Joseph E. Bender, Peracchi and Making Something Out of Nothing, or Does Debt Have a Zero Basis to its Maker and Further Ruminations on the Substance and Form of Transaction, 77 TAXES 3, 13 (1999); Michael M. Megaard & Susan L. Megaard, *Can Shareholder's Note Avoid Gain on Transfer of Excess Liabilities?*, 71 J. TAX'N 244 (1989); Steven Quiring, *Section 357(c) and the Elusive Basis of the Issuer's Note*, 57 TAX LAW. 97 (2003).

no doubt has (or had) practical importance,⁴ perhaps a major attraction for tax scholars is that the issue involves fundamental questions relating to basis and liabilities.

Another issue under section 357(c) is the character of gain that is recognized under the provision, that is, whether it should be capital gain or ordinary income. Unlike the “promissory note” issue under this provision, the “character issue” has not received much in the way of extensive scholarly analysis.⁵ Yet, the issue seems ripe for a more detailed examination. The statute suggests that the character of section 357(c) gain should be based on the character of the transferred assets,⁶ but this does not provide a clear answer when two or more assets of differing character are transferred to the corporation. The Treasury regulations prescribe a method for determining the character of section 357(c) gain in this situation that allocates the gain according to the relative fair market value of the transferred assets.⁷ However, a few U.S. Tax Court decisions have not followed this method,⁸ and several commentators have stated that the regulatory method is simply wrong;⁹ instead, these cases and commentators espouse an alternative method that determines the character of section 357(c) gain based on the relative amount of realized gain on the transferred assets.¹⁰ Similar to the promissory note issue, the character

⁴Changes made in 1999 to section 357 regarding what constitutes an assumption of a liability may have mooted the issue, or at least reduce its importance. See Lazar, *supra* note 3, at 60–62.

⁵Several commentators have devoted portions of articles or treatises addressing the issue. See, e.g., DOUGLAS A. KAHN & JEFFREY S. LEHMAN, CORPORATE TAXATION INCOME TAXATION 657–59 (5th ed. 2001); Carter G. Bishop, *A Tale of Two Liabilities*, 16 WM. MITCHELL L. REV. 1, 19 & n.41 (1990); Karen C. Burke, *Contributions, Distributions, and Assumptions of Liabilities: Confronting Economic Reality*, 56 TAX LAW. 383, 399 (2003); Frank M. Burke, Jr. & Sam W. Chisholm, *Section 357: A Hidden Trap in Tax-Free Incorporations*, 25 TAX L. REV. 211, 233–34 (1970); Benjamin J. Cohen & Ronald E. Whitney, *Revisiting the Allocation of Boot in Section 351 Exchanges*, 48 TAX LAW. 959, 991–1007 (1995); George C. Koutouras & Mark Q. Tizabgar, *Boot Distributions and Assumption of Liabilities*, 782 TAX MNGT. PORT. (BNA) A-37 & n.354 (2007); Joel Rabinovitz, *Allocating Boot in Section 351 Exchanges*, 24 TAX L. REV. 337, 360 (1969); Howard J. Rothman et al., *Transfers to Controlled Corporations: In General*, 758 TAX MNGT. PORT. (BNA) A-86 & n.772 (2008); Thomas R. White, III, *Sleepers that Travel with Section 351 Transfers*, 56 VA. L. REV. 37, 56–57 (1970). The most extensive scholarly analysis addressing the section 357(c) character issue is the article by Cohen and Whitney, which, while assuming the correctness of the so-called relative realized gain allocation method, offers and analyzes a construct for this approach from which I borrow heavily. See Cohen & Whitney, *supra*, at 997–1005.

⁶See I.R.C. § 357(c)(1) (flush language).

⁷See Reg. § 1.357-2(b), Exs. (1), (2).

⁸See *Rosen v. Commissioner*, 62 T.C. 11, 19–20 (1974); *Raich v. Commissioner*, 46 T.C. 604, 608–09 (1966); *Easson v. Commissioner*, 33 T.C. 963, 970–71 (1960), *acq.* 1964-2 C.B., *nonacq.* 1964-2 C.B. 8, *rev'd on other grounds*, 294 F.2d 653 (9th Cir. 1961).

⁹See, e.g., Burke & Chisholm, *supra* note 5, at 233–34; Rabinovitz, *supra* note 5, at 360; Rothman, *supra* note 5, at A-41 n.354.

¹⁰See *Easson*, 33 T.C. at 971–72; Koutouras & Tizabgar, *supra* note 5, at A-37 & n.354; Rabinovitz, *supra* note 5, at 361; *cf. Rosen*, 62 T.C. at 19; *Raich*, 46 T.C. at 611.

issue involves some interesting fundamental issues, such as the manner in which basis is recovered in section 351 dispositions that involve the assumption of liabilities, as well as the way these dispositions should be conceptualized for tax purposes.

This Article analyzes the section 357(c) character issue and determines which of the competing methods and underlying constructs is more appropriate in light of the relevant tax rules and principles, and in particular those relating to nonrecognition. Part II of the Article begins the analysis by providing a brief primer on section 351, section 357, and related provisions applying to transfers of property to controlled corporations, along with the policies and principles underlying these rules. Part III describes two competing methods for determining the character of section 357(c) gain: the relative fair market value allocation method that is provided under the Treasury regulations, and the relative realized gain allocation method that has been applied in a few U.S. Tax Court decisions and advocated by several commentators. Part IV offers different ways of conceptualizing transfers to corporations in connection with the assumption of liabilities, each of which supports one of the competing methods for determining the character of section 357(c) gain. The relative fair market value allocation method is supported by an aggregate asset construct that combines the tax attributes of the transferred assets; the relative realized gain allocation method is supported by a modified separate assets construct that generally treats the transaction as transfers of separate assets.

Part V evaluates the constructs and resulting methods by examining section 351 and related provisions, including their underlying principles as well as general principles, and determines that the modified separate assets construct and resulting relative realized gain allocation method is the more appropriate manner for determining the character of section 357(c) gain. Part VI considers whether the modified separate assets construct should be modified for assets with secured liabilities, and decides against doing this for conceptual and administrative reasons. Based on this analysis, Part VII recommends the adoption of the relative realized gain allocation method for characterizing section 357(c) gain, along with a method for coordinating this approach with that used for recognizing gain under section 351(b) where a transferor receives boot in addition to having liabilities assumed. This part also evaluates whether the Treasury has the power to adopt the relative realized gain allocation method by amending the section 357 regulations without the need for congressional authorization. Part VIII provides the conclusion.

II. Provisions Applying to Transfers of Property to Controlled Corporations

A. Nonrecognition Treatment and Special Basis Rules

On a disposition of an asset, the transferor realizes gain or loss equal to the difference between the amount realized and the transferor's adjusted basis in

the property.¹¹ Normally, any realized gain or loss on a disposition is recognized, that is, included in gross income or potentially deductible as a loss.¹² However, a special set of tax rules applies to transfers of property to controlled corporations.

Section 351(a) provides that a transferor will not recognize gain or loss upon the transfer of property to a corporation in exchange for the corporation's stock, provided that the transferor or group of transferors controls the corporation immediately following the exchange.¹³ To the extent that a transferor receives money or other property in addition to stock, referred to as boot, section 351(b) requires the transferor to recognize any gain realized by the transferor on the exchange;¹⁴ however, any loss realized by the transferor cannot be recognized, regardless of the receipt of boot.¹⁵ Under section 1032, a corporation will not recognize gain or loss when it receives money or property in exchange for its stock.¹⁶

Special basis rules generally preserve any realized gain or loss that avoids recognition as part of a section 351 exchange. Section 358 generally provides that the transferor in a section 351 transaction will take a basis in the stock received in the exchange equal to the basis of the property transferred to the corporation, plus any gain recognized by the transferor on the transaction, less the value of any boot received.¹⁷ Under section 362, the corporation generally takes a basis in the property received in the exchange that is the same as the transferor's basis in the property, plus any gain recognized by the transferor on the transaction.¹⁸ These rules are modified by section 362(e), which generally provides that a corporation's aggregate adjusted basis in property received in a section 351 transaction cannot exceed the aggregate fair market value of such property immediately after the transaction.¹⁹

Section 351 was enacted to prevent the adverse tax consequences associated with a realization event from deterring corporate formations that amount merely to a change in the form of a taxpayer's holdings.²⁰ Accordingly, section

¹¹ See I.R.C. § 1001(a).

¹² See I.R.C. § 1001(c).

¹³ See I.R.C. § 351(a). Control for this purpose is the ownership of stock constituting (1) at least 80% of the voting power of the corporate stock and (2) at least 80% of the total number of shares of nonvoting stock. See I.R.C. § 368(c).

¹⁴ See I.R.C. § 351(b)(1).

¹⁵ See I.R.C. § 351(b)(2).

¹⁶ See I.R.C. § 1032(a). Section 1032(a) provides nonrecognition to the corporation regardless of whether the transferor controls the corporation immediately after the exchange.

¹⁷ See I.R.C. § 358(a).

¹⁸ See I.R.C. § 362(a).

¹⁹ See I.R.C. § 362(e)(2). Any reduction of a corporation's section 362(a) basis as a result of section 362(e)(2) is allocated among the property transferred to the corporation in proportion to their respective built-in losses prior to the exchange. See *id.* In lieu of applying the fair market value limitation to the corporation's basis in the transferred property, under section 362(e) the transferor and corporation can elect to apply the fair market value limitation to the transferor's stock basis. See *id.*

²⁰ See S. REP. NO. 275, at 11 (1921), as reprinted in 1939-1 C.B. 181, 188.

351 generally allows such transactions to escape current taxation. However, the policy reason for providing tax-free treatment to corporate formations does not support the permanent exclusion of economic gains or the permanent disallowance of economic losses. Consequently, sections 358 and 362 preserve realized gains and losses that have yet to be recognized, so that these items will be reflected in taxable income upon subsequent dispositions of the stock received by the transferor and the property received by the corporation.²¹ More specifically, section 358 effectuates a gain-loss preservation principle, under which the gain or loss realized by the transferor on a section 351 transaction is equal to the gain or loss recognized by the transferor on the transaction, plus the gain or loss inherent in the stock received by the transferor following the exchange. Section 362 similarly effectuates a gain-loss preservation principle—the gain or loss realized by the transferor on a section 351 transaction is equal to the gain or loss recognized by the transferor on the transaction, plus the gain or loss inherent in the assets transferred to the corporation following the exchange. Together, these provisions generally bring about the double preservation of realized gain or loss that is not recognized on the section 351 transaction.²²

As mentioned above, section 351(b) requires a transferor to recognize the amount, if any, of realized gain on the transferred assets to the extent of the amount or value of boot received.²³ In applying section 351(b) to situations where more than one asset is transferred to a corporation in exchange for stock and boot, the Service allocates the boot to the transferred assets based on their relative fair market values, and then applies section 351(b) separately to each asset, so that the transferor is required to recognize the lesser of the realized gain or the value of allocable boot with respect to each asset.²⁴ In

²¹ See BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.10[1]-[2] (7th ed. 2000).

²² Cf. Jasper L. Cummings, Jr., *The Silent Policies of Conversion and Cloning of Tax Basis and Their Corporate Applications*, 48 TAX L. REV. 113, 131 (1992) (referring to the double preservation of gain and loss as the price paid for the double nonrecognition of gain or loss received by the shareholder and corporation in a section 351 transaction); David A. Weisbach, *The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax*, 60 TAX L. REV. 215 (2007) (stating that the tax law must measure income at both the corporate shareholder and subsidiary levels to prevent easy avoidance). This is subject to the rule set forth in section 362(e).

²³ See *supra* notes 14–15 and accompanying text.

²⁴ See Rev. Rul. 1968-55, 1968-1 C.B. 140. In the ruling, the Service states that an asset-by-asset approach requires that each category of consideration received by the transferor must be separately allocated to the transferred assets in proportion to the relative fair market values of the assets. See *id.* The Service supports the use of this allocation method by referring to Treasury Regulation section 1.1245-4(c)(1), which, for purposes of determining the amount of section 1245 gain, uses the same method to allocate consideration where both section 1245 property and non-section 1245 property are transferred in certain nonrecognition transactions (including section 351 exchanges). See *id.* While authorities in support of the Revenue Ruling 1968-55 allocation method appear to be scarce, the method seems “reasonable and consistent” with approaches taken in other areas. See Rabinovitz, *supra* note 5, at 341, 344.

determining the corporation's section 362(a) basis in the transferred assets, the Service similarly applies an asset-by-asset approach and requires that the gain recognized on a specific asset be used to increase that asset's basis.²⁵ Allocating the recognized gain in this manner for section 362(a) purposes effectuates the gain-loss preservation principle on an individual asset basis. This ensures that gain or loss that is realized yet unrecognized with respect to an asset in a section 351 transaction is recognized when that asset is subsequently disposed of. Furthermore, effectuating the preservation principle on an individual asset basis preserves the appropriate amount of gain or loss from the standpoint of character.

The following example illustrates the use of an asset-by-asset approach under sections 351(b) and 362(a):

Example 1. Assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In exchange, the corporation transfers to the individual \$150 of stock and \$50 of cash. Asset A is a capital asset, and Asset B is an ordinary asset. At the time of the transfer, Asset A has a fair market value of \$100 and an adjusted basis in the individual's hands of \$90, and Asset B has a fair market value of \$100 and an adjusted basis in the individual's hands of \$10. For purposes of section 351(b), \$25 of cash would be allocated to each of the assets,²⁶ resulting in \$10 of recognized capital gain on Asset A (the lesser of \$10 of realized gain or \$25 of allocable boot) and \$25 of recognized ordinary income on Asset B (the lesser of \$90 of realized gain or \$25 of allocable boot). Under section 362(a), the corporation would take a basis of \$100 in Asset A (transferor's basis of \$90 plus \$10 of gain recognized by the transferor with respect to this asset) and a basis of \$35 in Asset B (transferor's basis of \$10 plus \$25 of gain recognized by the transferor with respect to this asset). Applying section 362(a) in this manner preserves the appropriate amount of gain or loss from the standpoint of character. That is, with respect to Asset A, the individual realizes \$10 of capital gain and recognizes \$10 of capital gain, with no gain or loss preserved (fair market value and basis of \$100 in corporation's hands); with respect to Asset B, the individual realizes \$90 of ordinary income and recognizes \$25 of ordinary income, with \$65 of ordinary income preserved (fair market value of \$100 and basis of \$35 in the corporation's hands).

B. *Assumption of Liabilities and Section 357(c) Gain*

Absent a special rule, the assumption of a transferor's liabilities by the transferee corporation in a section 351 transaction would be considered the receipt of boot by the transferor, thereby requiring the transferor to recognize any

²⁵ See, e.g., P.L.R. 1985-50-037 (Sept. 19, 1985); P.L.R. 1985-40-048 (July 5, 1985); P.L.R. 1985-17-040 (Jan. 30, 1985); P.L.R. 1985-16-031 (Jan. 18, 1985); P.L.R. 1985-12-071 (Dec. 18, 1984).

²⁶ This is because the assets have equal fair market values.

realized gain to the extent of the assumed liabilities.²⁷ This treatment would cause many incorporations of going businesses to become taxable events, and thus frustrate the policy of section 351. Section 357(a), enacted to prevent this result,²⁸ provides that the assumption of liabilities²⁹ generally will not constitute the receipt of boot for purposes of section 351.³⁰ In order to preserve the appropriate amount of gain or loss in the transferor's stock, section 358(d) treats the assumption of liabilities as money received by the transferor for purposes of determining the transferor's basis of the stock received in the section 351 transaction.³¹ As an exception to section 357(a), section 357(b) treats the assumption of liabilities as the receipt of boot if the transferor's principal purpose with respect to the assumption either was a purpose to avoid federal income tax or was not a bona fide business purpose.³²

The following example illustrates the application of sections 357(a) and 358(d):

Example 2. Assume that an individual transfers an asset with a fair market value of \$100 and an adjusted basis of \$20 to a corporation in a transaction qualifying under section 351. In exchange, the corporation transfers \$90 of stock and assumes (for purposes of section 357) \$10 of section 357(a) liabilities of the individual (*e.g.*, longstanding business liabilities). Pursuant

²⁷ See *United States v. Hendler*, 303 U.S. 564 (1938) (holding that for purposes of the reorganization provisions, the assumption of liabilities is considered the equivalent of cash received by the party whose liabilities are assumed, therefore triggering the recognition of boot gain). For a complete discussion of *Hendler*, see Karen C. Burke, *The Story of Hendler: From Pyrrhic Victory to Modern Section 357*, BUSINESS TAX STORIES 181 (Steven A. Bank & Kirk J. Stark eds., 2005).

²⁸ See H.R. REP. NO. 76-855 (1939), as reprinted in 1939-2 C.B. 504, 518-20. Also playing an important role in the enactment of section 357(a)'s statutory predecessor was that the *Hendler* decision probably would have entitled transferee corporations to increase their bases in assets for gain that should have been recognized by the transferors upon the assumption of liabilities. The increased basis would have generated tax savings through depreciation deductions and reduced gain or increased losses on asset sales, but the government's claims for additional taxes against the transferors might have been barred by the statute of limitations. Therefore, in addition to taxpayers, the government also had reason for overriding *Hendler*. See RICHARD L. DOERNBERG & HOWARD E. ABRAMS, FEDERAL INCOME TAXATION OF CORPORATIONS AND PARTNERSHIPS 24-25 (3rd ed. 2000); Burke, *Hendler: Modern Section 357*, *supra* note 27, at 191-92.

²⁹ A recourse liability is treated as having been assumed if, on the basis of all the facts and circumstances, the transferee corporation has agreed to, and is expected to, satisfy the liability, regardless of whether the transferor has been relieved of the liability. A nonrecourse liability is generally treated as having been assumed where the transferee corporation takes an asset subject to the liability. See I.R.C. § 357(d).

³⁰ See I.R.C. § 357(a). Section 357(a) also applies to section 361 transactions in the context of corporate reorganizations. See *id.*

³¹ See I.R.C. § 358(d)(1).

³² See I.R.C. § 357(b). Section 357(b) is aimed at the situation where a transferor borrows on the eve of incorporation and then transfers the liability to the corporation, which effectively results in the receipt of cash by the transferor. Transfers of personal liabilities to the transferee corporation are also covered. See BITTKER & EUSTICE, *supra* note 21, at ¶ 3.06[1][a].

to section 357(a), the assumption of liabilities will not be treated as boot, and therefore, under section 351(a), the individual will recognize none of her realized gain of \$80 (amount realized of \$100 less adjusted basis of \$20) on the transaction. Under section 358, the individual will take a \$10 basis in the stock received, which is equal to the individual's basis in the property transferred (\$20), plus the gain recognized by the individual (\$0), minus the money or other boot received by the individual (\$10, due to the assumption of liabilities, which is treated as money received for basis purposes). These results satisfy the gain-loss preservation principle, as the gain realized by the individual (\$80) equals the gain recognized by the individual (\$0) plus the gain inherent in the stock following the exchange (\$80, the difference between the stock's fair market value of \$90 and its basis of \$10).

If in Example 2 the asset had a basis of \$5 in the individual's hands, a straightforward application of sections 357(a) and 358 would result in no gain recognized and a basis of *negative* \$5 in the stock (\$5 basis in the asset, plus \$0 gain recognized, minus \$10 money received for basis purposes). However, the tax law does not permit a negative basis.³³ And providing a stock basis of zero without the recognition of gain on these facts would violate the gain-loss preservation principle: the \$95 of realized gain (amount realized of \$100 less the asset's adjusted basis of \$5) would *not* equal the \$0 of recognized gain plus the \$90 of gain inherent in the stock following the transaction (the difference between the stock's fair market value of \$90 and its basis of \$0). To avoid having a negative basis while adhering to the gain-loss preservation principle, Congress enacted section 357(c),³⁴ which provides that the transferor in a section 351 transaction³⁵ will recognize gain to the extent that the total liabilities

³³See, e.g., *Esson v. Commissioner*, 33 T.C. 963, 971 (1960), *acq.* 1964-2 C.B., *nonacq.* 1964-2 C.B. 8, *rev'd on other grounds*, 294 F.2d 653 (9th Cir. 1961).

³⁴See George Cooper, *Negative Basis*, 75 HARV. L. REV. 1352, 1358-60 (1962); cf. Lazar, *supra* note 3, at 53 n.42 (stating that this is the most common rationale for section 357(c)).

