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DEPARTMENT: Letters to the Editor (LTE)

CITE: 79 Tax Notes 1647

HEADLINE: 79 Tax Notes 1647 - ANOTHER TAKE ON PERACCHI. (Section 357) (Doc 98-19903 (2 pages))

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CODE: Section 357

SUMMARY:
[*1647]

Robert H. Wellen comments on the Peracchi decision.

To the Editor:

Regarding the controversy on the Peracchi case, /1/ I hesitate to offer another formulation, but here goes.

To illustrate, the controversy arises when 'Transferor' makes a transfer to 'Corporation' and receives the stock of Corporation. Specifically, the transfer to Corporation consists of two elements:

- o Property, e.g., the assets of Transferor's business, with total basis of \$ 100 and value of \$ 500.

- o Transferor's own note with a face amount, issue price and value of \$ 50.

In exchange, Corporation assumes \$ 150 of Transferor's liabilities (related to the property transferred) and issues all of its outstanding stock to Transferor. The value of this stock is \$ 400 (\$ 500 value of property, plus \$ 50 value of note, less \$ 150 of Transferor liabilities assumed).

The whole transaction is usually thought of as an exchange of property for stock, with an assumption of liabilities, under sections 351 and 357. Thus, the question is usually framed this way: Does Transferor get basis 'credit' for its own note and so avoid \$ 50 gain recognition under section 357(c) (\$ 150 liabilities assumed less \$ 100 basis of property transferred, excluding the note)? The IRS and the Tax Court think that transferor gets no basis credit for the note, on the theory that Transferor has a zero basis note. /2/ On the other side, two courts of appeal have allowed Transferor basis credit for the note and so allowed section 357(c) to be avoided. /3/

Although there is room for disagreement, it seems to me that this situation should have the following income tax results:

Corporation

- o Corporation should not be taxed on income or gain when it receives Transferor's note.

- o Corporation should not be taxed on income or gain when Transferor pays off the note.

- o If the note is discharged without full payment, Corporation should have a bad debt deduction, unless the note is considered a sham and disregarded. In this case, Corporation should be treated as paying a dividend. See footnote 4.

Transferor

- o Transferor should not be taxed on income or gain when it issues its own note and receives the stock of Corporation.

- o Transferor should not have any loss or deduction when it pays off the note.

- o If the note is discharged without full payment, Transferor should have COD income, or, if the note is disregarded, a dividend.

- o By issuing its own note to Corporation, Transferor should not obtain any tax benefits (e.g., avoidance of section 357(c) gain or, if Corporation is an S corporation, stock basis that would allow current use of Corporation's losses under section 1366(d)(1)) at least so long as Corporation remains in Transferor's control, or until the note is paid off, sold, etc. /4/

- o When Transferor sells the stock of Corporation, Transferor should get basis credit for the note, because the entry of a new stockholder often will give the note economic reality. (Section 267(a) should prevent any undue loss deductions.)

These wholesome results cannot all be achieved under either a zero basis formulation or a face-amount (or fair market value) basis formulation for the note. Under a zero basis regime, it is hard to explain why Corporation does not recognize taxable gain when the note is paid off or, for that matter, why Transferor (or any

other borrower) does not recognize gain when it issues its own note. Under a fair market value basis regime, Transferor would escape tax regardless of whether the note is ever paid off.

[*1648]

The key to a workable analysis may be the Lessinger court's observation that Transferor's note is not 'property' in Transferor's own hands. If not, then Transferor's exchange of its own note for stock of Corporation is not a section 351 exchange, even if it occurs along with a property-for-stock exchange that does qualify under section 351.

Viewing the events this way, we have two separate transactions:

1. Under sections 351 and 357, Transferor exchanges \$ 500 worth of property for \$ 350 worth of stock and \$ 150 of liability assumption.

2. Transferor purchases \$ 50 worth of stock of Corporation with its own \$ 50 note.

In other words, Transferor does not sell its \$ 50 note for \$ 50 worth of stock. Instead, it purchases the stock for purchase money debt. This purchase of stock is separate from the section 351/357 exchange of the other property for stock and liability assumption. /5/

This analysis would avoid the zero basis conundrum and would have pretty good results, as follows:

Corporation

Exchange of Property for Stock and Liability Assumption

- o Corporation pays no tax on receiving the \$ 500 worth of property (other than the Transferor note) in exchange for \$ 350 worth of its own stock and assumption of \$ 150 of liabilities (section 1032).
- o Corporation takes a carryover basis of \$ 100 in this property.