³⁵Section 357(c) also applies to a transfer of property by one corporation to another corporation that is subject to section 361 and occurs pursuant to a divisive D reorganization. See *supra* note 2. Very generally, a divisive D reorganization is a transaction qualifying for full or partial nonrecognition, in which a corporation transfers property to a controlled corporation and then distributes stock in the controlled corporation to its shareholders in a divisive spin-off, split-up, or split-off reorganization. See I.R.C. §§ 355, 368(a)(1)(D); BITTKER & EUSTICE, *supra* note 21, at ¶ 12.26[1]. Prior to 2004, section 357(c) also applied to nondivisive D reorganizations (see I.R.C. § 357(c)(1)(B) (prior to 2004)), which very generally are transfers to controlled corporations that are not followed by divisive transactions and require the liquidation of the transferor corporation. See I.R.C. §§ 354(b), 368(a)(1)(D); BITTKER & EUSTICE, *supra* note 21, at ¶ 12.26[1]. It should be noted that in the D reorganization context, section 357(c) apparently is no longer aimed at avoiding a negative basis. (Congress's original reason for applying section 357(c) to D reorganizations apparently was to address the negative basis problem in this context as well, but Congress's intention was frustrated as a result of other statutory changes made upon the enactment of the provision. See Cooper, *supra* note 34, at 1358-60.) This is because for the most part, a D reorganization requires that the transferor corporation distribute the stock of the transferee corporation to its shareholders, and the basis that these shareholders take in the distributed stock is determined based on their basis in

assumed by the corporation exceed the transferor's aggregate adjusted basis in the properties transferred.³⁶

the stock of the transferor corporation. See I.R.C. §§ 354(b)(1), 355(a)(1)(D), 368(a)(1)(D), 358(a); Cooper, *supra* note 34, at 1359; Candace A. Ridgway & Larry E. Phillips, *Corporate Acquisitions-D Reorganizations*, 772 TAX MNGT. PORT. (BNA) A-64 (2004). Therefore, the transferor's bases in the transferred assets and the assumed liabilities play a small role, if any, in determining the basis in the stock of the transferee corporation and thus the fact that the assumed liabilities may exceed the assets' bases is of little consequence for basis purposes. Indeed, the Senate report that accompanies the 2004 amendments to section 357(c) does not mention the negative basis problem as a reason for limiting the provision's applicability to divisive D reorganizations. See S. REP. NO. 108-192 (2004). Instead, the Senate report refers to the fact that in a nondivisive D reorganization, the assumption of the transferor corporation's liabilities does not enrich the transferor because it is required to transfer all of its assets and go out of existence. See *id.* Consequently, the current rationale for applying section 357(c) to divisive D reorganizations appears to be a desire to tax the transferor corporation to the extent that it ends up with the economic equivalent of cash received, due to the assumption of liabilities, that exceeds the transferor's total basis in the transferred property. To this extent, Congress is not willing to ignore for tax purposes the transferor corporation's disposition of property. Note that aside from the application of section 357(c), the transferor corporation's disposition of property pursuant to a divisive D reorganization is essentially ignored, given that no gain or loss is generally recognized, and that realized but unrecognized gain or loss is not preserved in the stock of the transferee corporation (unlike what occurs in a section 351 transaction).

³⁶ See I.R.C. § 357(c)(1). Where a section 351 transaction involves more than one transferor, section 357(c) is applied separately to each transferor. Rev. Rul. 1966-142, 1966-2 C.B. 66. In determining the amount of liabilities assumed for purposes of section 357(c), the statute generally excludes obligations that would give rise to a deduction (or which would be described in section 736(a)) if paid by the transferor. See I.R.C. § 357(c)(3).

Prior to 1999, section 357(c) gain was recognized to the extent that "the sum of the liabilities assumed, *plus the amount of liabilities to which the property is subject*" exceeded the transferor's aggregate basis in the transferred assets. See § 357(c)(1) (prior to amendments made by the Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(d)(4), 113 Stat. 127 (codified as amended in scattered sections of 26 U.S.C.)) (emphasis added). Under this rule, recourse liabilities secured by the transferred assets were taken into account in determining section 357(c) gain, even if the transferor remained personally liable on the obligations. See Reg. § 1.357-2(a). In light of this rule, taxpayers attempted to eliminate section 357(c) by employing several techniques, the most famous being the contribution of the taxpayer's own promissory note in an attempt to increase the basis of the property transferred to the corporation. This led to the rejection by the Service (see Rev. Rul. 1968-629, 1968-2 C.B. 154) and the Tax Court (see, e.g., *Alderman v. Commissioner*, 55 T.C. 662 (1971)) of the promissory note technique for eliminating section 357(c) gain, its acceptance by two federal courts of appeals (see *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998); *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989)), and much scholarship on the issue (see *supra* note 3). Under the post-1998 rule, section 357(c) only takes into account liabilities assumed, which in the case of recourse liabilities, are treated as having been assumed if, on the basis of all the facts and circumstances, the transferee corporation has agreed to, and is expected to, satisfy the liability, regardless of whether the transferor has been relieved of the liability. See I.R.C. § 357(d)(1)(A). With the current rule, transferors may be able to avoid section 357(c) gain with respect to secured recourse liabilities by agreeing with the transferee corporations that the transferors, rather than the corporations, will satisfy the recourse liability. See *Bogdanski, Section 357(d)*, *supra* note 3, at 26. With respect to recourse liabilities, this may moot the promissory note issue, and indeed may have effectively written section 357(c) out of the Code. See *id.* at 27; Burke, Hendler: *Modern Section 357*, *supra* note 27, at 200 n.118 &

Applying section 357(c) to the facts of Example 2, as modified above, results in \$5 of recognized gain (\$10 of liabilities less \$5 of adjusted basis) and a stock basis of \$0 ((\$5 basis in the asset, plus \$5 gain recognized, minus \$10 money received for basis purposes). With these results, the gain-loss preservation principle is satisfied—\$95 of realized gain equals \$5 of recognized gain plus \$90 of gain inherent in stock following the transaction.

As with section 351(b) gain, section 357(c) gain will generally result in an increase in the corporation's basis in the property received pursuant to section 362(a).³⁷ However, section 362(d)(1) provides a limitation, under which a corporation's basis in the property received cannot be increased above the fair market value of the property as a result of the recognition of gain under section 357(c).³⁸ Congress's apparent reason for enacting section 362(d)(1) was to create a general anti-abuse measure aimed at perceived corporate tax shelter abuses.³⁹

III. Approaches for Determining the Character of Section 357(c) Gain

With regard to the character of section 357(c) gain, the statute provides, somewhat cryptically, that such gain is treated as from the sale or exchange of property that is a capital asset or is not a capital asset, as the case may be.⁴⁰ The legislative history of the provision indicates that this determination is

204. Nevertheless, there is some possibility that given the "on the basis of all the facts and circumstances" language contained in the statute, the Service could establish that parties agreed and expected that the corporation, rather than the transferor, would satisfy the liability, despite an express agreement to the contrary. See Bogdanski, *Section 357(d)*, *supra* note 3, at 22–24, 27. Thus, section 357(c) may still have some vitality with respect to recourse liabilities. With regard to nonrecourse liabilities, section 357(c) should continue to have significant impact, given that a nonrecourse liability is generally treated as having been assumed where the transferee corporation takes an asset subject to the liability, with an exception for the amount of a liability that is also secured by assets not transferred to the corporation (to the extent that the owner of the other assets has agreed with the transferee, and is expected, to satisfy the liability, or the other assets' fair market value, if lower). See I.R.C. § 357(d). In this regard, the Service and the Treasury have been studying section 357(d) and intend to issue proposed regulations that address certain issues arising under the provision, several of which involve the amount of nonrecourse liabilities that a transferee of property is treated as having assumed. See Announcement 2003-37, 2003-1 C.B. 1025.

³⁷As discussed earlier, under section 362(a) the corporation's basis in the property received in a section 351 transaction is equal to the transferor's basis in the property, increased by the amount of gain recognized by the transferor on the transaction. See I.R.C. § 362(a).

³⁸See I.R.C. § 362(d)(1).

³⁹See STAFF OF J. COMM. ON TAX'N, 107TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS 10 (Comm. Print 2001); Burke, *Confronting Economic Reality*, *supra* note 5, at 394. Some commentators have indicated that Congress enacted the provision specifically to prevent a corporation from taking a basis in property that is above its fair market value where the amount of liabilities assumed on a transfer exceeds the property's fair market value. See *NYSBA Tax Section Comments on Proposed Regs Requiring Exchange of Net Value for Nonrecognition Treatment*, 2006 TAX NOTES TODAY 15-10 (Jan. 24, 2006) [hereinafter *NYSBA Comments*].

⁴⁰See I.R.C. § 357(c)(1).

based on the character of the assets transferred to the corporation.⁴¹ For situations involving the transfer of two or more assets of differing character, two methods have emerged for determining the character of section 357(c) gain: the relative fair market value allocation method provided under the Treasury Regulations and sanctioned by section 357(c)'s legislative history, and the relative realized gain allocation method that has been applied in a few U.S. Tax Court decisions and advocated by several commentators. These methods are discussed below.

A. *Relative Fair Market Value Allocation Method*

By way of examples, Treasury Regulation section 1.357-2(b) provides that the character of section 357(c) gain is determined based on the relative fair market values of the assets transferred to the corporation.⁴² According to the regulations, if half of the transferred assets, based on their fair market values, are capital assets and half are not, then half of the section 357(c) gain will be treated as capital gain and half will be other than capital gain.⁴³ The regulations also provide a similar example involving capital assets with long-term and short-term holding periods.⁴⁴ The regulatory rule is apparently based on the Senate report accompanying the enactment of section 357(c), which contains an example that is almost identical to the holding period example found in the regulations.⁴⁵

It is not clear why Congress and the Treasury chose the relative fair market value method for determining the character of section 357(c) gain. Perhaps it is thought to logically follow from the section 357(c) recognition rule, which aggregates the properties transferred to the corporation in determining whether liabilities exceed adjusted basis.⁴⁶ As I demonstrate in Part IV, a construct that treats the transferred properties as an aggregate supports using the relative fair market value allocation method.⁴⁷ Alternatively, Congress and the Treasury may have chosen this method because it can apply even when all of the transferred assets have realized losses.⁴⁸

⁴¹ See S. REP. NO. 83-1622 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4908.

⁴² See Reg. § 1.357-2(b), Exs. (1), (2).

⁴³ See *id.*, Ex. (2).

⁴⁴ See *id.*, Ex. (1).

⁴⁵ See S. REP. NO. 83-1622 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4908.

⁴⁶ See Rothman, *supra* note 5, at A-86.

⁴⁷ See *infra* notes 99–104 and accompanying text.

⁴⁸ Perhaps this was a factor in adopting this method as opposed to the relative realized gain allocation method. Cf. BITTKER & EUSTICE, *supra* note 21, at ¶ 3.06[4][d]-[e] (noting that while the relative realized gain allocation method is reasonable, it is not obviously correct, since section 357(c) can apply even if all of the transferred assets have a value that is less than their adjusted basis). As discussed in Part V.E, there should be no need to apply any characterization method where all of the transferred assets have realized losses, because of the lack of section 357(c) gain in this situation; this is consistent with the proposed “net value” regulations under sections 351 and 368 (which are discussed in Part V.E). However, Congress and Treasury may not have had this view when section 357(c) was enacted and the section 357(c) regulations

Several commentators have criticized the relative fair market value allocation method because it can result in the allocation of section 357(c) gain for characterization purposes to assets that lack realized gain (or that have less realized gain than the gain being allocated to them).⁴⁹ The following example illustrates this:

Example 3. Assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In connection with the transfer, the corporation assumes (for purposes of section 357) \$140 of section 357(a) liabilities of the individual (e.g., longstanding business liabilities). Asset A is a capital asset with a fair market value of \$100 and an adjusted basis in the individual's hands of \$20. Asset B is an ordinary asset with a fair market value of \$100 and an adjusted basis in the individual's hands of \$110. On the transfer, the individual would recognize \$10 of section 357(c) gain.⁵⁰ Under the relative fair market value method, \$5 of the gain is capital gain, and \$5 of the gain is ordinary income.⁵¹ Thus, the regulatory method has the effect of allocating for characterization purposes \$5 of the gain to Asset B, which has a realized loss of \$10,⁵² what some commentators view as an absurd result.⁵³

were adopted. See G.C.M. 33,915 (Aug. 26, 1968) (concluding for purposes of a proposed revenue ruling (that was never issued) that section 357(c) treats as gain the excess of liabilities assumed over the adjusted basis of property transferred to a corporation, even though the liabilities may exceed the fair market value of the transferred property; finding nothing in the legislative history of section 357(c) that supports other than a literal application of the provision).

One commentator is of the view that the regulatory method does not reflect a thought-out and deliberate approach for characterizing section 357(c) gain. See John D. Fredericks, *The Character of Section 357(c) Gain: Why the Underlying Regulation is Capable of Producing Absurd Results*, 48 Tax Law. 167, 175 (1994). His views are based on the assertion that the example in the House report, calling for the relative fair market value allocation method in determining whether section 357(c) gain is long- or short-term capital gain, reflected an approach by the House of Representatives to characterize section 357(c) with reference to the stock in the transferee corporation, as opposed to the transferred assets. See H.R. REP. NO. 83-1337 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4268-69. According to this commentator, the example was retained in the Senate report and adopted (and expanded) in the regulations without considering the fact that the Senate amended the House bill so as to characterize section 357(c) based on the nature of the transferred assets. See Fredericks, *supra*, at 172-75.

⁴⁹ See STEPHEN A. LIND ET AL., *FUNDAMENTALS OF CORPORATE TAXATION—CASES AND MATERIALS* 83 n.8 (6th ed. 2005); DAVID J. SHAKOW, *THE TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS* 78 (1991); Bishop, *supra* note 5, at 19 n.41 (noting that the regulation can produce counter-intuitive results); Burke, *Confronting Economic Reality*, *supra* note 5, at 399; Burke & Chisholm, *supra* note 5, at 233-34; Cohen & Whitney, *supra* note 5, at 991-95; Fredericks, *supra* note 48, at 168; Rabinovitz, *supra* note 5, at 360; Rothman, *supra* note 5, at A-41 n.354; White, *supra* note 5, at 56-57.

⁵⁰ This is equal to the difference between the assumed liabilities of \$140 and the assets' aggregate adjusted basis of \$130.

⁵¹ This is because the assets have equal fair market values.

⁵² This is because Asset B has a fair market value of \$100 and an adjusted basis of \$110.

⁵³ See Rabinovitz, *supra* note 5, at 360; Rothman, *supra* note 5, at A-41 n.354.

B. *Relative Realized Gain Allocation Method*

An alternative approach for determining the character of section 357(c) gain would be to allocate the gain to the transferred assets based on their relative amount of realized gain. In *Easson v. Commissioner*,⁵⁴ the Tax Court used the relative realized gain allocation method to characterize what amounted to section 357(c) gain. Actually, the case involved a taxable year that was prior to the effective date of section 357(c), but the Tax Court nevertheless required the taxpayer to recognize gain to the extent that the liabilities transferred to the corporation exceeded the taxpayer's aggregate basis in the transferred assets.⁵⁵ The Tax Court determined the character of the recognized gain by allocating the gain to the transferred assets, a building and land, in proportion to the realized gains on these assets.⁵⁶ While Treasury Regulation section 1.357-2(b) had been promulgated at the time that the case was decided, the Tax Court was not bound by the regulation's relative fair market value allocation method given the taxable year involved.⁵⁷

Subsequently, in two cases involving taxable years subject to Treasury Regulation section 1.357-2(b), the Tax Court allocated section 357(c) gain solely to assets with realized gain despite the relative fair market value approach called for by the regulations. In *Raich v. Commissioner*,⁵⁸ the Tax Court allocated the entire amount of section 357(c) gain to assets with realized gain, which were accounts receivable and depreciable equipment; the court decided not to allocate any of the gain to cash and prepaid rent because these assets lacked any gain or loss.⁵⁹ As a consequence, the Tax Court treated the section 357(c) gain as ordinary income because the accounts receivable and depreciable equipment were ordinary assets.⁶⁰ In its analysis, the Tax Court observed that the character of section 357(c) gain depends on the type of the individual assets transferred.⁶¹ However, the court did not mention Treasury Regulation section 1.357-2(b) and instead relied on case law treating the sale of a business as a sale of separate assets for purposes of determining the character of any gain or loss.⁶² Similarly, in *Rosen v. Commissioner*,⁶³ the Tax Court allocated the entire amount of section 357(c) gain solely to the transferred assets with

⁵⁴ 33 T.C. 963 (1960).

⁵⁵ The Tax Court viewed the enactment of section 357(c) as a clarification of existing law as opposed to a change in the law. The court of appeals reversed the Tax Court on this point. See *Easson*, 294 F.2d 653, 654 (9th Cir. 1961).

⁵⁶ The gain allocated to the building was ordinary income pursuant to the statutory predecessor to section 1239; the gain allocated to the land was long-term capital gain.

⁵⁷ The Tax Court did not mention the regulation.

⁵⁸ 46 T.C. 604 (1966).

⁵⁹ See *id.* at 611.

⁶⁰ See *id.* The accounts receivable were excluded from the definition of capital assets under section 1221(4) (currently section 1221(a)(4)), and gain on the equipment was treated as ordinary income under section 1239. See *id.*

⁶¹ See *id.*

⁶² See *id.*

⁶³ 62 T.C. 11 (1974), *aff'd without opinion*, 515 F.2d. 507 (3d Cir. 1975).

realized gain, which were jukeboxes that constituted section 1245 property, and treated the section 357(c) gain as ordinary income.⁶⁴ The Tax Court did note that the character of section 357(c) gain is determined by allocating the gain among the transferred assets based on their relative fair market values, citing Treasury Regulation section 1.357-2 for this proposition.⁶⁵ However, the court declined to allocate any section 357(c) gain to transferred assets that had not appreciated in value, concluding that it is only logical to allocate the entire gain to the assets with realized gain.⁶⁶

It should be noted that unlike the Tax Court in *Easson*, the court in *Raich* and *Rosen* did not actually apply the relative realized gain allocation method, but instead allocated all of the section 357(c) gain to the transferred assets with realized gain. In both cases, the only assets with realized gain were ordinary assets, so it was unnecessary to further apportion the section 357(c) gain among these assets by referring to the relative amounts of realized gain.⁶⁷ This may be significant as a matter of positive law, given that the Tax Court may be reading Treasury Regulation section 1.357-2(b) as characterizing section 357(c) gain on the basis of the relative fair market values of *appreciated* assets. In any event, this would appear to be a strained interpretation of the regulation,⁶⁸ and one that apparently lacks any theoretical support.⁶⁹

In addition to the case law, several commentators have advocated using the relative realized gain allocation method to determine the character of section 357(c) gain.⁷⁰ They argue that the regulatory method can produce distorted results, which would be avoided by allocating the section 357(c) gain among

⁶⁴ See *id.* at 19–20.

⁶⁵ See *id.*

⁶⁶ See *id.*

⁶⁷ See *Rosen*, 62 T.C. at 19–20; *Raich*, 46 T.C. at 611.

⁶⁸ The examples contained in Treasury Regulation section 1.357-2(b) do not mention that the assets involved are appreciated in value. See Reg. § 1.357-2(b), Exs. (1), (2).

⁶⁹ Neither of the constructs offered in Part IV supports an approach that would characterize section 357(c) gain on the basis of the relative fair market values of appreciated assets. Moreover, such an approach could still produce what are arguably distorted results—the allocation of an amount of section 357(c) gain that exceeds the realized gain on a particular asset.

Another possibility is that the Tax Court is reading the regulation as providing a method that is only applicable where all of the assets are appreciated assets, and that where one or more loss assets are present, another method may be used to characterize the section 357(c) gain. Cf. Bishop, *supra* note 5, at 19 n.41 (suggesting that the regulatory method perhaps can be considered illustrative only where all of the assets have realized gain, and that where some of the assets have realized loss, it may be more realistic to use the relative realized gain allocation method to characterize section 357(c) gain). However, even with all appreciated assets, the regulatory method may produce results that are arguably distorted, as noted above.

⁷⁰ See KAHN & LEHMAN, *supra* note 5, at 657–59 (contending that either section 357(c) gain should be allocated among the transferred properties that have realized gain, or among the properties with secured liabilities in excess of their bases); SHAKOW, *supra* note 49, at 78; Bishop, *supra* note 5, at 19 n.41; Burke & Chisholm, *supra* note 5, at 233–34; Rabinovitz, *supra* note 5, at 360; Rothman, *supra* note 5, at A-41 n.354; cf. Burke, *Confronting Economic Reality*, *supra* note 5, at 400; Cohen & Whitney, *supra* note 5, at 995 (assuming this method to be correct based on the Tax Court decisions and leanings of commentators).

the assets based on their relative amounts of realized gain.⁷¹ While none of these commentators have engaged in an extensive analysis of the appropriate method for characterizing section 357(c) gain, their basic point, which they illustrate through examples, is that it is wrong to characterize section 357(c) gain with regard to assets that lack realized gain, and that instead section 357(c) gain should be attributed to the assets that produced it.⁷² Applying the relative realized gain method to the facts of the Example 3⁷³ demonstrates the asserted virtues of this method. All \$10 of section 357(c) would be characterized with reference to Asset A because it is the only asset with realized gain, and would be capital gain because Asset A is a capital asset.⁷⁴ Thus, all of the section 357(c) gain would be attributed to the asset that has increased in value; none of the gain would be attributed to the asset that has declined in value.

IV. Conceptualizing Transfers to Corporations with the Assumption of Section 357(a) Liabilities

As discussed above, commentators critical of the regulatory approach for characterizing section 357(c) gain conclude that the approach is wrong because it can result in the allocation of gain to assets that lack realized gain.⁷⁵ Given that these commentators are referring to the realized gains on *individual* assets, these criticisms are apparently based on the premise that the assets should be viewed separately for purposes of the character determination. However, it is clear that for basis recovery purposes, the statute calls for an aggregate approach that combines the bases of the individual assets.⁷⁶ A pure separate assets approach would allow for the recovery of basis only to the extent that assumed liabilities allocated to individual assets (presumably done on the basis of relative fair market values) did not exceed the basis of these assets. Therefore, in light of the statutory rule, it is not so certain that the regulatory approach is wrong and an approach that characterizes section 357(c) gain based on the relative realized gains on the transferred assets is cor-

⁷¹ See *supra* note 70.

⁷² *Id.*

⁷³ See *supra* notes 50–53 and accompanying text.

⁷⁴ If instead Asset B had a fair market value of \$130 and thus a realized gain of \$20, there would be \$100 of total realized gain, 20% of which is attributed to Asset B and 80% attributed to Asset A; in this case, \$8 of the section 357(c) gain would be allocated to Asset A and be capital gain, \$2 of the gain would be allocated to Asset B and be ordinary income.

⁷⁵ See *supra* note 49 and accompanying text.

⁷⁶ Under section 357(c), gain is recognized only to the extent that assumed liabilities exceed the aggregate adjusted basis in the transferred assets. See I.R.C. § 357(c)(1).

rect.⁷⁷ At the very least, this issue warrants further analysis.

Indeed, one can conceptualize a transfer of assets to a corporation with the assumption of liabilities in a manner that justifies the relative fair market value allocation method used in the regulations.⁷⁸ On the other hand, it is also possible to view these transactions in a way that supports using the relative amounts of realized gain on the transferred assets to determine the character of section 357(c) gain.⁷⁹ This part offers and examines these two constructs for analyzing the tax treatment of section 351 dispositions accompanied by the assumption of the transferor's liabilities. The next part of the Article then determines which of the two conceptualizations and resulting approaches for determining the character of section 357(c) gain is the more appropriate one by examining section 351 and related provisions, along with their underlying principles as well as more general tax principles.⁸⁰

As with other tax issues, constructs for the recognition of gain in these situations should inform the choice of the appropriate method for determining the character of section 357(c) gain.⁸¹ Such gain should relate to the gain realized on the property transferred, and the constructs allow for this relationship to be seen and analyzed. More specifically, the constructs offered below recognize that section 357(c) gain results from the allocation of a portion of the section 357(a) liabilities to the realized gain on the transferred assets, similar to the way in which boot is allocated to realized gain for purposes of section 351(b). The constructs differ, however, in their view of the property transferred—that is, as an aggregate of assets or as separate assets.⁸²

A. Assumed Section 357(a) Liabilities Are the Economic Equivalent of Cash Received that Is First Applied Against Aggregate Basis

Under any construct for section 351 dispositions with the assumption of liabilities, the assumed section 357(a) liabilities should be treated as the eco-

⁷⁷Moreover, more than one allocation method could address the commentator's concern. For example, a method that characterized section 357(c) gain based on the relative fair market values of *appreciated* assets generally would avoid the problems noted with respect to the regulatory approach. An exception would be where the amount of section 357(c) gain allocated to an asset exceeded the realized gain on that asset, but this could be addressed by allocating the excess gain to the other appreciated assets.

⁷⁸See *infra* notes 99–104 and accompanying text.

⁷⁹See *infra* notes 105–119 and accompanying text.

⁸⁰*Cf.* Rabinovitz, *supra* note 5, at 350 (engaging in a similar analysis in deciding on the approach for determining boot gain under section 351(b) where there are transfers of multiple assets).

⁸¹As an example, Revenue Ruling 1968-55 uses a construct for the recognition of section 351(b) gain under which each asset is viewed as separately transferred to the corporation in exchange for a ratable portion of stock and boot. Rev. Rul. 1968-55, 1968-1 C.B. 140.

⁸²While the constructs and analysis that follow focus on the assumption of liabilities in the section 351 context, the same constructs and analysis also should apply to the assumption of liabilities in connection with divisive D reorganizations. In both contexts, gain is potentially recognized upon the transfer of property to a controlled corporation as a result of the assumption of liabilities, and the gain needs to be attributed to the transferred assets.

conomic equivalent of cash received that is first applied against the transferor's aggregate adjusted basis in the transferred property.⁸³ This follows from the effect of sections 357(a) and (c), which allow a transferor to recover section 357(a) liabilities⁸⁴ tax free to the extent of the aggregate adjusted basis in the transferred assets, and the fact that the assumed liabilities are the economic equivalent of cash received by the transferor (that is used to satisfy the transferor's indebtedness). Thus, the statute permits such tax-free treatment by effectively treating a portion of the constructive cash as received for the part of the assets that consists entirely of basis. Following the recovery of the aggregate basis in the transferred assets, the remaining amount of constructive cash should be viewed as applied against the remaining value of the transferred assets. Conceptually, 357(c) gain results because the remaining constructive cash is received for the part of the assets that has zero basis due to the prior recovery of the transferor's basis in the assets. In other words, the remaining constructive cash is received for the part of the assets that consists entirely of realized gain.

In light of income tax principles, section 357(c) is unremarkable in that it requires the recognition of gain to the extent that the constructive cash exceeds the transferor's basis in the transferred assets, thereby obviating the need for a negative basis in the stock received by the transferor. The real significance of sections 357(a) and (c) from the standpoint of tax principles is that these provisions first apply the constructive cash against the basis in the transferred property, as opposed to realized gain or a combination of basis and realized gain,⁸⁵ and aggregate the bases in the transferred property for this purpose. The "aggregate recovery of basis first" approach is based on Congress's desire to facilitate the tax-free formation of corporations and similar transactions that arguably represent a restructuring of a taxpayer's holdings;⁸⁶ in this regard, it is not uncommon for liabilities to be assumed upon the transfer of assets to a corporation, especially those that comprise a going business.⁸⁷ Another reason for this treatment may be the fact that the assumed liabilities do not provide a transferor with liquidity to pay a current tax.⁸⁸

The basis recovery approach permitted for section 357(a) liabilities is different than the usual treatment for cash or other forms of boot received by a transferor in section 351 transactions (or other nonrecognition transactions). Normally, boot is first applied against the amount of realized gain, if any, that

⁸³This conceptualization should also apply in the context of divisive D reorganizations.

⁸⁴See *supra* notes 29–32 and accompanying text.

⁸⁵See HOWARD E. ABRAMS & RICHARD L. DOERNBERG, FEDERAL CORPORATE TAXATION 27–28 (4th ed. 1998) (stating that there is a "basis first" rule for liabilities and a "gain first" rule for boot).

⁸⁶See Rabinovitz, *supra* note 5, at 353; *supra* notes 27–28 and accompanying text.

⁸⁷See Rabinovitz, *supra* note 5, at 353.

⁸⁸*Cf.* Temp. Reg. § 15a.453-1(b)(3)(i), which generally excludes assumed liabilities from payments for purposes of recognizing gain under the installment method because they do not provide the seller with liquidity to pay tax.

a transferor has in the transferred property, thereby triggering the recognition of any realized gain to this extent.⁸⁹ Thus, section 351 (and other nonrecognition provisions) can be viewed as effectively treating the disposition of property with realized gain as two dispositions: (i) the transfer of a portion of the property representing realized gain in exchange for boot and, to the extent that realized gain exceeds boot, stock (or other nonrecognition property), and (ii) the transfer of the portion of the property representing adjusted basis in exchange for stock (or other nonrecognition property) and, to the extent that boot exceeds realized gain, boot.⁹⁰ The first such disposition is taxable to the extent of the boot, whereas the second one is nontaxable. The boot recognition rule apparently is based on the view that the transaction does not represent a mere change in form to the extent that the taxpayer is viewed as having “cashed out.”⁹¹ Perhaps also playing a role is a desire to enhance revenue collection by taxing the transferor on realized gain to the extent that he has the cash or other boot in hand.⁹²

Aside from section 357, a recovery of basis first approach is also used in applying the installment method of reporting gain on a sale of property where the buyer assumes liabilities of the seller.⁹³ Regulations under section 453 provide that the assumption of qualifying indebtedness is not treated as a payment received by the seller for purposes of recognizing gain under the installment method, except to the extent that the amount of qualifying indebtedness exceeds the seller's adjusted basis in the property that is sold.⁹⁴ Like the basis recovery approach used under sections 357(a) and (c), a seller is permitted to receive the benefit of assumed liabilities in a tax-free manner to the extent of her basis in the property that is disposed of.⁹⁵ Unlike section 357, however, the regulations under section 453 do not appear to permit a taxpayer to aggregate the bases of more than one property for purposes of determining the amount of liabilities that can be assumed without an imme-

⁸⁹ See, e.g., I.R.C. §§ 351(b)(1), 1031(b).

⁹⁰ Cf. *Peracchi v. Commissioner*, 143 F.3d 487, 490 (9th Cir. 1998) (viewing section 351(b) as treating a taxpayer as if she sold part of the property for cash and exchanged part of the property for stock).

⁹¹ See *id.*

⁹² It should be noted that instead of the current rule, Congress could have required the recognition of realized gain based on the percentage of boot received as consideration in the transaction; for example, if in a section 351 transaction the taxpayer received consideration consisting of 80% stock and 20% boot, 20% of the taxpayer's realized gain on the transaction would be recognized. This rule can be conceptualized by again viewing the transaction as separate dispositions of portions of the transferred property representing realized gain and adjusted basis, but with the stock and boot ratably allocated (on the basis of relative fair market values) to each portion. While this approach may do better at providing nonrecognition to the extent that the transaction is perceived as a change in form, perhaps it was not chosen either because of the revenue collection considerations mentioned above or administrative concerns.

⁹³ See Lazar, *supra* note 3, at 52–53.

⁹⁴ See Temp. Reg. § 15a.453-1(b)(3)(i).

⁹⁵ This is the effect of treating assumed liabilities as non-payments for purposes of recognizing gain under the installment method.

diate tax.⁹⁶

While it is clear that section 357 calls for a recovery of basis first approach with respect to section 357(a) liabilities, it is not clear from the terms of the statute how this approach should be conceptualized and carried out when a person transfers two or more assets to a corporation in a section 351 transaction involving the assumption of liabilities.⁹⁷ The next sections offer two possible constructs for this situation.⁹⁸

B. *Aggregate Asset Construct (AAC)*

In light of the aggregate basis recovery rule provided in sections 357(a) and (c), perhaps the most straightforward way of viewing a section 351 transaction involving the transfer of multiple assets and the assumption of section 357(a) liabilities is to treat the transaction as a transfer of an aggregate asset, which combines the fair market values and bases of the assets transferred to the corporation.⁹⁹ This aggregate asset is viewed as being made up of the individual assets in proportion to their relative fair market values.

Under this aggregate asset construct (AAC), the assumed liabilities, being the economic equivalent of cash, would first recover the combined adjusted basis of the merged assets, reflecting the “recovery of basis first” approach called for by the statute. The excess of assumed liabilities over this aggregate adjusted basis (referred to as “excess 357(a) liabilities”) is then applied against the remaining value of the aggregate asset, all of which consists of realized gain because of the full recovery of aggregate basis. Gain is thereby recognized to this extent. The character of recognized gain on the application of excess 357(a) liabilities to the realized gain on the aggregate asset should be based on the character of the assets transferred, in accordance with their relative fair market values. This follows from treating the aggregate asset as made up of the individual assets in proportion to their fair market values.¹⁰⁰

This conceptualization supports the approach adopted in Treasury Regulation section 1.357-2(b), under which the character of section 357(c) gain is determined by allocating the gain to the transferred assets in proportion to the relative fair market values of the assets.¹⁰¹ While not indicated in the

⁹⁶ See Temp. Reg. § 15a.453-1(b)(3)(i). *But see* Joe Kelly Butler, Inc. v. Commissioner, 87 T.C. 734 (1986) (in applying the pre-1980 version of section of 453, allowing a taxpayer to aggregate the bases of properties sold in a bulk sale for purposes of comparing basis to liabilities assumed in determining the amount of deemed payment in the year of sale).

⁹⁷ See *supra* notes 40–41 and accompanying text.

⁹⁸ As noted previously, these constructs should also apply in the divisive D reorganization context. See *supra* note 82.

⁹⁹ Cf. Rabinovitz, *supra* note 5, at 339 (evaluating the use of an aggregate approach for determining boot gain under section 351(b) where there is a transfer of multiple assets).

¹⁰⁰ Cf. *id.* at 353 (suggesting that if an aggregate approach is used for determining boot gain under section 351(b) where there are transfers of multiple assets, the character of the gain would need to be determined by apportioning the gain among the assets in some manner that is dependent on their relative fair market values).

¹⁰¹ See Reg. § 1.357-2(b), Exs. (1), (2).

legislative history regarding section 357(c), Congress may have had this construct in mind in suggesting the approach for determining the character of section 357(c) gain,¹⁰² which the Treasury ultimately adopted in the section 357 regulations.¹⁰³

The following example illustrates the AAC:

Example 4. Assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In connection with transfer, the corporation assumes (for purposes of section 357) \$140 of section 357(a) liabilities of the individual (e.g., longstanding business liabilities). Asset A is a capital asset, and Asset B is an ordinary asset. At the time of the transfer, Asset A has a fair market value of \$100 and an adjusted basis in the individual's hands of \$0, and Asset B has a fair market value of \$100 and an adjusted basis in the individual's hands of \$50. Under the AAC, the individual is treated as having transferred a single asset that combines the fair market values and adjusted bases of assets A and B, that is, an asset with a \$200 fair market value and \$50 adjusted basis. The assumed liabilities would first recover the individual's \$50 adjusted basis in the transferred asset. The \$90 of excess 357(a) liabilities would be applied to the \$150 of realized gain on the asset, resulting in \$90 of recognized gain – the section 357(c) gain on the transaction. Because the realized gain results from the combined attributes of both assets, for purposes of determining the character of the gain under this construct, the realized and recognized gain should be viewed as attributable to the individual assets in proportion to their fair market values. As a result, with Asset A and Asset B being of equal value, one half of the recognized gain, or \$45, should be attributable to Asset A and thus capital gain, and one half of the recognized gain, or \$45, should be attributable to Asset B and thus ordinary income.¹⁰⁴

C. *Modified Separate Assets Construct (MSAC)*

An alternative way of viewing a section 351 transaction involving the transfer of multiple assets and the assumption of section 357(a) liabilities is to treat the transaction as transfers of separate assets, but make necessary adjustments to accommodate the rule that gain is recognized only to the extent that total assumed liabilities exceed the aggregate basis in the transferred assets. Specifically, this modified separate assets construct (MSAC) would treat the transaction as transfers of separate assets, which should generally result in ratably allocating the assumed liabilities and other consideration to the individual

¹⁰² See S. REP. NO. 83-1622 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4908.

¹⁰³ Alternatively, Congress and Treasury may have chosen this method because it can apply even when all of the transferred assets have realized losses. See *supra* note 48 and accompanying text.

¹⁰⁴ The relative fair market value allocation method contained in the regulations would produce the same results. See Reg. § 1.357-2(b), Ex. (2).

assets based on the relative fair market values of the assets.¹⁰⁵ However, in order to adhere to the statutory rule requiring that assumed liabilities first recover the aggregate adjusted basis of the transferred assets before the recognition of gain, a few modifications are needed.

First, because the amount of assumed liabilities not in excess of the aggregate adjusted basis is treated as a tax-free recovery of basis, it is necessary generally to allocate a portion of the section 357(a) liabilities to each of the transferred assets in an amount equal to the adjusted basis of the particular asset. An allocation of section 357(a) liabilities strictly based on the relative fair market values of the transferred assets could result in some assets receiving an amount of assumed liabilities that exceeds basis, while other assets receiving an amount of assumed liabilities that is below basis, thereby violating the statute's aggregate basis recovery approach. However, in no case should the amount of assumed liabilities allocated to an asset exceed that asset's fair market value, as the consideration treated as received for an asset should not exceed the asset's fair market value.¹⁰⁶ For those assets having an adjusted basis in excess of fair market value, the excess basis would need to be allocated to assets with realized gains. This adjustment is necessary in order to allow for the excess basis of assets with realized losses to offset assumed liabilities, which is required given that gain is recognized only to the extent that assumed liabilities exceed the aggregate basis in the transferred assets. The amount of assumed liabilities that is allocated to each of the transferred assets in this first step is treated as a tax-free recovery of basis.

The next step is to allocate the remaining section 357(a) liabilities, referred to as excess 357(a) liabilities,¹⁰⁷ to the individual assets. This allocation should be based on the relative *remaining* values of the transferred assets, that is, the fair market values of the transferred assets less the previous allocations of assumed liabilities. The alternative of basing this allocation on the relative *full* values of the transferred assets is not sensible, because this would allocate additional amounts of assumed liabilities to the loss assets for which their value has already been fully recovered through the first allocation of assumed

¹⁰⁵As discussed previously, in applying a separate asset approach, the Service uses this method to allocate stock and boot where a taxpayer transfers multiple assets to a corporation in a section 351 transaction in exchange for stock and boot. See Rev. Rul. 1968-55, 1968-1 C.B. 140; *supra* notes 23-24 and accompanying text; see also Blanchard, *supra* note 3, at 1440-41 (using this method to analyze the effect of transferring a promissory note on the recognition of section 357(c) gain, after concluding that such notes do not constitute property for purposes of section 351).

¹⁰⁶*Cf.* Cohen & Whitney, *supra* note 5, at 982 (stating this in connection with allocating secured liabilities using an asset-by-asset approach for determining boot gain under section 351(b) where there is a transfer of multiple assets); Rabinovitz, *supra* note 5, at 346 (same).

¹⁰⁷See *supra* text accompanying note 100.

liabilities.¹⁰⁸ Gain would be recognized on each of the transferred assets to the extent that excess 357(a) liabilities are allocated to the particular asset. This is because all of the remaining values of the individual assets consist of realized gain as a result of the full recovery of each asset's basis (including basis allocated from other assets). The character of the recognized gain on each of the separate assets would be based on the type of asset involved.

The MSAC generally supports the approach used in a few Tax Court decisions and advocated by several commentators, under which the character of section 357(c) gain is determined by allocating the gain to the transferred assets in proportion to the relative amounts of realized gain on the assets.¹⁰⁹ As illustrated below, the MSAC determines the character of section 357(c) gain based on the relative amounts of realized gain on the transferred assets where either all of the transferred assets have realized gain or one or more assets have realized loss and there is only one asset with realized gain. This construct can also support the relative realized gain allocation method in the situation involving one or more loss assets and multiple gain assets, depending on the method that is used to allocate the excess basis of the loss assets to the gain assets.¹¹⁰

A few examples will serve to illustrate the use of the MSAC in different situations.

Example 5. Assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In connection with transfer, the corporation assumes (for purposes of section 357) \$140 of section 357(a) liabilities of the individual (e.g., longstanding business liabilities). Asset A is a capital asset, and Asset B is an ordinary asset. At the time of the transfer, Asset A has a fair market value of \$100 and an adjusted basis in the individual's hands of \$0, and Asset B has a fair market value of \$100 and an adjusted basis in the individual's hands of \$50. Under the MSAC, the individual is treated as separately transferring Asset A and

¹⁰⁸ Even if a relative full value allocation is limited to gain assets, distortions could result given that the amount of additional assumed liabilities allocated to a gain asset, when added to the amount of assumed liabilities allocated in the first step, could exceed the value of the particular asset.