Purchase of Stock With Transferor's Note

- o Corporation pays no tax on receiving the Transferor's \$ 50 note for \$ 50 worth of its own stock (section 1032).
- o Corporation takes a basis in Transferor's note equal to its \$ 50 issue price.
- o If Transferor's note is paid in full, there will be no gain or loss to Corporation.

- o If Transferor's note is discharged without full payment, there will be a loss to Corporation, or, if the note is disregarded, there will be a nondeductible dividend.

Transferor

Exchange of Property for Stock and Liability Assumption

- o In the exchange of \$ 500 worth of property (excluding the note) for \$ 350 worth of stock and \$ 150 of assumed liabilities, Transferor has the usual section 351 consequences, including \$ 50 gain under section 357(c).
- o Transferor's basis in the stock received is \$ 0 (\$ 100 property basis, less \$ 150 liability assumption, plus \$ 50 gain under section 357(c)).
- o When Transferor sells this stock, it will recognize \$ 350 gain, in addition to the \$ 50 of gain under section 357(c) at the time of the exchange.

Purchase of Stock With Transferor's Note

- o Transferor pays no tax on the purchase of \$ 50 worth of corporation stock with its own \$ 50 note.
- o Transferor's basis in the \$ 50 worth of stock purchased with Transferor's note is equal to the \$ 50 issue price of the note.
- o When Transferor sells this stock, there will be no gain or loss (unless the value of the stock changes).
- o There are no tax consequences when Transferor's note is paid off.
- o If Transferor's note is discharged without full payment, there will be COD income to Transferor, or, if the note is disregarded, there will be dividend income.

Although these results seem generally sensible, there are loose ends with this analysis. They include the following, and I am sure there are others:

- o By purchasing stock with his or her own note, a shareholder of an S corporation perhaps could increase his or her stock basis and so make losses available for passthrough.
- o Different classes of stock could be issued in the two parts of the transaction. For example, preferred stock could be issued for the note and common stock for the other property, with potential for results that might be abusive:
 - o There could be a preferred stock bail-out that avoids section 306.
 - o Nonqualified preferred stock could be issued for the note without boot gain under section 351(g).
- o There would still be the problem of Corporation assuming liabilities (or taking property subject to liabilities) on which Transferor remains liable. /6/

To me, however, this analysis makes basic economic sense and achieves a fairer overall result than the other analyses do. The potential problems could be eliminated with proper guidance.

Very truly yours,

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Washington, D.C.
June 9, 1998

FOOTNOTES

/1/ See Brewer, 'Peracchi v. Lessinger: Two Circuits Divided by a Common Decision,' Tax Notes, May 25, 1998, p. 1063, and articles cited therein.

/2/ Rev. Rul. 68-629, 1968-2 C.B. 154; Alderman v. Commissioner, 55 T.C. 662 (1971). See also Rev. Rul. 74-503, 1974-2 C.B. 117.

/3/ Lessinger v. Commissioner, 872 F.2d 519, 89 TNT 80-12 (2d Cir. 1989); Peracchi v. Commissioner, No. 96-70606, Doc 98-14167 (21 pages), 98 TNT 86-11 (9th Cir. April 29, 1998).

/4/ This point is what the fight is about. To me, Transferor

should not get any tax benefit by issuing its own note to a controlled corporation, if only because it is difficult to determine whether the note has economic reality. This factual issue proved controversial in Peracchi and, I believe, in most cases. On the other hand, section 357(c) can be a trap for the unwary.

/5/ For an example of this type of analysis, see LTR 8851033, 88 TNT 260-57, modified by LTRs 8911046, 89 TNT 63-11, and 8928072, 89 TNT 146-26 (stock issued by Corporation to Transferor for a put option on stock of Corporation issued to other persons treated as option premium, not part of simultaneous section 351(a) exchange).

/6/ See, e.g., Owen v. Commissioner, 881 F.2d 832 (9th Cir. 1989). The administration has proposed legislation to deal with this problem in its 1998 budget.

END OF FOOTNOTES

INDEX: reorganizations, assumed liabilities

REFERENCES:

Subject Area:

Ivins, Phillips & Barker