¹⁰⁹ See *supra* notes 54–74 and accompanying text.

¹¹⁰ Two other commentators have proposed a similar construct for the relative realized gain allocation method, which they term as the “section 357(c)-based allocation of liabilities.” See Cohen & Whitney, *supra* note 5, at 997–99. These commentators do not use this construct to justify using the relative realized gain allocation method; instead, they assume that this method is correct based on the decisions of the Tax Court and the views of secondary authorities. See *id.* at 995. In fact, as a method of determining the character of section 357(c) gain, they view the construct as little more than a theoretical curiosity that merely represents an artificial computational means of achieving the same results as those under the relative realized gain allocation method. See *id.* at 998–99. However, these commentators see value in the construct as a way of coordinating the aggregate approach for recognizing section 357(c) gain with the asset-by-asset approach for recognizing gain due to the receipt of boot under section 351(b). See *id.* at 999–1005. As discussed in part V.D, I likewise recognize the advantages of the MSAC in coordinating the recognition of gain under sections 357(c) and 351(b).

Asset B to the corporation, and receiving in exchange for each asset a portion of the assumed liabilities and a portion of the stock. The assumed liabilities are first allocated to each of the assets in an amount equal to the adjusted basis of the particular asset; thus, \$0 of assumed liabilities are allocated to Asset A, and \$50 of assumed liabilities are allocated to Asset B. This portion of the assumed liabilities is treated as a tax-free recovery of basis. The \$90 of excess 357(a) liabilities are then allocated to the assets on the basis of their relative remaining values (after the recovery of value due to the prior allocation of assumed liabilities). Asset A has a remaining value of \$100 (original value of \$100 less \$0 recovery of value due to the prior allocation of assumed liabilities), and Asset B has a remaining value of \$50 (original value of \$100 less \$50 recovery of value due to the prior allocation of assumed liabilities). Thus, \$60 of the excess 357(a) liabilities are allocated to Asset A, and \$30 are allocated to Asset B. Since the bases of the assets have been fully recovered in the first step of allocating assumed liabilities, all of the remaining value represents realized gain. As a result, gain is recognized on each of the assets to the extent that excess 357(a) liabilities are allocated to the particular asset—\$60 of recognized gain on Asset A and \$30 of recognized gain on Asset B; this is the section 357(c) gain on the transaction. The character of the recognized gain on each of the assets is based on the type of asset involved. Therefore, the \$60 of recognized gain on Asset A is a capital gain, and the \$30 of recognized gain on Asset B is ordinary income.¹¹¹

Example 6. Assume that the facts are the same as in Example 5, except that Asset B has an adjusted basis of \$110. In this case, the excess of Asset B's adjusted basis over its fair market value, or \$10, is allocated to Asset A. Under the first step of the allocation process, assumed liabilities in the amounts of \$10 and \$100 are allocated to Asset A and Asset B, respectively. This portion of the assumed liabilities is treated as a tax-free recovery of basis. The \$30 of excess 357(a) liabilities¹¹² is then allocated to the assets on the basis of their relative remaining values. Since Asset A is the only asset with any remaining value, all of the excess 357(a) liabilities, or \$30, is allocated to the remaining value of Asset A, all of which represents realized gain. This results in \$30 of recognized gain on Asset A (the section 357(c) gain on the transaction), which would be capital gain because Asset A is a capital asset.¹¹³

If there were two assets with realized gain, this presents an issue of the manner in which to allocate the excess basis on the asset with realized loss, as illustrated in the following example:

Example 7. Assume the same facts as in Example 6 except that instead of Asset A, there is Asset A1, a capital asset, with a fair market value of \$60 and an adjusted basis of \$20, and Asset A2, an ordinary asset, with a fair market

¹¹¹The relative realized gain allocation method would produce the same results.

¹¹²The \$30 of excess section 357(a) liabilities is equal to the difference between the \$140 of section 357(a) liabilities and the \$110 of aggregate adjusted basis in the transferred assets.

¹¹³The relative realized gain allocation method would produce the same result.

value of \$40 and an adjusted basis of \$0. In this case, the excess of Asset B's adjusted basis over its fair market value, or \$10, would be allocated between Asset A1 and Asset A2. One way of doing this would be to allocate the excess basis based on the relative amounts of remaining value of the two assets, after the allocation of assumed liabilities in an amount equal to each asset's basis; with Asset A1 and Asset A2 each having a remaining value of \$40 at this point, \$5 of excess basis would be allocated to each asset. Under the first step of the allocation process, assumed liabilities in the amounts of \$100, \$25, and \$5 would be allocated to Asset B, Asset A1, and Asset A2, respectively. This portion of the assumed liabilities is treated as a tax-free recovery of basis. The \$10 of excess 357(a) liabilities¹¹⁴ are then allocated to the assets on the basis of their relative remaining values after the first step of the allocation process. Only Asset A1 and Asset A2 have remaining values, which for both assets is \$35.¹¹⁵ Thus, the excess 357(a) liabilities of \$10 would be split equally between Asset A1 and Asset A2, producing \$5 of capital gain and \$5 of ordinary income. Allocating the excess basis in this manner produces an overall result that is consistent with the Tax Court/commentators' approach that characterizes section 357(c) gain based on the relative amounts of realized gain on the transferred assets. Alternatively, the \$10 of excess basis on Asset B could be allocated to Asset A1 and Asset A2 based on their relative full values. This approach would allocate \$6 of excess basis to Asset A1 and \$4 of excess basis to Asset A2. This in turn would result in a first step allocation of assumed liabilities to Asset B, Asset A1, and Asset A2 in the amounts of \$100, \$26, and \$4, respectively, followed by a second step allocation of excess 357(a) liabilities to Asset A1 and Asset A2 in the amounts of \$4.86 and \$5.14,¹¹⁶ respectively, resulting in \$4.86 of capital gain and \$5.14 of ordinary income.¹¹⁷ Allocating excess basis in this manner would produce an overall result that differs from the Tax Court's and commentators' approach. It should be pointed out that the relative full value approach could result in an allocation of excess basis that causes an asset's total basis to exceed its fair market value.¹¹⁸ If this were to occur, a further adjustment would be necessary

¹¹⁴The \$10 of excess section 357(a) liabilities are equal to the difference between the \$140 of section 357(a) liabilities and the \$130 of aggregate adjusted basis in the transferred assets.

¹¹⁵Asset A1's remaining value of \$35 is equal to its full value of \$60 less the first step allocation of \$25 of assumed liabilities; Asset A2's remaining value of \$35 is equal to its full value of \$40 less the first step allocation of \$5 of assumed liabilities.

¹¹⁶This results from allocating the \$10 of excess section 357(a) liabilities to the assets based on their relative remaining values after the first step allocation, with such values being \$34 for Asset A1, \$36 for Asset A2, and \$0 for Asset B.

¹¹⁷The recognized gain on Asset A1 is capital gain, and the recognized gain on Asset A2 is ordinary income.

¹¹⁸To illustrate, if in Example 7 Asset A1 instead had a basis of \$59 (and there were \$180 of section 357(a) liabilities, so that there would still be section 357(c) gain), allocating \$6 of excess basis to Asset A1 would result in Asset A1 having a total basis of \$65, in excess of its fair market value.

for the reasons stated above.¹¹⁹

V. Determining the Appropriate Construct and Method

A. Overview

As demonstrated in the previous part, there are two ways of conceptualizing transfers to corporations in connection with the assumption of liabilities, each of which justifies the selection of one of the two competing methods for determining the character of section 357(c) gain. This part determines which of the two conceptualizations and resulting methods for determining the character of gain is the more appropriate one by examining section 351 and related provisions, along with their underlying principles as well as more general tax principles.¹²⁰

This part demonstrates that the MSAC and resulting relative realized gain allocation method is the more appropriate way to characterize section 357(c) gain. The MSAC is more consistent with the way in which the tax law treats transfers of multiple assets generally as well as in the context of section 351, and allows for the relevant tax attributes of individual assets to be taken into account. In contrast, the AAC is at odds with this treatment, going beyond

¹¹⁹ See *supra* note 106 and accompanying text.

¹²⁰ One commentator has proposed a third approach for characterizing section 357(c) gain, under which such gain would have the same character as that of the stock in the hands of the transferor. See Fredericks, *supra* note 48, at 175. The rationale for this proposed treatment is that section 357(c) recognizes gain in order to avoid assigning a negative basis to the transferor's stock, and therefore the gain should take the same character as the gain that would have resulted if a negative basis had been assigned. See *id.* As the commentator appears to acknowledge, this approach would be at odds with the approach intended by Congress, which looks to the character of the transferred assets, not the stock received, in characterizing section 357(c) gain. See S. REP. NO. 83-1622 (1954), reprinted in 1954 U.S.C.C.A.N 4621, 4681-83 (pointing out that the House bill treated section 357(c) gain as capital gain regardless of the nature of the transferred assets, and amending the statute in this regard); Fredericks, *supra* note 48, at 173-75 (chronicling the reasons for the Senate's change in the language of section 357(c)(1) that added the phrase "or of property which is not a capital asset as the case may be"). Thus, the Treasury apparently would lack the authority to use such an approach in the absence of a statutory amendment. More fundamentally, this approach violates certain principles of tax law. Congress has decided to recognize gain on the transfer, rather than preserve the gain via a negative basis, and the gain should be attributed to the transferred assets in some manner. In this regard, there appears to be no reasonable construct for the recognition of section 357(c) gain that ignores the character of the assets transferred. See *supra* note 82 and accompanying text. Moreover, with the proposed approach, there may well be failure to preserve the appropriate amount of gain or loss from the standpoint of character. See *supra* notes 22-25 and accompanying text. For example, in the situation where all of the transferred assets are appreciated ordinary assets, the use of this approach would characterize section 357(c) gain as capital gain, assuming the likely case that the corporate stock is a capital asset in the hands of the transferor. Under section 362(a), the corporation's basis in the transferred assets would be their basis in the hands of the transferor, plus the amount of gain recognized under section 357(c). See I.R.C. § 362(a). Therefore, the capital gain recognized by the transferor would result in a reduction in the amount of ordinary income preserved in the assets in the hands of the corporation, which violates the gain-loss preservation principle from the standpoint of character.

what is necessary to effectuate the rules of section 357, and obscures the realized gains and losses on individual assets. Furthermore, with the limitation imposed under section 362(d)(1) on the increase in the adjusted basis of assets due to the recognition section 357(c) gain, the application of the AAC and its relative fair market value allocation approach may result in a failure to preserve the correct amount of gain or loss in the assets transferred to the corporation. This part also shows that unlike the AAC, the MSAC allows for a consistent manner for addressing situations that involve both the assumption of section 357(a) liabilities and the receipt of boot subject to section 351(b).

Finally, this part responds to any criticism that the relative realized gain allocation method cannot accommodate the situation where all of the transferred assets have realized loss, by demonstrating that there should be no section 357(c) gain in this situation and thus no need to apply this (or any) method for determining the character of such gain.

B. MSAC is More Consistent with the Treatment of Multiple Asset Transfers and Takes into Account the Relevant Tax Attributes of Individual Assets

The tax law generally treats a transfer of multiple assets as transfers of separate assets for purposes of applying particular rules. For example, in the seminal case of *Williams v. McGowan*, the U.S. Court of Appeals for the Second Circuit held that where a taxpayer transfers several assets that comprise a business, each asset is separately determined to be a capital asset or not, as opposed to making this determination with respect to the business as a whole.¹²¹ The court reasoned that this approach is required given the statutory definition of a capital asset, which excludes particular types of assets such as inventory, accounts receivable and depreciable business property; according to the court, a business as a whole cannot be evaluated under this provision.¹²² The principle of *Williams v. McGowan* has been applied in other situations involving sales of multiple assets pursuant to a single transaction, including the application of section 267's loss disallowance rule¹²³ and qualification for the installment method of reporting gain.¹²⁴

As mentioned previously, in the section 351 context the Service applies an asset-by-asset approach for purposes of determining the amount of gain recognized due to the presence of boot. In Revenue Ruling 1968-55,¹²⁵ the Service addressed the issue of how to determine the amount of recognized gain under section 351(b) where several assets were transferred to a corporation in exchange for stock and cash. The Service ruled that for purposes of

¹²¹ See *Williams v. McGowan*, 152 F.2d 570, 572 (2d Cir. 1945).

¹²² See *id.*

¹²³ See, e.g., *Estate of Johnson v. Commissioner*, 42 T.C. 441, 445-46 (1964) (gain on some assets could not be offset by losses on other assets that are disallowed under section 267(a)(1)).

¹²⁴ See, e.g., *Johnson v. Commissioner*, 49 T.C. 324, 327-29 (1968) (qualification for installment method of reporting is determined on basis of individual assets).

¹²⁵ Rev. Rul. 1968-55, 1968-1 C.B. 140.

applying section 351(b) the transaction is treated as separate exchanges of each asset for a portion of the stock and cash.¹²⁶ In applying an asset-by-asset approach, the Service then went on to allocate the stock and cash to the transferred assets in proportion to the relative fair market values of these assets, and computed the amount of recognized gain on each asset accordingly (the lesser of the allocated cash or realized gain).¹²⁷

The tax treatment of multiple asset transfers described above allows for the tax attributes of individual assets to be taken into account, rather than having these attributes partially or completely obscured. For example, in a *Williams v. McGowan* type situation, each asset is evaluated under the capital asset definition, thus respecting the particular nature of each asset. Similarly, in applying section 351(b) to a transfer of multiple assets, the realized gain or loss on each asset is separately taken into account for potential recognition purposes; this prevents realized losses from offsetting realized gains, which would effectively allow for the recognition of losses in contravention of section 351(b)(2). This treatment also brings about the same result whether assets are transferred in one transaction or a series of transactions, thereby preventing form from overriding substance in taxing transactions. In both the *Williams v. McGowan* type situation and the section 351(b) situation, separate asset tax treatment produces the same result in a multiple asset transfer as would have occurred if the assets instead had been transferred in a series of transactions.¹²⁸

While the separate tax treatment of multiple asset transfers is no doubt the norm, there is the question of whether it is appropriate to use this approach for section 357(c) purposes, given the aggregate approach for recovering basis that is called for under the provision. If instead of one transaction, an individual transferred several assets and liabilities in two or more transactions, the results under section 357(c) may well be different.¹²⁹ Therefore, form *does* matter in the section 357(c) context, and the substance over form rationale for treating a multiple asset transfer as separate transactions does not seem applicable. Nevertheless, the other rationale for separate asset treatment—tak-

¹²⁶ See *id.*

¹²⁷ See *id.*

¹²⁸ In the section 351(b) context, this assumes that the transferor received the same proportions of stock and boot in the separate transactions.

¹²⁹ For example, assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In connection with transfer, the corporation assumes (for purposes of section 357) \$100 of section 357(a) liabilities of the individual (*e.g.*, longstanding business liabilities). At the time of the transfer, Asset A has a fair market value of \$100 and an adjusted basis in the individual's hands of \$0, and Asset B has a fair market value of \$100 and an adjusted basis in the individual's hands of \$100. Under these facts, there would be no section 357(c) gain, as the \$100 of assumed liabilities do not exceed the \$100 of aggregate basis in the transferred assets. However, if the assets were transferred in two separate section 351 transactions, with \$50 of liabilities assumed in each transaction (*i.e.*, prorating the section 357(a) liabilities among the two transactions), there would be \$50 of section 357(c) gain in the transaction involving Asset A (the difference between the \$50 of assumed liabilities and \$0 basis in Asset A).

ing into account the tax attributes of individual assets—is quite relevant in the section 357(c) context. Otherwise, the realized gains and losses of individual assets would be ignored, resulting in the possibility of section 357(c) gain being characterized with reference to assets that either lack any realized gain or have less realized gain than the gain being allocated to the particular asset. Consequently, to the extent possible in light of section 357(c)'s aggregate basis recovery approach, the norm of separate asset treatment for multiple asset transfers should also be preferred in the section 357(c) context.

As described above,¹³⁰ the MSAC for section 357(c) generally treats a transfer of multiple assets as transfers of separate assets and only calls for those modifications that are necessary in order to effectuate the rule set forth in section 357(c). On the other hand, the AAC for section 357(c) combines the attributes of multiple assets, and goes beyond what is needed under the statute to implement an aggregate approach for recovering basis.¹³¹ Thus, the MSAC is more consistent with the tax treatment of multiple asset transfers. Importantly, the MSAC prevents section 357(c) gain from being characterized with respect to assets that either lack any realized gain or have less realized gain than the gain being allocated to the particular asset; instead, its effect is to characterize section 357(c) gain according to the relative realized gain on the assets.¹³² Thus, this construct allows for the relevant tax attributes of individual assets to be taken into account, one of the benefits of separate asset treatment. In contrast, the AAC obscures the realized gains and losses on individual assets and results in the possibility of section 357(c) gain being characterized with reference to assets with realized loss, among other possible distortions. For these reasons, the MSAC and resulting relative realized gain allocation method should be preferred.

C. AAC May Fail to Preserve the Appropriate Amount of Gain or Loss in the Transferred Assets

As discussed earlier,¹³³ a corporation's basis in property received in a section 351 transaction is generally equal to the basis of the property in the hands of the transferor, increased by any gain recognized by the transferor in the section 351 transaction. This is limited by section 362(d)(1), which provides that a corporation's basis in property received in a section 351 transaction cannot be increased above the fair market value of the property as a result of the recognition of gain under section 357(c). In light of this limitation, in certain situations the AAC and relative fair market value allocation approach will result in a failure to preserve the appropriate amount of gain or loss in

¹³⁰ See *supra* notes 105–108 and accompanying text.

¹³¹ See *supra* notes 99–104 and accompanying text.

¹³² Nevertheless, under this construct the gain recognition results may vary depending on whether assets are transferred in one or more transactions. This is a consequence of the aggregate basis recovery approach called for under section 357(c).

¹³³ See *supra* notes 18–19 and accompanying text.

the assets transferred to a corporation in a section 351 transaction.¹³⁴ This provides another reason for preferring the MSAC to the AAC.¹³⁵

The following example demonstrates the failure of the AAC in this regard:

Example 8. Assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In connection with transfer, the corporation assumes (for purposes of section 357) \$140 of section 357(a) liabilities of the individual (e.g., longstanding business liabilities). Asset A is a capital asset, and Asset B is an ordinary asset. At the time of the transfer, Asset A has a fair market value of \$100 and an adjusted basis in the individual's hands of \$0, and Asset B has a fair market value of \$100 and an adjusted basis in the individual's hands of \$110. Under section 357(c), the individual will recognize \$30 of gain,¹³⁶ and using the relative fair market value allocation method, the gain will be divided equally between capital gain and ordinary income—\$15 of capital gain and \$15 of ordinary income.¹³⁷ Pursuant to section 362(a), the corporation will take a \$15 basis in Asset A, the basis in the hands of the individual (\$0) plus the gain recognized by the individual that is allocable to Asset A (\$15). While section 362(a) would similarly determine the corporation's basis in Asset B by starting with the individual's basis (\$110) and increasing it by the recognized gain allocable to Asset B (\$15), the section 362(d)(1) limitation prevents the corporation's basis in Asset B from being increased above its fair market value by virtue of section 357(c) gain; as a result, the corporation's basis in Asset B would be \$110, its basis in the hands of the individual.¹³⁸

¹³⁴The same potential for violating the gain-loss preservation principle exists in the context of divisive D reorganizations. As in the section 351 situation, a corporate transferee in a D reorganization generally takes a basis in the transferred property equal to the basis in the hands of the transferor, increased by the amount of gain recognized by the transferor. See I.R.C. § 362(b). Section 362(d) applies as well in the D reorganization context. See I.R.C. § 362(d)(1).

¹³⁵Two commentators have similarly argued that the existence of section 362(d)(1) provides another reason for preferring the relative realized gain allocation method for characterizing section 357(c) gain. See KAHN & LEHMAN, *supra* note 5, at 657–59 (concluding that with section 362(d)(1), the results produced by the relative fair market value allocation method seem contrary to the spirit of sections 357 and 368). Indeed, prior to the enactment of section 362(d)(1), one could claim that although the relative fair market value allocation method can attribute gain for characterization purposes to assets that lack realized gain (or have an insufficient amount thereof), with the basis rule contained in section 362(a) there would only be differences in timing and the taxpayer with respect to the gain or loss; ultimately, there would be the correct amount of capital gain-loss and ordinary income-loss recognized by the transferor and the corporation in the aggregate, because any excess capital gain or ordinary income recognized by the transferor would be reflected in a higher basis in the particular asset for the corporation. With section 362(d)(1), as explained below, this may no longer be the case.

¹³⁶This is equal to the difference between the assumed liabilities of \$140 and the assets' aggregate adjusted basis of \$110.

¹³⁷This is because the assets have equal fair market values.

¹³⁸The section 362(e)(2) basis limitation does not apply here to further limit the corporation's basis because the aggregate adjusted basis of the assets under section 362(a) (\$125) does not exceed the aggregate fair market value of the assets (\$200).

On the transfer, the individual realized a gain of \$100 on Asset A and a loss of \$10 on Asset B, for a net realized gain of \$90. The individual recognized a gain of \$30 on the transfer. Therefore, to satisfy the gain-loss preservation principle, there would need to be \$60 of gain preserved in the assets in the hands of the corporation.¹³⁹ With a basis of \$15 and fair market value of \$100, \$85 of gain is preserved in Asset A; with a basis of \$110 and fair market value of \$100, \$10 of loss is preserved in Asset B. Thus, a net gain of \$75 is preserved in the assets, and the gain-loss preservation principle is violated. The violation of this principle results from section 362(d)(1) preventing the increase in Asset B's basis by the gain allocated to this asset pursuant to the relative fair market value allocation method.

As Example 8 demonstrates, the basis mechanism will fail to preserve the appropriate amount of gain and loss where the relative fair market value allocation method is applied to a transfer of multiple assets involving at least one asset with a realized loss. This will also occur where at least one of the assets has less realized gain than the gain that is required to be recognized with respect to such asset under the relative fair market value allocation method.¹⁴⁰

If the relative realized gain allocation method had been used to determine the character of section 357(c) gain in Example 8, the basis mechanism would have preserved the appropriate amount of gain and loss.

Example 8 (redux). Using the relative realized gain allocation method, all \$30 of recognized gain would be capital gain, because Asset A is the only

¹³⁹ See *supra* note 22 and accompanying text.

¹⁴⁰ For example, assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In connection with the transfer, the corporation assumes (for purposes of section 357) \$140 of section 357(a) liabilities of the individual (e.g., longstanding business liabilities). Asset A is a capital asset, and Asset B is an ordinary asset. At the time of the transfer, Asset A has a fair market value of \$100 and an adjusted basis in the individual's hands of \$10, and Asset B has a fair market value of \$100 and an adjusted basis in the individual's hands of \$90. Under section 357(c), the individual will recognize \$40 of gain, and using the relative fair market value allocation method, the gain will be divided equally between capital gain and ordinary income—\$20 of capital gain and \$20 of ordinary income. Pursuant to section 362(a), the corporation will take a \$30 basis in Asset A, the basis in the hands of the individual (\$10) plus the gain recognized by the individual that is allocable to Asset A (\$20). While section 362(a) would similarly determine the corporation's basis in Asset B by starting with the individual's basis (\$90) and increasing it by the recognized gain allocable to Asset B (\$20), the section 362(d)(1) limitation prevents the corporation's basis in Asset B from being increased above its fair market value by virtue of a section 357(c) gain; as a result, the basis in Asset B would be limited to its fair market value, \$100. On the transfer, the individual realized a gain of \$90 on Asset A and a gain of \$10 on Asset B, for a total realized gain of \$100. The individual recognized a gain of \$40 on the transfer. Therefore, to satisfy the gain-loss preservation principle, there would need to be \$60 of gain preserved in the assets in the hands of the corporation. With a basis of \$30 and fair market value of \$100, \$70 of gain is preserved in Asset A; with a basis of \$100 and fair market value of \$100, no gain or loss is preserved in Asset B. Thus, a net gain of \$70 is preserved in the assets, and the gain-loss preservation principle is violated. The violation of this principle results from section 362(d)(1) preventing the increase in Asset B's basis by the full amount of gain allocated to this asset pursuant to the relative fair market value allocation method.

asset with realized gain and it is a capital asset. Pursuant to section 362(a), the corporation will take a \$30 basis in Asset A, the basis in the hands of the individual (\$0) plus the gain recognized by the individual that is allocable to Asset A (\$30). The corporation will take a \$110 basis in Asset B, the basis in the hands of the individual (\$110) plus the gain recognized by the individual that is allocable to Asset B (\$0). The section 362(d)(1) limit now would not apply in this situation. As before, to satisfy the gain-loss preservation principle, there would need to be \$60 of gain preserved in the assets in the hands of the corporation. With a basis of \$30 and fair market value of \$100, \$70 of gain is preserved in Asset A; with a basis of \$110 and fair market value of \$100, \$10 of loss is preserved in Asset B. Thus, a net gain of \$60 is preserved in the assets, and the gain-loss preservation principle is satisfied.

In applying the relative fair market value allocation approach to situations where section 362(d)(1) limits the corporation's adjusted basis in an asset, the gain-loss preservation results above may be improved by allocating the recognized gain with respect to that asset (or portion thereof) to other assets in determining the corporation's basis in the transferred assets under section 362. This approach would be contrary to the traditional approach of increasing the basis of an asset under section 362(a) by the amount of gain recognized with respect to that asset, and thus may not be supportable.¹⁴¹ On the other hand, section 362(a) coupled with section 362(d)(1) may be read as permitting this result. Increasing the basis of other property by the amount of section 357(c) gain arguably satisfies the requirements of both subsections, in that it increases the basis of property received by the corporation in the section 351 transaction by the amount of gain recognized by the transferor (satisfying section 362(a)), while not increasing the basis of any property above its fair market value (satisfying 362(d)(1)).¹⁴²

In any event, while increasing the basis of other property in connection with using the relative fair market value allocation method would preserve the appropriate amount of *total* gain or loss, it may fail to preserve the appropriate amounts of capital gain or capital loss and ordinary income or ordinary loss.¹⁴³ This is borne out by applying this approach to the facts of Example

¹⁴¹ See *supra* note 25 and accompanying text.

¹⁴² Cf. Burke, *Confronting Economic Reality*, *supra* note 5, at 400 (stating that reallocating the recognized gain to other appreciated property for basis purposes would not undermine section 362(d)'s purpose to prevent basis from being increased above fair market value).

¹⁴³ While C corporations generally do not receive a rate preference for net capital gain (see I.R.C. § 1201(a), (b)), they are subject to capital loss limitations. See I.R.C. §§ 1211(a), 1212(a). Moreover, in the case of S corporations, the character of income, gains, and losses (generally determined at the corporate level) flows through to the shareholders. See I.R.C. § 1366(b); Reg. § 1.1366-1(b). Thus, an individual shareholder will be entitled to a rate preference, and subject to the loss limitations, with respect to her pro-rata share of an S corporation's capital gains and losses. See I.R.C. §§ 1(h), 1211(b), 1212(b), 1366(a). Consequently, preserving the appropriate amount of capital gain-loss and ordinary income-loss at the corporate level has significant tax consequences.

8.¹⁴⁴

Example 8 (second redux). The corporation would take a \$30 basis in Asset A, the basis in the hands of the individual (\$0) plus the full amount of gain recognized by the individual (\$30), even though only \$15 of gain was allocated to Asset A for characterization purposes. The corporation would take a \$110 basis in Asset B, the basis in the hands of the individual (disregarding, due to section 362(d)(1), the \$15 of gain that was characterized with reference to Asset B). With a basis of \$30 and fair market value of \$100, \$70 of gain is preserved in Asset A; with a basis of \$110 and fair market value of \$100, \$10 of loss is preserved in Asset B. Thus, a net gain of \$60 is preserved in the assets, and the total amount of preserved gain is appropriate, given that there was net realized gain of \$90 and recognized gain of \$30. However, from the standpoint of character, the preserved amount of gain and loss is inappropriate. With respect to Asset A, the individual realized \$100 of capital gain and recognized \$15 of capital gain; with respect to Asset B, the individual realized \$10 of ordinary loss and recognized \$15 of ordinary income. Thus, to preserve the appropriate amount of character, there should be \$85 of capital gain preserved in Asset A and \$25 of gain and loss from the standpoint of ordinary loss preserved in Asset B. However, this is not the case, as the basis mechanism will preserve \$70 of capital gain in Asset A and \$10 of ordinary loss in Asset B.¹⁴⁵

Consequently, while increasing the basis of other assets in situations where the section 362(d)(1) limit applies does satisfy the preservation principle with respect to total gain or loss, there continues to be a violation of the principle from the standpoint of character. In fact, if taxpayers were able to so increase the basis of other assets, they may be able to use the relative fair market value allocation method to convert ordinary income into capital gain by reducing the impact of section 1239¹⁴⁶ (or section 1245¹⁴⁷ among other possibilities), as illustrated in the following example:¹⁴⁸

Example 9. Assume that an individual holds Asset A, a depreciable asset with a fair market value of \$150 and an adjusted basis of \$0. If the individual

¹⁴⁴ See *supra* notes 136–139 and accompanying text.

¹⁴⁵ It should be noted that it is possible for the character of assets to change in the hands of the corporation—for example where the transferor is a dealer in certain property but a corporation is not.

¹⁴⁶ Section 1239 treats gain recognized on the sale or exchange of depreciable property (in the hands of the transferee) between certain related persons as ordinary income. See I.R.C. § 1239(a). For this purpose, related persons include a corporation and a shareholder that owns (directly or indirectly) more than 50% of the value of the corporation's outstanding stock. See I.R.C. § 1239(b), (c).

¹⁴⁷ Section 1245 generally treats gain realized on the disposition of section 1245 property as ordinary income to the extent of the prior depreciation taken with respect to the property. See I.R.C. § 1245(a). Section 1245 property consists of depreciable personal property and certain specified types of depreciable real property. See I.R.C. § 1245(a)(3).

¹⁴⁸ Cf. Rev. Rul. 1960-302, 1960-2 C.B. 223 (pointing out that unless section 1239 applies for purposes of section 357(c), the purpose of section 1239 would not be carried out).

were to sell Asset A to a controlled corporation in order to step up the asset's adjusted basis and allow for subsequent depreciation deductions, section 1239 would treat the gain as ordinary income. Instead, the individual transfers Asset A along with Asset B to a corporation in a transaction qualifying under section 351. Asset B is a capital asset with a fair market value of \$1,000 and an adjusted basis of \$1,000. In connection with transfer, the corporation assumes (for purposes of section 357) \$1,100 of section 357(a) liabilities of the individual (e.g., longstanding business liabilities). Under section 357(c), the individual will recognize \$100 of gain,¹⁴⁹ and using the relative fair market value allocation method, the gain will be characterized as \$13.04 of ordinary income and \$86.96 of capital gain.¹⁵⁰ The corporation would take a \$1,000 basis in Asset B, the basis in the hands of the individual (disregarding, due to the section 362(d)(1) limit, the \$86.96 of gain that was characterized with reference to Asset B). If all of the gain can be used to increase the basis of Asset A, the corporation would take a \$100 basis in Asset A, the basis in the hands of the individual (\$0) plus the full amount of gain recognized by the individual (\$100) (even though only \$13.04 of gain was allocated to Asset A for characterization purposes). Thus, the related taxpayers have increased the basis in depreciable property by an amount of gain that is taxed at capital gains rates (the \$86.96 portion of the gain), thereby avoiding section 1239 to this extent.

Of course, denying taxpayers the ability to increase the basis of other assets where section 362(d)(1) applies could prevent the avoidance of sections 1239 or 1245. However, this measure would result in a violation of the gain-loss preservation principle with respect to amount (as well as character).¹⁵¹ A better approach is to use the relative realized gain allocation method to characterize section 357(c) gain, which would produce results that satisfy the gain-loss preservation principle both with respect to amount and character.¹⁵²

D. MSAC Allows for Consistent Treatment of Excess Liabilities and Boot

¹⁴⁹This is equal to the difference between the assumed liabilities of \$1100 and the assets' aggregate adjusted basis of \$1000.

¹⁵⁰This results from allocating the section 357(c) gain of \$100 to Asset A, an ordinary asset, and Asset B, a capital asset, in accordance with their fair market values of \$150 and \$1000, respectively.

¹⁵¹Moreover, given the current statutory language, it may take an amendment to section 362 to achieve this result. See *supra* note 142 and accompanying text.

¹⁵²As mentioned previously, Congress may have enacted section 362(d)(1) to prevent an adjusted basis above fair market value for property received by a corporation where the amount of liabilities assumed on the transfer exceeds the property's fair market value. See *supra* note 39. As discussed in part V.E, section 357 should not even be applicable in this situation, which is consistent with proposed regulations under section 351. With this view regarding section 357(c)'s applicability, section 362(d)(1) would apparently no longer be necessary. Cf. *NYSBA Comments, supra* note 39, at 8 (stating that section 362(d)(1) would become deadwood if the proposed regulations are adopted in the current form). Nevertheless, unless repealed, the provision would continue to bring about the results discussed in this section.

An additional reason for using the MSAC is that it allows for the same method of allocating excess section 357(a) liabilities and boot under section 351(b). In contrast, the AAC likely produces differing methods of allocating excess liabilities and boot, a result that appears unjustifiable given their similar function.

In the situation where section 357(c) gain is recognized, excess section 357(a) liabilities perform a similar function to boot under section 351(b) in that both generate recognized gain. Under either construct offered for analyzing section 357(c) gain, it can be seen that excess section 357(a) liabilities are applied against realized gain on the transferred assets to determine the gain that is recognized.¹⁵³ This is similar to the treatment under section 351(b) when a transferor receives boot, which causes gain to be recognized to the extent that the boot is applied against realized gain.¹⁵⁴ Thus, given that excess section 357(a) liabilities are treated like boot for recognition purposes, it seems that they should be allocated in the same manner as boot. Indeed, the assumption of section 357(b) liabilities, also outside of section 357(a) protection, is treated as boot for section 351(b) purposes¹⁵⁵ and thus apparently allocated as such.

The MSAC would allow for the same allocation method to be applied to excess 357(a) liabilities and boot. Under this construct, assumed liabilities first recover the basis of each asset transferred.¹⁵⁶ Following this, excess section 357(a) liabilities are then allocated to the assets based on their relative values remaining after the first step allocation of section 357(a) liabilities, thereby generating recognized gain (the section 357(c) gain).¹⁵⁷ This construct should be applied to the situation involving both assumed section 357(a) liabilities and boot by also allocating the boot in accordance with relative remaining values of the transferred assets.¹⁵⁸ Allocating the boot in this manner is the only sensible way of allocation that is consistent with the principles espoused in Revenue Ruling 1968-55, which allocates boot to the transferred assets based on their relative fair market values. The alternative of basing this allocation on the relative *full* values of the transferred assets would allocate boot to loss assets for which their value has already been fully recovered through the first allocation of section 357(a) liabilities (among other possible distor-

¹⁵³ See *supra* notes 99–100, 107–108 and accompanying text. Where one or more of the transferred assets have realized loss, the realized gain against which excess section 357(a) liabilities are applied would be net of the realized loss. Under the AAC, this results from combining the values and bases of the transferred assets (see *supra* note 99 and accompanying text); under the MSAC, this results from allocating the excess basis of assets with realized losses to assets with realized gains (see *supra* notes 106, 112–119 and accompanying text).

¹⁵⁴ See *supra* notes 14–15 and accompanying text.

¹⁵⁵ See *supra* note 32 and accompanying text.

¹⁵⁶ See *supra* note 106 and accompanying text.

¹⁵⁷ See *supra* notes 107–108 and accompanying text.

¹⁵⁸ Two other commentators have also proposed this approach for harmonizing the treatment of gains under sections 357(c) and section 351(b). See Cohen & Whitney, *supra* note 5, at 998–1005.

tions). Accordingly, both excess section 357(a) liabilities and boot should be included in the second step of the allocation process, thereby resulting in the same method of allocation for these items.¹⁵⁹ This results in both the section 357(c) gain and the boot being allocated to the transferred assets in accordance with the relative amounts of realized gain on the assets.

The following example illustrates the use of the MSAC in a situation involving both the assumption of section 357(a) liabilities and the receipt of boot.

Example 10. Assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In connection with the transfer, the corporation assumes \$150 of section 357(a) liabilities of the individual (*e.g.*, longstanding business liabilities). In addition, the corporation transfers to the individual \$30 of cash and \$20 of stock. Asset A is a capital asset, and Asset B is an ordinary asset. At the time of the transfer, Asset A has a fair market value of \$100 and an adjusted basis in the individual's hands of \$90, and Asset B has a fair market value of \$100 and an adjusted basis in the individual's hands of \$10. Under the MSAC, the individual is treated as separately transferring Asset A and Asset B to the corporation, and receiving in exchange for each asset a portion of the assumed liabilities, cash, and stock. Under the first step of the allocation process, the assumed liabilities are allocated to each of the assets in an amount equal to the adjusted basis of the particular asset; thus, \$90 of assumed liabilities are allocated to Asset A, and \$10 of assumed liabilities are allocated to Asset B. This portion of the assumed liabilities is treated as a tax-free recovery of basis. In the second step of the process, the \$50 of excess section 357(a) liabilities and \$30 of cash are allocated to the assets based on their relative remaining values (after the recovery of value due to the prior allocation of assumed liabilities); thus a total of \$80 of excess section 357(a) liabilities and cash is allocated to the remaining values of the transferred assets. Asset A has a remaining value of \$10 (full value of \$100, less \$90 recovery of value due to the prior allocation of assumed liabilities), and Asset B has a remaining value of \$90 (full value of \$100, less \$10 recovery of value due to the prior allocation of assumed liabilities). Accordingly, in the second step, \$8 of excess section 357(a) liabilities and cash are allocated to Asset A, and \$72 are allocated to Asset B. Since the bases of the assets have been fully recovered in the first step, all of the remaining value represents realized gain. As a result, gain is recognized on each of the assets to the extent that excess 357(a) liabilities and cash are allocated to the particular asset—\$8 of recognized gain on Asset A¹⁶⁰ and \$72 of recognized gain on Asset B.¹⁶¹ The character of the recognized gain on each of the assets is based on the type of asset involved. Therefore, the \$8 of recognized

¹⁵⁹Even where there is no section 357(c) gain, the appropriate conceptualization of section 351 dispositions with the assumption of liabilities is important for determining the amount and character of section 351(b) gain resulting from the receipt of boot. See *infra* notes 220–225 and accompanying text.

¹⁶⁰\$5 of the gain is section 357(c) gain, and \$3 of the gain is section 351(b) gain.

¹⁶¹\$45 of the gain is section 357(c) gain, and \$27 of the gain is section 351(b) gain.

gain on Asset A is a capital gain, and the \$72 of recognized gain on Asset B is ordinary income.

In contrast to the MSAC, the AAC would likely result in differing methods of allocating excess section 357(a) liabilities and boot—that is, the AAC would be used for allocating excess section 357(a) liabilities, but a separate asset approach would likely be used for allocating boot. Specifically, under the AAC, section 357(a) liabilities would first be applied to the aggregate basis in the transferred assets to the extent thereof. Excess section 357(a) liabilities would then be applied to the aggregate realized gain on the transferred assets, thereby generating recognized gain (the section 357(c) gain), which, for characterization purposes, is attributable to the transferred assets in accordance with their relative fair market values. With the receipt of boot by the transferor, the third step would be to allocate the boot to the transferred assets, and to be consistent with the principles espoused in Revenue Ruling 1968-55, this should be done on a separate asset basis by allocating portions of the boot separately to each of the transferred assets.¹⁶² The alternative of allocating boot on an aggregate asset basis would exacerbate the potential distortions created by the AAC, that is, increase the amount of gain that is recognized with respect to an asset that either lacks realized gain or has an insufficient amount thereof. Consequently, under the AAC, excess section 357(a) liabilities would be allocated to the transferred assets on the basis of the AAC, whereas boot would likely be allocated on the basis of a separate asset approach—an inconsistency that appears unjustifiable given the similar function of excess 357(a) liabilities and boot.

Applying the AAC to the facts of Example 10 illustrates this inconsistent treatment of excess 357(a) liabilities and boot.

Example 10 (redux). For purposes of characterizing section 357(c) gain, the AAC treats the situation as the transfer of an aggregate asset with a fair market value of \$200 and an adjusted basis of \$100, which combines the attributes of Asset A and Asset B. In the first step of the allocation process, the section 357(a) liabilities would recover the \$100 of aggregate basis in the transferred assets. In the second step, the \$50 of excess 357(a) liabilities would be applied against the \$100 of aggregate realized gain on the asset, resulting in \$50 of recognized gain (the section 357(c) gain on the transaction). With Asset A and Asset B being of equal value, one half of the recognized gain, or \$25, should be attributable to Asset A and thus capital gain, and one half of the recognized gain, or \$25, should be attributable to Asset B and thus ordinary income. In the third step of the allocation process, the \$30 of boot would be separately allocated to the two assets based on their remaining values at this

¹⁶²It is sensible to base the allocation of boot on the relative remaining values of the transferred assets (following the first two steps of the allocation process), as opposed to the full values of the transferred assets. The alternative of allocating boot based on the transferred assets' full fair market values would result in the possible distortions mentioned above. See *supra* note 158 and accompanying text.

point. Asset A has a remaining value of *negative* \$15 at this point—\$100 full value, less \$90 of first-step section 357(a) liabilities (to the extent of its basis), less \$25 of second-step excess section 357(a) liabilities. Asset B has a remaining value of \$65 at this point—\$100 full value, less \$10 of first-step section 357(a) liabilities (to the extent of its basis), less \$25 of second-step excess section 357(a) liabilities. Therefore, all \$30 of boot would be allocated to Asset B, resulting in \$30 of recognized ordinary income under section 351(b).¹⁶³

E. No Section 357(c) Gain and Thus No Need to Apply a Characterization Method Where All Assets Have Realized Losses

As the previous parts demonstrate, general tax principles and those underlying section 351 (and related provisions) support using the MSAC and relative realized gain allocation method for determining the character of section 357(c) gain, rather than the AAC and relative fair market value allocation method. However, an objection that may be raised with the relative realized gain allocation method is that it cannot be applied where all of the transferred assets have realized losses.¹⁶⁴ Thus, it may be argued that despite the virtues of the relative realized gain allocation method from the standpoint of tax principles, it is still necessary to determine the character of section 357(c) gain by referring to the relative fair market values of the transferred assets.¹⁶⁵

This argument against using the relative realized gain allocation method assumes that in the situation where all of the transferred assets have realized losses, the section 357(c) gain would be the excess of the total assumed liabilities over the aggregate adjusted basis of the transferred assets. However, as explained below, it is proper to view the amount of assumed liabilities for purposes of section 357(a) as being no greater than the aggregate fair market value of the transferred assets. With this view of the amount of section 357(a) liabilities, in the situation where all of the assets have realized losses, there will be no section 357(c) gain and thus no need to apply the relative realized gain allocation method or any other characterization rule.

In the situation where assets are transferred to a corporation in exchange for stock and assumption of the transferor's liabilities, and the assumed liabilities exceed the fair market value of the assets transferred, section 351 should

¹⁶³The gain recognized under section 351(b) is the lesser of boot or realized gain. All \$65 of remaining value of Asset B represents realized gain because of the full recovery of basis in the first step of the allocation process. The recognized gain is ordinary income because Asset B is an ordinary asset.

¹⁶⁴*Cf.* BITTKER & EUSTICE, *supra* note 21, at ¶ 3.06[4][d]-[e] (noting that while the relative realized gain allocation method is reasonable, it is not obviously correct, since section 357(c) can apply even if all of the transferred assets have a value that is less than their adjusted basis).

¹⁶⁵Of course, an alternative would be to generally use the relative realized gain allocation method, except for the situation where all of the transferred assets have realized losses, in which case the relative fair market value allocation method would be used instead. As I demonstrate below, this alternative approach should not be necessary, given that there should be no section 357(c) gain where all of the transferred assets have realized losses. *See infra* notes 166–174 and accompanying text.

apply, if at all, only to the extent of the fair market value of the transferred assets.¹⁶⁶ Only to this extent is the stock and debt relief being received in exchange for the assets transferred.¹⁶⁷ Proposed regulations under section 351 adopt this approach, and in doing so, effectively treat the assets as being exchanged for the assumed liabilities to the extent thereof.¹⁶⁸ As a result, the proposed regulations would treat the above situation as outside of section 351 because no part of the assets is exchanged for stock.¹⁶⁹ Commentators on the proposed regulations, while agreeing that section 351's applicability should be limited to the fair market value of the assets, claim that the proposed regulation's front loading of liability assumptions appears to be inappropriate given the general approach under section 351 and other provisions is to treat assets

¹⁶⁶Section 361 should only apply to this extent as well in the context of a D reorganization.

In this connection, it may be appropriate to treat the fair market value of assets subject to nonrecourse indebtedness as not less than the amount of such indebtedness. This would be consistent with the principles of section 7701(g), which uses this approach for purposes of determining gain or loss under Code sections that base such determinations on the fair market value of property. *See* I.R.C. § 7701(g). In this regard, with respect to proposed regulations under section 351 (discussed *infra* notes 166–170 and accompanying text), the Service and the Treasury are considering a rule that effectively adopts this treatment for determining whether a transaction qualifies under section 351. *See infra* note 174.

¹⁶⁷Nevertheless, at least one case has applied section 357(c) to the entirety of an exchange even though the incorporated business was found to be clearly insolvent. *See Rosen v. Commissioner*, 62 T.C. 11 (1974). Furthermore, the Service at one time took the position that section 357(c) treats as recognized gain the excess of liabilities assumed over the aggregate adjusted basis of property transferred to a corporation, even though the liabilities may exceed the fair market value of the transferred property. *See G.C.M. 33,915* (Aug. 26, 1968). The Service based its conclusion on the fact that there is nothing in the legislative history of section 357(c) that supports other than a literal application of the provision. Neither of these authorities apparently addressed the threshold question of whether, and the extent to which, section 351 applied to the transactions at issue.

It should be noted that both the MSAC and AAC support using a fair market value of the assets limit on applying sections 351 and 357; under either construct, the consideration treated as received for an asset should not exceed the asset's fair market value. *Cf. supra* note 106 and accompanying text. Nevertheless, the method yielded by the AAC, the relative fair market value allocation method, can accommodate the situation where section 357(c) gain results even though all of the transferred assets have realized losses.

¹⁶⁸*See* Prop. Reg. § 1.351-1(a)(1)(iii), 70 Fed. Reg. 11,903 (2005). Proposed regulations under section 368 similarly impose this so-called "net value" requirement for divisive D reorganizations (and for most other types of reorganizations). *See* Prop. Reg. § 1.368-1(b)(1), (f), 70 Fed. Reg. 11,903 (2005).

¹⁶⁹*See* Prop. Reg. § 1.351-1(a)(2), 70 Fed. Reg. 11,903 (2005), Ex. (4) (containing a similar example and concluding that section 351 does not apply). It should be noted that by enacting section 362(d), Congress may be indicating that a transfer of property in which the assumed liabilities exceed the property's value can qualify under section 351. *See NYSBA Comments, supra* note 39, at 7. This is because Congress may have enacted section 362(d)(1) to prevent an adjusted basis above fair market value for property received by a corporation in this situation. Nevertheless, given that the provision was enacted as a response to inappropriate tax planning, Congress apparently was not making a statement regarding whether such a transfer is subject to section 351. *See NYSBA Comments, supra* note 39, at 8.

as being transferred in exchange either for qualifying property (*e.g.*, stock) received to the extent thereof or a proportionate part of each item of consideration received.¹⁷⁰ Absent a compelling reason for the proposed regulations' treatment, these commentators recommend that in situations like that above, a portion of the liabilities and stock should be treated as exchanged for the assets transferred, and therefore sections 351 and 357 should apply to this extent.¹⁷¹

Regardless of the approach used for attributing stock and assumed liabilities to assets transferred to a controlled corporation, with section 351 only applying to the extent of the fair market value of the transferred assets, there should be no section 357(c) gain in the situation where all of the transferred assets have realized losses. Section 357(c) gain results if section 357(a) liabilities exceed the aggregate adjusted basis of the transferred assets. Where all of the transferred assets have realized losses, the aggregate adjusted basis of the assets will exceed the assets' aggregate fair market value. Because sections 351 and 357 should not apply to amounts of stock received and liabilities assumed that are above the fair market value of the transferred assets, the aggregate amount of section 357(a) liabilities should not exceed the aggregate fair market of these assets.¹⁷² Consequently, where all of the transferred assets have realized losses, the aggregate 357(a) liabilities should not exceed the aggregate adjusted basis of the transferred assets, and thus there should be no section 357(c) gain.¹⁷³ Therefore, the relative realized gain allocation method (or any other characterization method) should never need to be applied in the situation where all of the assets have realized losses. The following example illustrates this proposition:

¹⁷⁰ See *ABA Members Comment on Proposed Regs Requiring Exchange of Net Value for Nonrecognition Treatment*, 2006 TAX NOTES TODAY 79-16, at 1-4 (Apr. 25, 2006) [hereinafter *ABA Comment*].

¹⁷¹ See *id.* These commentators appear to be recommending either a front-loaded application of the stock to the assets transferred or pro-rata application of stock and other consideration to the assets transferred. See *id.*

¹⁷² In general, it would appear that the remainder of the liabilities assumed by the corporation should be treated as a corporate distribution to the transferor. See *ABA Comment, supra* note 170 at 3; cf. Cohen & Whitney, *supra* note 5, at 1011 (stating that one way of treating this situation is as a constructive distribution); BITTKER & EUSTICE, *supra* note 21, at ¶ 3.16 (stating that based on language in the section 351 regulations suggesting that a section 301 distribution may occur in connection with a section 351 transaction, it is possible for the receipt by the transferor of stock or money or both that exceeds the fair market value of the property transferred to constitute a distribution). In the case of nonrecourse liabilities, the entire amount of liabilities may possibly be treated as the amount realized on the disposition of the asset. See Reg. § 1.1001-2; See *NYSBA Comments, supra* note 39, at 10. The proposed section 351 regulations are silent on this issue and related issues, and commentators have asked the Treasury to state explicitly the results in situations where section 351 does not apply to a transaction because of the net value requirements imposed under the proposed regulations. See *ABA Comment, supra* note 170 at 6.

¹⁷³ Likewise, there should be no section 357(c) in an analogous situation involving a purported divisive D reorganization.

Example 11. Assume that an individual transfers two assets, Asset A and Asset B, to a corporation. In connection with transfer, the corporation assumes \$220 of longstanding business liabilities of the individual. The individual also receives stock of the corporation worth \$30. At the time of the transfer, Asset A has a fair market value of \$50 and an adjusted basis in the individual's hands of \$100, and Asset B has a fair market value of \$75 and an adjusted basis in the individual's hands of \$100. As discussed above, the portion of the transaction potentially subject to section 351 should be limited to the aggregate fair market value of the transferred assets, which is \$125 on these facts. That is, no more than a combined \$125 of stock and assumed liabilities should be treated as consideration received by the transferor in a section 351 transaction. Because the section 357(a) liabilities cannot exceed \$125 and the assets' aggregate adjusted basis is \$200, section 357(c) cannot apply to these facts. More specifically, the proposed section 351 regulations would effectively treat the assets as exchanged for the assumption of liabilities to the extent thereof; therefore, the assets would be treated as transferred solely for the assumption of \$125 of liabilities, and sections 351 and 357, including section 357(c), would not apply because no stock was exchanged for the assets. Under the commentators' recommendation that would treat the assets as exchanged for the stock to the extent thereof, the assets would be treated as transferred for \$30 of stock and \$95 of assumed liabilities. Under this view, section 351 would apply; however, with \$95 of section 357(a) liabilities and \$200 of aggregate adjusted basis in the transferred assets, there would be no section 357(c) gain. Alternatively, under the commentators' recommendation that would treat a proportionate part of the stock and assumed liabilities as exchanged for the assets, the assets would be treated as exchanged for \$15 of stock and \$110 of assumed liabilities. Under this view, section 351 would apply; however, with \$110 of section 357(a) liabilities and \$200 of aggregate adjusted basis in the transferred assets, there would again be no section 357(c) gain. Thus, under either the proposed regulations' approach or the commentators' approaches, there would be no section 357(c) gain in this situation.¹⁷⁴

¹⁷⁴The Service and the Treasury are considering a change to the net value proposed regulations that may result in the recognition of section 357(c) in such a situation where nonrecourse liabilities are assumed. Specifically, they are considering a rule that would disregard the amount by which a nonrecourse liability exceeds the fair market value of the encumbered asset for purposes of determining the amount of liabilities that are assumed in applying the net value requirement. See Preamble Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11,903 (proposed Mar. 10, 2005) (to be codified at 26 C.F.R. pt. 1). They are basing the contemplated change on a position taken in Revenue Ruling 1992-53, where the Service disregarded such excess nonrecourse indebtedness for purposes of applying the insolvency exception to discharge of indebtedness income under section 108. See Rev. Rul. 1992-53, 1992-2 C.B. 48. This position is based on an economic view of excess nonrecourse liabilities, as opposed to the tax law view pursuant to *Tufts v. Commissioner*, 461 U.S. 300 (1983) and similar authorities (discussed below), which considers such amounts as liabilities for tax purposes. There is, however, a related tax law view that would support the rule being contemplated by the Service and Treasury: incorporate the principles of section 7701(g) and treat the fair market value of

property subject to nonrecourse indebtedness as not less than the amount of such indebtedness for purposes of the net value requirement.

If the assumed liabilities in Example 11 were nonrecourse liabilities secured by Asset A, with the contemplated rule, sections 351 and 357 would apply to the transaction. This is because only \$50 of the liabilities would be taken into account for purposes of the net value requirement (disregarding the excess of the \$220 liability over the \$50 fair market value of Asset A), which is less than the \$125 aggregate fair market value of the transferred assets. Consequently, there would be section 357(c) gain of \$20 (the excess of the \$220 of assumed liabilities over the \$200 aggregate basis in the transferred assets). However, with the liabilities being nonrecourse, there would be realized gain with respect to Asset A in light of Treasury Regulation section 1.1001-2 and *Tufts v. Commissioner*, 461 U.S. 300 (1983) (except in rare circumstances), and thus the relative realized gain allocation method should be able to accommodate this type of situation in almost all cases. (In this regard, the Service and the Treasury have stated that any rule disregarding excess nonrecourse indebtedness would be limited to the net value regulations and would not apply for other income tax purposes, such as determining the amount realized under section 1001. See Preamble Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11,903 (proposed Mar. 10, 2005) (to be codified at 26 C.F.R. pt. 1)). These authorities generally treat the amount of nonrecourse indebtedness that encumbers property as part of the amount realized on the disposition of the property, regardless of the property's fair market value at the time of disposition. See Reg. § 1.1001-2(a), (b); *Tufts v. Commissioner*, 461 U.S. 300 (1983). There is an exception that treats nonrecourse acquisition indebtedness as not part of the amount realized to the extent that the liability was not taken into account in determining the transferor's basis in the property. See Reg. § 1.1001-2(a)(3). However, this exception appears to have quite limited application, and may have been designed to apply to situations where there is artificially inflated nonrecourse purchase money debt that is excluded from basis, or where a transferor takes a basis under section 1014 in property acquired from a decedent that is lower than the amount of nonrecourse indebtedness encumbering the property. See *Koutouras & Tizabgar*, *supra* note 5, at A-33. Thus, assuming the very likely case that the exception does not apply, the amount realized on the disposition of Asset A would be at least \$220, the amount of nonrecourse indebtedness encumbering the property (perhaps the amount realized would also include a portion of the stock), and consequently, Asset A would have a realized gain of at least \$120 (amount realized of at least \$220 less its adjusted basis of \$100). Therefore, the relative realized gain allocation method should be able to accommodate this situation, resulting in the \$20 of section 357(c) gain being allocated to Asset A (the only asset with realized gain) for characterization purposes. (Alternatively, if the principles of section 1060 are applied to this situation (see *infra* notes 190–201 and accompanying text), the amount realized that is attributable to the nonrecourse indebtedness may be allocated to each of assets transferred (depending on their type), in which case both assets may have realized gain for purposes of characterizing the section 357(c) gain).

In order to apply the relative realized gain allocation method in all circumstances should the Service and Treasury revise the net value regulations as contemplated, I recommend that for this purpose the amount realized under Treasury Regulation section 1.1001-2 be determined without regard to the exception for acquisition nonrecourse indebtedness that is excluded from the transferor's basis. Such an approach would not increase the amount of section 357(c) gain but merely would affect its characterization, and thus should not violate the apparent policy of Treasury Regulation section 1.1001-2(a)(3), that is, not to tax the discharge of liabilities to the extent that the liabilities provided the transferor with no previous tax benefit. *Cf.* Reg. § 1.338-6(c)(4) (providing that liabilities incurred on the acquisition of the property from which the purchaser is discharged on the subsequent sale will be included in the amount realized, even if the liabilities were not included in the purchaser's basis in the particular property, but were included in the adjusted gross-up basis for all of the assets in a deemed purchase under section 338).

VI. Modifying the MSAC for Secured Liabilities?

Before recommending that Treasury adopt the MSAC and its resulting method of characterizing section 357(c) gain based on the relative amounts of realized gain on the transferred assets, it is worth considering whether modifications should be made for situations where assumed liabilities are secured by transferred assets. Secured liabilities may be viewed as bearing a closer connection to the assets securing them, as compared to other assets, and this raises the issue as to whether these liabilities should first be allocated to the encumbered assets in recognizing gain under the MSAC.

A. *Modified MSAC for Secured Liabilities*

More specifically, for situations involving secured liabilities, the MSAC could be modified as follows.¹⁷⁵ The construct would continue to treat the transaction as transfers of separate assets, with the allocation of assumed liabilities to the transferred assets again done in two steps—first allocating the amount of assumed liabilities not in excess of the aggregate adjusted basis and then allocating excess section 357(a) liabilities. Under the first step, assumed liabilities would continue to be allocated to each of the transferred assets in an amount equal to the adjusted basis of the particular asset (which includes basis allocated from other assets) and treated as a tax-free recovery of basis. Under the second step in the process, however, there would be changes. While the MSAC allocates excess section 357(a) liabilities to the transferred assets based on their relative remaining values, the *modified* MSAC would allocate to an encumbered asset the lesser of (i) excess of secured liabilities over the adjusted basis of the encumbered asset or (ii) the excess section 357(a) liabilities (referred to collectively as “secured excess section 357(a) liabilities”), provided that this amount did not exceed the remaining value of the encumbered asset.¹⁷⁶ Under a new third step in the process, the amount of excess section 357(a) liabilities that exceed the amount of secured excess section 357(a) liabilities (referred to as “unsecured excess section 357(a) liabilities”) would then be allocated to the transferred assets based on their remaining values. Gain would continue to be recognized on each of the transferred assets to the extent that excess section 357(a) liabilities (both the secured and unsecured variety) are allocated to the particular asset, the character of the gain being based on the type of asset involved. The general effect of these modifications is to characterize section 357(c) gain resulting from the assumption of secured liabilities based on the character of the encumbered assets, as opposed to all of the assets transferred in a section 351 transaction.

¹⁷⁵The following construct borrows heavily from, and expands on to a degree, a method provided by Cohen and Whitney for allocating secured liabilities in characterizing section 357(c) gain. See Cohen & Whitney, *supra* note 5, at 1005–07.

¹⁷⁶If secured excess section 357(a) liabilities exceeded the remaining value of the encumbered asset, the excess portion of such liabilities would be allocated to the other assets based on their relative remaining values after the first step in the allocation process.

The following example illustrates the use of the modified MSAC in a situation involving secured liabilities.

Example 12. Assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In connection with transfer, the corporation assumes (for purposes of section 357) \$140 of section 357(a) liabilities of the individual (e.g., longstanding business liabilities), which are secured by Asset A. Asset A is a capital asset, and Asset B is an ordinary asset. At the time of the transfer, Asset A has a fair market value of \$100 and an adjusted basis in the individual's hands of \$0, and Asset B has a fair market value of \$100 and an adjusted basis in the individual's hands of \$50. Under the modified MSAC, the individual is treated as separately transferring Asset A and Asset B to the corporation, and receiving in exchange for each asset a portion of the assumed liabilities and a portion of the stock. The assumed liabilities are first allocated to each of the assets in an amount equal to the adjusted basis of the particular asset; thus, \$0 of assumed liabilities are allocated to Asset A, and \$50 of assumed liabilities are allocated to Asset B. This portion of the assumed liabilities is treated as a tax-free recovery of basis. The \$90 of excess 357(a) liabilities, which here are secured excess section 357(a) liabilities, are then allocated to Asset A, the asset securing these liabilities, up to the remaining value of Asset A. Since Asset A has a remaining value of \$100 (original value of \$100 less \$0 recovery of value due to the prior allocation of assumed liabilities), all \$90 of secured excess section 357(a) liabilities are allocated to Asset A, and none is allocated to Asset B. Because the bases of the assets have been fully recovered in the first step of allocating assumed liabilities, all of the remaining value represents realized gain. As a result, gain is recognized on each of the assets to the extent that secured excess 357(a) liabilities are allocated to the particular asset—\$90 of recognized gain on Asset A and \$0 of recognized gain on Asset B. The character of the \$90 of recognized gain on Asset A is a capital gain.

On the facts of Example 12, all \$90 of section 357(c) gain is characterized based on the character of the asset securing the liabilities that are assumed in the transaction. This should be compared to an application of the MSAC in Example 5,¹⁷⁷ where the \$90 of section 357(c) gain is characterized based on the character of both assets involved in the transaction, with the gain apportioned for this purpose in accordance with the relative amounts of realized gain on these assets.

Where the assumed liabilities consist of both secured and unsecured liabilities, the modified MSAC would generally characterize a portion of the section 357(c) gain based on the character of the encumbered assets and a portion of such gain based on the character of each of the transferred assets, apportioning the latter in proportion to the realized gains with respect to the unencumbered assets, and the realized gains less secured excess section 357(a)

¹⁷⁷ See *supra* note 111 and accompanying text.

liabilities with respect to the encumbered assets.¹⁷⁸ The following example demonstrates this:

Example 13. Assume the same facts as in Example 12, except that instead of the corporation assuming \$140 of section 357(a) liabilities secured by Asset A, the corporation assumes \$50 of liabilities secured by Asset A and \$90 of unsecured liabilities. Under the modified MSAC, the assumed liabilities are first allocated to each of the assets in an amount equal to the adjusted basis of the particular asset; thus, \$0 of assumed liabilities are allocated to Asset A, and \$50 of assumed liabilities are allocated to Asset B. This portion of the assumed liabilities is treated as a tax-free recovery of basis. The \$50 of excess secured excess section 357(a) liabilities are then allocated to Asset A, the encumbered asset, up to the remaining value of Asset A. Since Asset A has a remaining value of \$100 (original value of \$100 less \$0 recovery of value due to the prior allocation of assumed liabilities), all \$50 of secured excess section 357(a) liabilities are allocated to Asset A. The \$40 of unsecured excess section 357(a) liabilities are then allocated to the assets on the basis of their relative remaining values (after the recovery of value due to the prior allocations of assumed liabilities). Asset A has a remaining value of \$50 (original value of \$100 less \$50 recovery of value due to the prior allocations of assumed liabilities), and Asset B has a remaining value of \$50 (original value of \$100 less \$50 recovery of value due to the prior allocations of assumed liabilities). Thus, \$20 of the unsecured excess section 357(a) liabilities are allocated to Asset A, and \$20 are allocated to Asset B. Since the bases of the assets have been fully recovered in the first step of allocating assumed liabilities, all of the remaining value after the first step represents realized gain. As a result, gain is recognized on each of the assets to the extent of the total excess section 357(a) liabilities that are allocated to the particular asset—\$70 of recognized gain on Asset A and \$20 of recognized gain on Asset B. The character of the recognized gain on each of the assets is based on the type of asset involved. Therefore, the \$70 of recognized gain on Asset A is a capital gain, and the \$20 of recognized gain on Asset B is ordinary income.

B. *To Modify or Not?*

The question remains, however, whether it is appropriate to so modify the MSAC for situations involving secured liabilities. In this regard, a few commentators appear to view the direct allocation of secured liabilities to the

¹⁷⁸This assumes that there are both secured and unsecured excess section 357(a) liabilities.

encumbered assets as having considerable intuitive appeal.¹⁷⁹ Commentators also point to some analogous support for this approach.¹⁸⁰ Specifically, the Tax Court in *H & M Auto Electric, Inc. v. Commissioner*¹⁸¹ and the Service in Revenue Ruling 1980-283¹⁸² directly allocated a secured liability to an encumbered asset for purposes of recognizing gain under section 311(c) of the 1954 Code (old section 311(c)). Old section 311(c) required a corporation to recognize gain on the distribution of property with respect to its stock, to the extent that the liabilities assumed or taken subject to by the shareholder exceeded the corporation's adjusted basis in the distributed property; this provision was an exception to section 311(a) of the 1954 Code, which generally provided that a corporation did not recognize gain or loss on distributions with respect to its stock. On the facts of both the case and ruling, the corporation distributed two assets and the shareholder assumed two liabilities, one liability being secured by one of the distributed assets and the other liability being unsecured. After deciding that old section 311(c) applied to the distributed assets individually (as opposed to in the aggregate), the Tax Court and the Service then matched the liabilities to the distributed assets for purposes of determining whether liabilities exceeded basis, by directly allocating the secured liability to the encumbered asset and by allocating the unsecured liability to both assets in proportion to their fair market values.

The Tax Court in *H & M Auto Electric, Inc. v. Commissioner* provided no reason for directly allocating the secured liability to the encumbered asset, other than stating that “[t]he logical application of matching liabilities to assets, we believe, is to allocate a secured liability to the asset which secures it,” and noting that this approach conforms to economic reality because the gain to the corporation on being relieved of the secured liability is less than the value of the encumbered asset.¹⁸³ The Service in Revenue Ruling 1980-283 provided no explanation for the direct allocation of the secured liability to the encumbered asset. Perhaps both the Tax Court and the Service, in particular

¹⁷⁹ See Cohen & Whitney, *supra* note 5, at 982, 996, 1005 (stating this in the context of allocating secured liabilities for purposes of section 351(b); providing that such a direct allocation of secured liabilities would seem to have considerable merit and is consistent with their separate assets construct for characterizing section 357(c) “if it is assumed that section 357(c) gain attributable to secured liabilities is allocable directly to the encumbered asset”); cf. KAHN & LEHMAN, *supra* note 5, at 658 (suggesting as an alternative that it would be far more sensible to allocate section 357(c) gain among the transferred assets that were subject to liabilities in excess of their basis); Burke, Hender: *Modern Section 357*, *supra* note 27, at 198 (noting the possible allocation of section 357(c) gain directly to encumbered assets to the extent of the excess of secured liabilities over the basis of such assets); Rabinovitz, *supra* note 5, at 345–46 (favoring the direct allocation of secured liabilities in the section 351(b) context); White, *supra* note 5, at 56 n.93 (noting that the allocation of secured liabilities other than to the encumbered assets seems artificial).

¹⁸⁰ See Cohen & Whitney, *supra* note 5, at 983–86.

¹⁸¹ 92 T.C. 1269 (1989).

¹⁸² Rev. Rul. 1980-283, 1980-2 C.B. 108.

¹⁸³ 92 T.C. 1269, 1274 (1989). Presumably, the court was saying that on the particular facts, it was not necessary to attribute any of this gain to the other property that was distributed.

the latter, were influenced by the regulations under old section 311(c), which contained an example involving the distribution of a single asset subject to a liability that resulted in the distributing corporation recognizing gain to the extent that the liability exceeded the basis of the distributed property.¹⁸⁴ Thus as analogous authority, *H & M Auto Electric, Inc. v. Commissioner* and Revenue Ruling 1980-283 do not appear to provide a principled basis for directly allocating secured liabilities in using the MSAC to determine the character of section 357(c) gain.

Indeed, the conceptual basis for using this approach in characterizing section 357(c) gain does not appear to be strong. Under general tax principles, the assumption of liabilities is viewed as the economic equivalent of receiving cash; sections 358(d) and 357(c) are consistent with this view in that these provisions first allow such constructive cash to recover a transferor's aggregate basis in the transferred property and then recognize gain to the extent that such basis is exceeded.¹⁸⁵ The fact that the constructive cash may be viewed as earmarked to specific property in the case of secured liabilities would not appear to affect the allocation of assumed liabilities, any more than an agreement to allocate cash to transferred properties affects the allocation of boot under section 351(b). In this regard, Revenue Ruling 1968-55, discussed earlier,¹⁸⁶ allocates cash received in a section 351 transaction to the transferred assets in proportion to their fair market values, and although not dealing with an attempt to specifically allocate boot to particular assets, would appear to prevent specific allocations of boot.¹⁸⁷

Agreements that allocate boot to specific properties would typically have no effect beyond those relating to taxation, and thus concerns of potential tax manipulation suggest that such agreements generally should be disregarded

¹⁸⁴The Service referred to this example in its analysis of whether old section 311(c) applied on an asset-by-asset or aggregate basis. The Service appeared to assume that liabilities related to specific assets are allocated to those assets. See Rev. Rul. 1980-283, 1980-2 C.B. 108. For assumed liabilities not related to distributed property (which is not addressed in the old section 311(c) regulations), the Service allocated such liabilities among all of the distributed property according to properties' relative fair market values in order to consistently apply an asset-by-asset approach. See *id.*

¹⁸⁵See *supra* notes 83-84 and accompanying text.

¹⁸⁶See *supra* notes 24, 125-27 and accompanying text.

¹⁸⁷The ruling does not state whether or not there were specific allocations of cash or stock to the properties transferred, thus suggesting that this is not relevant for applying the ratable allocation method. In Revenue Ruling 1985-164, the Service did not permit a transferor in a section 351 transaction to determine the bases and holding periods in stock and securities received by designating that specific property was being exchanged for particular stock or securities. See Rev. Rul. 1985-164, 1985-2 C.B. 117. Instead, the Service held that pursuant to regulations under section 358, the aggregate basis of the transferred property is allocated among the stock and securities in proportion to their fair market values. See *id.* The Service also required that each share of stock and each security take a split holding period based on the holding period of the assets transferred. See *id.*

for tax purposes.¹⁸⁸ Beyond such concerns, there appears to be a more fundamental concept underlying the approach taken in Revenue Ruling 1968-55. Since the stock and cash (or other boot) are exchanged for assets in a single, integrated transaction, aside from tax consequences the parties to a transaction should only be interested in the total amounts that are exchanged. Consequently, each item of consideration received by the transferor should be viewed as relating to all of the assets transferred. It seems appropriate, then, to allocate the stock and cash ratably to all of the assets transferred, as any other means of allocation would appear to be artificial. And this concept should apply with equal force to cash that is deemed to be received due to the assumption of secured liabilities; even though a particular asset secures a liability, its assumption provides the transferor with consideration that is attributable to all of the transferred assets.¹⁸⁹ Thus, conceptually, it appears that secured liabilities should not be treated any differently than unsecured liabilities for purposes of the MSAC.

Furthermore, there is analogous authority that supports this conceptual basis for treating secured and unsecured liabilities in the same manner. On a disposition of assets that comprise a trade or business, regulations under section 1060 treat all liabilities assumed or taken subject to by the purchaser, whether secured or unsecured, recourse or nonrecourse, as part of the consideration paid for the business assets,¹⁹⁰ for purposes of determining the seller's gain and loss on the assets sold and the purchaser's basis in the assets acquired.¹⁹¹ The regulations allocate the consideration to the sold or acquired assets based on the residual allocation method,¹⁹² which allocates the consideration to the assets in each of several predetermined asset classes to the extent of, and in proportion to, the fair market value of the assets in each class.¹⁹³

¹⁸⁸ Cf. BITTKER & EUSTICE, *supra* note 21, at ¶ 3.05[2]-[3] (stating that an agreement allocating boot and stock to specific property in a section 351 transaction is not likely to be controlling; however, if the allocation serves a business purpose and there are several independent transferors, it may pass muster). Of course, specifically allocating secured excess section 357(a) liabilities to encumbered assets does not pose the same concern of tax avoidance, given that such liabilities are being allocated pursuant to a pre-existing arrangement that appears unrelated to the transaction and its tax consequences. Nevertheless, some manipulation may still be possible; for example, a taxpayer that is planning for an eventual section 351 transaction may be able to take advantage of a specific allocation approach by effectively converting unsecured liabilities to secured liabilities by borrowing against specific assets and using the loan proceeds to pay off unsecured liabilities. Section 357(b) may apply to curb such manipulation, however. See *supra* note 32 and accompanying text.

¹⁸⁹ This would be most evident where the amount of the secured liabilities exceeded the value of the encumbered asset.

¹⁹⁰ See Reg. § 1.1060-1(c)(1) (seller's consideration includes the aggregate amount realized under section 1001(b)); Reg. § 1.1001-2(a) (amount realized generally includes the amount of liabilities from which the seller is discharged as a result of the disposition, including nonrecourse liabilities that are secured by the transferred property).

¹⁹¹ See Reg. § 1.1060-1(a)(1), -1(b), -1(c)(1).

¹⁹² See Reg. § 1.1060-1(c)(2).

¹⁹³ See Reg. §§ 1.338-6(b), -6(c), 1.338-7.

The method employs a priority system under which consideration is first allocated to Class I assets¹⁹⁴ to the extent of their fair market value, then to Class II¹⁹⁵ assets to the extent of their fair market value, and so on to other asset classes.¹⁹⁶ Any consideration remaining after amounts have been allocated to the first six asset classes is allocated to goodwill and going concern value, which comprise Class VII assets.¹⁹⁷

Section 1060 was enacted to stem the controversy concerning valuations of good will and going concern value upon the disposition of business assets.¹⁹⁸ In doing so, section 1060 adopts a method of allocation that recognizes that all consideration given by a purchaser, including the assumption or taking subject to liabilities,¹⁹⁹ relates to all of the assets transferred by the seller. In particular, the section 1060 regulations eschew the direct allocation of secured liabilities to encumbered assets, even if the liabilities are nonrecourse.²⁰⁰ While the section 1060 regulations do not apply to determine the allocation of section 357(c) gain,²⁰¹ their underlying principles support treating secured and unsecured liabilities in the same manner for purposes of the MSAC.

In addition to the conceptual reasons, there are administrative reasons against modifying the MSAC for secured liabilities. Unlike the MSAC, the modified MSAC does not result in a simple method for characterizing section 357(c) gain. As previously discussed, the MSAC allocates section 357(c) gain to the transferred assets for characterization purposes on the basis of a single factor that applies in all circumstances -- the assets' relative amounts of real-

¹⁹⁴This consists of cash, general deposit accounts, and the like. See Reg. § 1.338-6(b)(1).

¹⁹⁵This generally consists of actively traded personal property within the meaning of section 1092(d)(1). See Reg. § 1.338-6(b)(2)(ii).

¹⁹⁶See Reg. § 1.338-6(b)(1), -6(b)(2)(i).

¹⁹⁷See Reg. § 1.338-6(b)(2)(i), (vii). The regulations allow the seller and purchaser to agree in writing as to the consideration allocated to, or as the fair market value of, the assets, with such agreement being generally binding on the parties. However, the Service may challenge the allocations or values set forth in the allocation agreement. See Reg. § 1.1060-1(c)(4).

¹⁹⁸See STAFF OF THE J. COMM. ON TAX'N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 258-59 (Comm. Print 1987).

¹⁹⁹See *supra* note 190.

²⁰⁰See Howard J. Rothman et al., *Capital Assets*, 561 TAX MNGT. PORT. (BNA) A-110 n.1125 (1994); cf. Reg. § 1.338-6(c)(4) (providing that on a subsequent sale of property by the purchaser, liabilities incurred on the acquisition of the property from which the purchaser is discharged on the subsequent sale will be included in the amount realized even if they were not included in the purchaser's basis in the property).

²⁰¹See Reg. § 1.1060-1(b)(8) (providing that section 1060 does not apply either to nonrecognition assets or the amount of money or other property that is transferred for nonrecognition assets (collectively referred to as nonrecognition exchange property); beyond that, section 1060 will apply to a transaction involving a nonrecognition exchange); Reg. § 1.1060-1(d), Ex. 1 (illustrating the application of section 1060 to a single transaction that includes a like-kind exchange (a nonrecognition exchange) as well as an exchange subject to section 1060).

ized gain.²⁰² In contrast, as the examples above reveal, the modified MSAC results in several alternative methods for allocating section 357(c) gain, with different methods applying for different circumstances and with some of the methods employing more than one factor. For example, where a single asset secures all section 357(a) liabilities, the character of the section 357(c) gain is generally determined solely by reference to the character of the encumbered asset, with an exception for situations where the amount of section 357(c) gain exceeds the encumbered asset's realized gain.²⁰³ Where the section 357(a) liabilities consist of both secured liabilities (with a single encumbered asset) and unsecured liabilities, the section 357(c) gain is generally allocated to the transferred assets for characterization purposes in two steps:²⁰⁴ first, to the extent of secured excess section 357(a) liabilities, the section 357(c) gain is generally allocated to the encumbered asset;²⁰⁵ second, section 357(c) gain in excess of secured excess section 357(a) liabilities is allocated to all of the transferred assets, apportioning such gain in proportion to the realized gains with respect to the unencumbered assets, and the realized gain less secured excess section 357(a) liabilities with respect to the encumbered asset.²⁰⁶ Other alter-

²⁰² See *supra* notes 109–10 and accompanying text. As discussed previously, in the situation involving one or more loss assets and multiple gain assets, the MSAC could alternatively allocate the excess basis on loss assets in a manner producing a result that is not in accord with the relative realized gain allocation method. See *supra* notes 114–19 and accompanying text.

²⁰³ If the amount of section 357(c) gain exceeds the encumbered asset's realized gain, the character of the excess amount of section 357(c) gain is determined based on the character of the unencumbered assets, apportioning such gain in accordance with the unencumbered assets' relative amounts of realized gain. This results from the application of the modified MSAC as described in *supra* note 176.

²⁰⁴ This assumes that there are both secured and unsecured *excess* section 357(a) liabilities, that is, the secured liabilities exceed the basis of the encumbered asset, and the unsecured liabilities exceed the aggregate basis of the unencumbered assets.

²⁰⁵ If this portion of the section 357(c) gain exceeds the encumbered asset's realized gain, the character of the excess amount of gain is determined based on the character of the unencumbered assets, apportioning such gain in accordance with the unencumbered assets' relative amounts of realized gain. This results from the application of the modified MSAC as described in *supra* note 176.

²⁰⁶ This results from the application of the modified MSAC as described in the text accompanying *supra* note 178 and Example 13 *supra* Part VI.A. As discussed previously, although there is some uncertainty, transferors may be able to avoid having recourse liabilities being treated as assumed simply by agreeing that the transferors, rather than the corporation, will satisfy the liability. See *supra* note 36. If this is the case, the assumption of unsecured liabilities for purposes of section 357 may be a rarity, given that unsecured liabilities as to a transferor apparently would have to be recourse liabilities (that is, they apparently cannot be nonrecourse). This in turn may reduce the complexity of a modified MSAC for secured liabilities.

native methods would apply where there are multiple encumbered assets.²⁰⁷ Moreover, there would be further complications for situations involving both the assumption of secured liabilities and the receipt of boot.²⁰⁸

Given the lack of a strong conceptual basis for treating secured and unsecured liabilities differently under the MSAC, and the complexity that this approach would engender, this Article recommends that the MSAC not be modified to allocate secured liabilities directly to encumbered assets.²⁰⁹ Accordingly, all liabilities, whether secured or unsecured, recourse or nonrecourse, should be treated the same way in applying the MSAC.

VII. Recommendations

A. *Revise Section 357 Regulations to Adopt Relative Realized Gain Allocation Method for Characterizing Section 357(c) Gain*

For the reasons expressed in Parts V and VI, this Article recommends the adoption of the MSAC and resulting relative realized gain allocation method

²⁰⁷For example, where there are only secured liabilities and multiple encumbered assets, the modified MSAC should result in the character of the section 357(c) gain generally being determined by allocating the gain to each of the encumbered assets to the extent that the amount of secured liabilities exceeds the adjusted basis with respect to the asset. Further adjustments would be needed, however, if the amount of section 357(c) gain that is allocated to an encumbered asset exceeds that asset's realized gain. *Cf. supra* note 203. As another example, where there are multiple encumbered assets along with the unsecured liabilities (and both secured and unsecured excess section 357(a) liabilities (see *supra* note 176 and accompanying text)), the section 357(c) gain would be allocated to the transferred assets for characterization purposes in two steps: first, the section 357(c) gain generally would be allocated to each of the encumbered assets to the extent that the amount of secured liabilities exceeds the adjusted basis with respect to the asset; second, section 357(c) gain in excess of the gain allocated in the first step would be allocated to all of the transferred assets, apportioning such gain in proportion to the realized gains with respect to the unencumbered assets, and the realized gain less first step allocated gain with respect to the encumbered assets. Again, further adjustments would be needed if the amount of section 357(c) gain that is allocated to an encumbered asset exceeds that asset's realized gain.

²⁰⁸The modified MSAC for secured liabilities should allocate boot in accordance with the method suggested above for allocating unsecured excess section 357(a) liabilities, that is, based on the remaining values of the transferred assets after (1) first allocating section 357(a) liabilities to the assets to the extent of their adjusted bases and (2) then allocating secured excess section 357(a) liabilities to the encumbered asset(s). See Cohen & Whitney, *supra* note 5, at 1006–07; *cf. Example 13 supra* Part VI.A. This is analogous to the method for allocating boot under the MSAC. See *supra* Part V.D.

²⁰⁹*Cf. Fred B. Brown, Proposal to Reform the Like Kind and Involuntary Conversion Rules in Light of Fundamental Tax Policies: A Simpler, More Rational, and More Unified Approach*, 67 Mo. L. REV. 705, 723 (2002) (contending that in crafting the particular features of the like kind and involuntary conversion rules, tax administration concerns should be the deciding factor when there is uncertainty regarding efficiency and equity analyses); David A. Weisbach, *Should a Short Sale Against the Box Be a Realization Event?*, 50 NAT'L TAX J. 495, 503–04 (1997) (concluding that given the uncertain efficiency gains of the proposal being evaluated, administrative considerations should prevail in devising a rule treating short against the box transactions (and related transactions) as realization events).

for characterizing section 357(c) gain.²¹⁰ Specifically, Treasury Regulation section 1.357-2(b) should be revised so as to replace the relative fair market value allocation method for characterizing section 357(c) gain with the relative realized gain allocation method.²¹¹ Under a revised regulation, the section 357(c) gain would be allocated to the transferred assets based on the relative amounts of gain realized on the assets and characterized accordingly. Section 357(c) gain that is allocated to ordinary assets would be ordinary income; section 357(c) gain that is allocated to capital assets would be capital gain, either long- or short-term based on the holding periods of the assets to which the gain is allocated.

The revised regulation should also make clear that special characterization rules apply to the allocated section 357(c) gain.²¹² For example, section 1239, if applicable, should apply to the allocated gain,²¹³ thereby converting the gain to ordinary income.²¹⁴ Likewise, the regulation should specify that section 357(c) gain allocated to section 1245 property is included in the gain recognized with respect to that asset for purposes of applying section 1245(b) (3).²¹⁵ This section provides that for certain tax free transactions (including section 351), the amount of section 1245 recapture income²¹⁶ shall not exceed the gain recognized on the transfer of the property (determined without regard to section 1245).²¹⁷ Furthermore, the revised regulation should provide that section 357(c) gain allocated to property specified in section 1231(b)²¹⁸ is included as section 1231 gain for purposes of section 1231's

²¹⁰As discussed previously, in the situation involving one or more loss assets and multiple gain assets, the MSAC could alternatively allocate the excess basis on loss assets in a manner producing a result that is not in accordance with the relative realized gain allocation method. See *supra* notes 114–19 and accompanying text. Because the alternative manner of allocating excess basis for this situation results in greater complexity, this Article recommends against using it, thus allowing for the use of the relative realized gain allocation method in all circumstances.

²¹¹As discussed below, the Treasury may well lack the authority to amend the regulations in this manner, and thus may need congressional authorization to do so. See *infra* notes 226–40 and accompanying text.

²¹²*Cf.* BITTKER & EUSTICE, *supra* note 21, at ¶ 3.06[4][d] (stating that the statutory language leaves the classification of section 357(c) gain to other Code provisions).

²¹³This is the position taken by the Service in Revenue Ruling 1960-302, which was followed by the Tax Court in *Alderman v. Commissioner*, 55 T.C. 662, 665–66 (1971). Rev. Rul. 1960-302, 1960-2 C.B. 223.

²¹⁴See *supra* note 146.

²¹⁵See *Rosen v. Commissioner*, 62 T.C. 11, 19–20 (1974), *aff'd*, 515 F.2d 507 (3d Cir. 1975) (subjecting section 357(c) gain to ordinary income treatment under section 1245).

²¹⁶See *supra* note 147.

²¹⁷See I.R.C. § 1245(b)(3).

²¹⁸Section 1231 property generally includes depreciable property and land that is used in a trade or business, which is held for more than one year. See I.R.C. § 1231(b).

hotspot rules.²¹⁹

B. Issue Revenue Ruling to Coordinate Method with Approach for Recognizing Boot Gain

In addition, for situations where a transferor receives boot in addition to recognizing section 357(c) gain, the Service should issue a revenue ruling that coordinates the MSAC and resulting relative realized gain allocation method for characterizing section 357(c) gain with the approach used for recognizing gain under section 351(b).²²⁰ As discussed in Part V.D., this coordinated approach should allocate the boot to the transferred assets based on their relative amounts of realized gain.²²¹ This would result in the same allocation method applying to the boot and section 357(c) gain, a sensible result given the similarity between boot and the excess section 357(a) liabilities that gen-

²¹⁹Under these rules, gains and losses from dispositions of section 1231 property generally will be treated as long-term capital gains and long-term capital losses if the gains exceed the losses for the particular taxable year. If section 1231 gains do not exceed section 1231 losses, the gains and losses will be treated as ordinary income and ordinary loss. See I.R.C. § 1231(a).

The propriety of using section 1231 to characterize section 357(c) gain is not certain, with some commentators stating that section 1231 apparently does not apply to section 357(c) gain. See BITTKER & EUSTICE, *supra* note 21, at ¶ 3.06[4][d]-[e] n.137. This view appears to be based on either the statutory language (considering such gain as “gain from a sale or exchange of a capital asset or property that is not a capital asset”) or the language contained in the regulations (providing that if half of the transferred assets, based on their fair market values, are capital assets and half are not, then half of the section 357(c) gain will be treated as capital gain and half will be other than capital gain), neither of which mentions section 1231. See I.R.C. § 357(c)(1); Reg. § 1.357-2(b), Ex. (2). The Tax Court may have taken this position in *Christopher v. Commissioner*, 48 T.C.M. (CCH) 663, 666 n.5, T.C.M. (P-H) ¶ 84,394 at 1544 n.5 (1984) (concluding that section 357(c) gain “does not qualify for capital gain treatment since the property transferred included both inventory and depreciable assets used in the petitioner’s trade or business”). However, section 357(c)’s language seems broad enough to allow for section 1231 characterization—with section 1231(b) property being a type of property that is not a capital asset and thus within a category of property mentioned in section 357(c)(1). Alternatively, since the application of section 1231 ultimately leads to capital gain or ordinary income treatment, its application seems to be sanctioned by the language of section 357(c)(1). Furthermore, there appears to be no policy reason for subjecting section 357(c) gain to some special characterization rules but not to others. It should also be noted that the Service in Revenue Ruling 1960-302, after determining that the transferred property was section 1231 property, went on to determine that section 1239 applied to treat the section 357(c) gain as ordinary income. Rev. Rul. 1960-302, 1960-2 C.B. 223. If section 357(c) does not allow for the application of section 1231, there would have been no need for the Service to apply section 1239, given that the transferred property, being depreciable property used in a trade or business, was not a capital asset and thus would have generated ordinary income in any event. Thus, the Service appears to take the position that section 1231 applies to section 357(c) gain.

²²⁰The proposed revenue ruling would supplement Revenue Ruling 1968-55, which addresses the allocation of boot in a section 351 transaction. See *supra* note 24 and accompanying text.

²²¹See *supra* notes 158–59 and accompanying text.

erate section 357(c) gain.²²²

The proposed revenue ruling should also address the situation involving the receipt of boot and assumption of section 357(a) liabilities, but without section 357(c) gain because the assumed liabilities do not exceed the aggregate adjusted basis of the transferred assets. Consistent with the other recommendations, this Article recommends the use of the MSAC for this situation. An illustration follows:

Example 14. Assume that an individual transfers two assets, Asset A and Asset B, to a corporation in a transaction qualifying under section 351. In connection with the transfer, the corporation assumes \$80 of section 357(a) liabilities of the individual (*e.g.*, longstanding business liabilities). In addition, the corporation transfers to the individual \$60 of cash and \$60 of stock. Asset A is a capital asset, and Asset B is an ordinary asset. At the time of the transfer, Asset A has a fair market value of \$100 and an adjusted basis in the individual's hands of \$90, and Asset B has a fair market value of \$100 and an adjusted basis in the individual's hands of \$0. Under the MSAC, the individual is treated as separately transferring Asset A and Asset B to the corporation, and receiving in exchange for each asset a portion of the assumed liabilities, cash, and stock. Under the first step of the allocation process, the assumed liabilities are allocated to each of the assets in an amount not in excess of the adjusted basis of the particular asset; thus, \$80 of assumed liabilities are allocated to Asset A, and \$0 of assumed liabilities are allocated to Asset B. This portion of the assumed liabilities is treated as a tax-free recovery of basis. In the second step of the process, the \$60 of cash is allocated to the assets based on their relative remaining values (after the recovery of value due to the prior allocation of assumed liabilities). Asset A has a remaining value of \$20 (full value of \$100, less \$80 recovery of value due to the prior allocation of assumed liabilities), and Asset B has a remaining value of \$100 (full value of \$100, less \$0 recovery of value due to the prior allocation of assumed liabilities). Accordingly, in the second step, \$10 of cash is allocated to Asset A, and \$50 is allocated to Asset B. Under section 351(b), the amount of gain recognized on each of the assets is the lesser of the realized gain or the boot allocated to that asset. Asset A has \$10 of realized gain (remaining value of \$20 less remaining basis of \$10), and consequently \$10 of gain is recognized on Asset A;²²³ Asset B has \$100 of realized gain (remaining value of \$100 less remaining basis of \$0), and consequently \$50 of gain is recognized on Asset B.²²⁴ The character of the recognized gain on each of the assets is based on the type of asset involved. Therefore, the \$10 of recognized gain on Asset A is a capital gain, and the \$50 of recognized gain on Asset B is ordinary income.

Using the MSAC in the above situation appears to be the only sensible approach for coordinating the application of sections 357(a) and 351(b). The

²²² See *supra* notes 153–54 and accompanying text.

²²³ This is the lesser of \$10 of realized gain and \$10 of allocated boot.

²²⁴ This is the lesser of \$100 of realized gain and \$50 of allocated boot.

alternative approach of applying the Revenue Ruling 1968-55 method by ignoring the assumption of liabilities may allocate to an asset a total amount of boot and assumed liabilities that exceeds the fair market value of the asset.²²⁵

C. Treasury's Power to Revise the Section 357 Regulations

There is a substantial question of whether the Treasury has the power to revise the section 357 regulations in the manner described above. In light of recent case law, the Treasury's authority to do so would likely be evaluated under the standard set forth in *Chevron U.S.A. Inc. v. National Resources Defense Council, Inc.*²²⁶ because such a regulation, if promulgated, should carry the force of law given that it would be an interpretative regulation issued under section 7805(a) and subject to notice and comment.²²⁷ Under the *Chevron* standard, a regulation will be upheld if two conditions are satisfied: (i) the intent of Congress is not clear with respect to the particular issue and (ii) the regulation is based on a permissible construction of the statute.²²⁸ In determining Congress's intention on a particular issue, a court should employ traditional tools of statutory construction,²²⁹ which should include an examination of the statute's legislative history.²³⁰

Under step one of the *Chevron* standard, the inquiry would be whether Congress clearly expressed its intent regarding the method to be used for characterizing section 357(c) gain. In this regard, the statutory language of section 357(c)(1) appears to permit any method of allocating such gain to the transferred assets, as it provides that the excess of section 357(a) liabilities over the transferor's aggregate adjusted basis in the transferred property "shall be

²²⁵As an illustration, so applying the Revenue Ruling 1968-55 method in Example 14 would allocate to Asset A \$30 of boot (one-half of the total given that the assets have equal full fair market values) and \$80 of liabilities (up to each asset's basis), which totals \$110. This amount exceeds Asset A's fair market value of \$100.

²²⁶467 U.S. 837 (1984).

²²⁷See *Swallows Holding v. Commissioner*, 515 F.3d 162 (3d Cir. 2008), *rev'g* 126 T.C. 96 (2006); *cf.* *Litriello v. United States*, 484 F.3d 372 (6th Cir. 2007), *rev'g denied*, 2007 U.S. App. LEXIS 23640 (6th Cir. 2007), *cert. denied*, 126 S.Ct. 1290 (2008); *McNamee v. Dep't of Treasury*, 488 F.3d 100 (2d Cir. 2007), *aff'g*, 96 A.F.T.R.2d 6746 (D. Conn. 2005). It should be pointed out that while most circuits use *Chevron* to analyze challenges to regulations issued under section 7805(a), all circuits do not. See Steve R. Johnson, *Swallows Holding: Chevron's Growing Traction in Tax Litigation*, 27 SECTION OF TAX 'N NEWS QUARTERLY, Summer 2008, at 1, 10. Instead, a less deferential standard, such as the standard announced in *National Mufflers Dealer Ass'n v. United States*, 440 U.S. 472 (1979), may be used to determine the validity of such regulations. Since I ultimately conclude that even under the more deferential *Chevron* standard Treasury would lack the power to revise the section 357 regulations as recommended (see *infra* notes 238–40 and accompanying text), whether or not to apply *Chevron* does not appear to be critical for my analysis.

²²⁸See *Chevron*, 467 U.S. at 842–43.

²²⁹See *id.* at 843.

²³⁰*Cf. id.* at 845 (A court should not disturb an agency's interpretation that represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, "unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned.")

considered as gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.” However, the following statement and example contained in the Senate Report accompanying the enactment of section 357(c) indicates a congressional intent to use the relative fair market value allocation method currently found in the regulations.²³¹

The determination of whether a gain resulting from the transfer of capital assets is long- or short-term capital gain shall be made by reference to the holding period to the transferor of the assets transferred. For example, if all of such assets transferred are capital assets and *half of the assets (ascertained by reference to their fair market value at the time of the transfer)* have been held for less than 6 months and the remaining half of the assets have been held for more than 6 months, half of the excess of the amount of the liability over the adjusted basis of the property *shall be* taxed as short-term capital gain, and the remaining half *shall be* taxed as long-term capital gain (emphasis supplied).

While this example applies the relative fair market value allocation method to determine the amount of section 357(c) gain that is long- and short-term capital gain on a transfer of capital assets held long and short term, it is difficult to imagine that Congress intended for a different allocation method to apply where the transferred assets consist of capital assets and ordinary assets. Indeed, if a particular transfer involved long- and short-term capital assets along with ordinary assets, the use of different allocation methods would result in the total amount of capital gain being determined based on the relative amounts of realized gain on the transferred assets, but the long-term and short-term amounts of such gain being determined based on the relative fair market values of the capital assets—a result that seems quite illogical. There is the possibility that the example in the Senate report provides a *possible* method of allocating section 357(c) gain. However, it seems rather clear that by using the phrase “for example,” the report is not suggesting a possible method, but instead an application of a chosen method to a particular set of facts.²³²

There is also the possibility that by enacting section 362(d)(1), Congress has implied that the relative realized gain allocation method, rather than the relative fair market value allocation method, should be used to characterize

²³¹The House Report contains a very similar example, but this was intended to illustrate the approach taken in the House bill that characterized section 357(c) gain as capital gain without regard to the nature of the transferred assets, an approach that Congress ultimately did not adopt. See *supra* note 48.

²³²As noted earlier, one commentator is of the view that the example contained in the Senate Report does not reflect a thought out and deliberate approach for characterizing section 357(c) gain. See *supra* note 48. However, it would be difficult to conclude that the insertion of this example in the report was not deliberate, and the fact that the approach may not have been thought out (which is far from clear) does not seem relevant to the question of whether it was intended.

section 357(c) gain.²³³ As mentioned previously, section 362(d)(1) provides that a corporation's basis in property received in a section 351 transaction cannot be increased above the fair market value of the property as a result of the recognition of gain under section 357(c). The analysis in Part V.C. demonstrates that with the section 362(d)(1) limitation, the relative fair market value allocation method may result in a failure to preserve the appropriate amount of gain or loss in the assets transferred to a corporation in a section 351 transaction. Thus, it may be contended that since Congress would not want there to be violations of the gain-loss preservation principle, by implication Congress must no longer intend for the use of the relative fair market value allocation method. The problem, of course, with this line of reasoning is that it assumes that when enacting section 362(d)(1), Congress was aware of the effect of using the relative fair market value allocation method on the gain-loss preservation principle as a result of section 362(d)(1); such awareness on the part of Congress seems quite unlikely. Another problem with this view is that it assumes that Congress is so protective of the gain-loss preservation principle, which also may not be the case. Thus, it is difficult to interpret the enactment of section 362(d)(1) as signaling a congressional intention that detracts from Congress's previous expression regarding the method for characterizing section 357(c) gain.

Finally, the fact that a few Tax Court decisions have ignored the regulatory method and instead characterized section 357(c) gain on the basis of assets with realized gain²³⁴ does suggest that the latter method is reasonable. However, none of these cases purported to determine that Congress did not clearly express its intent as to the proper method for characterizing section 357(c) gain,²³⁵ which, according to *Chevron*, must first be decided before evaluating the reasonableness of an agency interpretation.²³⁶ In this regard, the cases do not mention that legislative history set forth above.²³⁷ Thus, it would seem that the conclusions reached in these cases would have little bearing on the analysis under *Chevron* step one of a regulation adopting the relative realized gain allocation method.

Consequently, based on section 357(c)'s legislative history, it seems that Congress has clearly expressed its intent to characterize section 357(c) gain

²³³ Cf. KAHN & LEHMAN, *supra* note 5, at 658–59 (stating that it is possible, though unlikely, that the enactment of section 362(d)(1) invalidated the regulatory scheme for characterizing section 357(c) gain).

²³⁴ See *Rosen v. Commissioner*, 62 T.C. 11 (1974); *Raich v. Commissioner*, 46 T.C. 604 (1966); *Easson v. Commissioner*, 33 T.C. 963, 970–71 (1960), *acq.* 1964-2 C.B., *nonacq.* 1964-2 C.B. 8, *rev'd on other grounds*, 294 F.2d 653 (9th Cir. 1961).

²³⁵ See *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842–43 (1984).

²³⁶ See *id.*

²³⁷ See *Rosen*, 62 T.C. at 11; *Raich*, 46 T.C. at 604; *Easson*, 33 T.C. at 970–71.

based on the relative fair market values of the transferred assets.²³⁸ Under *Chevron*, if the intent of Congress is clear, both the courts and the administrative agency must yield to the intent of Congress.²³⁹ Thus, it appears that based on the statute's legislative history, the Treasury would not have the power to revise Treasury Regulation section 1.357-2(b) so as to replace the relative fair market value allocation method with the relative realized gain allocation method.²⁴⁰ Accordingly, it would be advisable for the Treasury to seek congressional authorization to issue regulations adopting the relative realized gain allocation method.

VIII. Conclusion

Using the MSAC and its resulting relative realized gain allocation method to determine the character of section 357(c) gain satisfies several principles of federal income taxation. The MSAC implements the aggregate basis recovery approach called for under sections 357(a) and (c), while generally treating a transfer of multiple assets as transfers of separate assets. As a result, the construct allows for the relevant tax attributes of individual assets to be taken into account, thus preventing section 357(c) gain from being characterized with reference to assets that either lack any realized gain or have less realized gain than the gain being allocated to the particular asset. In addition, the use of the MSAC avoids the potential failure of the AAC to preserve the correct amount of gain or loss in the assets transferred to the corporation. Moreover, the MSAC allows for the same approach for allocating excess section 357(a) liabilities and boot under section 351(b), a sensible result given their similar function. Finally, because sections 351 and 357 should only apply to the extent of the fair market value of the transferred assets,²⁴¹ there should be no section 357(c) gain in the situation where all of the transferred assets have realized losses; consequently, the MSAC and resulting relative realized gain allocation method should not fail to work in this situation.

²³⁸If, instead, it was determined that Congress did not clearly express its intent as to the method for characterizing section 357(c) gain, the analysis would proceed to step two of the *Chevron* standard (*i.e.*, whether the regulation is based on a permissible construction of the statute). See *Chevron*, 467 U.S. at 842–43. Based on the analysis set forth in this Article, a regulation adopting the relative realized gain allocation method should be determined to be based on a permissible construction of section 357(c).

²³⁹See *id.*

²⁴⁰*Cf.* Burke & Chisholm, *supra* note 5, at 234 (referring to section 357(c)'s legislative history as presumably being responsible for the regulatory method, and concluding that unless a reason for this method exists, Congress should correct the treatment of section 357(c) gain). As noted above, it is possible that a less deferential standard, in particular, the standard announced in *National Mufflers*, would be used to evaluate tax regulations promulgated under section 7805(a). See *supra* note 227. *A fortiori*, under a less deferential standard, the Treasury should also lack the power to make the recommended revision.

²⁴¹The same is true with regard to the application of section 361 in the divisive reorganization context.

