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The Liability-Offset Theory of *Peracchi*

BRADLEY T. BORDEN AND DOUGLAS L. LONGHOFFER*

I. Introduction

Transfers of property subject to liabilities are the focus of significant commentary and multiple court decisions.¹ Such transactions conducted between unrelated parties raise complicated issues and may trigger taxable gain or cancellation of indebtedness income.² The issues become more complicated if the transfer is to a controlled corporation.

Transfers to controlled corporations differ fundamentally from transfers to unrelated parties. For instance, transfers to controlled corporations often represent mere changes in the form of legal ownership of property. Tax law recognizes that difference and generally taxes transfers to unrelated parties—but often allows tax-free contributions to corporations.³ Whereas liability relief is part of the amount realized or cancellation of indebtedness income if it is part of a transfer to an unrelated party, it generally does not trigger gain or cancellation of indebtedness income if it is part of a contribution to a controlled corporation.⁴

If, as part of a section 351 transaction, a corporation assumes liabilities that exceed the adjusted basis of the transferred properties, section 357(c) generally requires a taxpayer to recognize gain on the transaction.⁵ Taxpayers may structure transactions to avoid section 357(c) gain. For example, a taxpayer may contribute a self-created note to the corporation, hoping it will increase the basis of contributed property, or reduce assumed liability. In *Peracchi v. Commissioner*, the Court of Appeals for the Ninth Circuit held that a shareholder has a basis in a self-created note contributed to a corporation as part of a section 351 transaction.⁶ That holding allowed the taxpayer to avoid section 357(c) gain.⁷

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¹See, e.g., *Crane v. Commissioner*, 331 U.S. 1 (1947).

²See, e.g., *Commissioner v. Tufts*, 461 U.S. 300 (1983); *2925 Briarpark Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999); *Gehl v. Commissioner*, 102 T.C. 784 (1984).

³See I.R.C. § 1001(c) (requiring gain recognition generally on the disposition of property); I.R.C. § 351(a) (allowing nonrecognition on transfers to controlled corporations). All section references are to the Internal Revenue Code of 1986, as amended, unless stated otherwise.

⁴See I.R.C. § 357.

⁵See I.R.C. § 357(c).

⁶See *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998). Importantly, the Ninth Circuit decided *Peracchi* under a prior version of section 357(c). See *infra* Part II.D.

⁷See *Peracchi*, 143 F.3d 487.

The Ninth Circuit's holding in *Peracchi* sparked substantial debate because it contradicted what many felt to be well-settled law: that section 357(c) operated mechanically and that methods to avoid section 357(c) gain were limited. Commentators suggest that by allowing the contributor to take a basis in a self-created note, the court granted shareholders the power to eliminate section 357(c) gain and essentially "pull the teeth" out of that section.⁸

Commentators have advanced two general theories for the proper tax treatment of contributed self-created notes since *Peracchi*, but neither of them has satisfactorily addressed these transactions from both an economic and tax perspective. This Article argues that a satisfactory theory of the proper tax treatment of contributed self-created notes under section 357(c) should satisfy four criteria (referred to hereafter as the "Four Criteria"): (1) recognize the economic substance of the transaction; (2) appropriately tax both the corporation and the shareholder on contribution; (3) properly account for payments made by the shareholder on the note; and (4) properly treat the corporation's subsequent disposition of the note or repayment of the liability. Theories presented prior to this Article fail to adequately address these Four Criteria.

Because the Four Criteria are essential to the analysis that follows, they deserve brief consideration. First, a theory properly recognizes the economic substance of a transaction if it considers whether a contribution alters a shareholder's economic situation. For example, the theory must ask what interest a shareholder takes in a corporation and how the contributed note affects that interest. The theory must also properly account for the shareholder's economic situation before and after the contribution. If the shareholder's economic situation does not change as part of the contribution, neither the shareholder nor the corporation should recognize gain or loss on the contribution.

Second, the theory must appropriately tax both the contributing shareholder and the corporation. That generally requires that the shareholder and corporation recognize no gain or loss on the contribution. It also requires that the shareholder and corporation take the appropriate bases in the stock and contributed property.

Third, the theory must properly account for the shareholder's payment on the contributed note. The treatment of the shareholder's payment must be consistent with the treatment of the contribution and generally should not result in taxable gain or loss to the shareholder or corporation.

⁸Michael M. Megaard & Susan L. Megaard, *Risky Business: Can a Shareholder's Own Note Truly Avoid Section 357(c) Gain?*, 89 J. TAX'N 69, 69 (1998). But see BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 3.06[4][b], at 3-35 (7th ed. 2000) ("To be sure, [if a contributed self-created promissory note is effective to eliminate section 357(c) gain, section] 357(c) would lose its potency; but this would not compromise its function, because the note in fact eliminates the benefit that the transferor gets from transferring property subject to liabilities in excess of basis—the very same protective job assigned to [section] 357(c).").

Fourth, the theory must properly treat the disposition of the note by the corporation. This treatment should relate to the tax treatment applied to the contribution of the note. The theory must also properly account for any payments the corporation makes on the assumed liability. That treatment should be consistent with tax treatment afforded the contribution of the note.

The discussion below reveals that the *Peracchi* decision fails to properly account for the basis in the note, so it fails the second criterion. That failure causes difficulties with the third and fourth criteria. Therefore, its rationale is unacceptable. As a result of *Peracchi*, the existing theories and criticisms often focus on whether the note constitutes property for purposes of a section 351 exchange, and whether the note has a basis in the shareholder's or the corporation's hands.⁹ One such theory, which this Article refers to as the separate-transaction theory, argues that the law should not treat stock issued in exchange for self-created notes as stock issued for property.¹⁰ This theory suggests that the law should treat the contribution of property and self-created notes as two separate transactions—the transfer of property in exchange for stock and the transfer of the note in exchange for stock.¹¹ The separate-transaction theory fails, however, to appropriately tax the contribution. Under this theory, the shareholder will often recognize gain on the contribution. Thus, the separate-transaction theory fails the second criterion.

Other commentators have proposed an open-transaction theory.¹² This theory leaves the transaction open, requiring the shareholder to accrue basis in stock as payments are made on the note.¹³ This theory fails the fourth criterion by not properly addressing the corporate disposition of the note. The discussion below illustrates that this failure creates unnecessary confusion by potentially giving the contributor of the self-created note a negative basis in the stock received.¹⁴

This Article suggests that a fully developed liability-offset theory, which views the contribution of a self-created promissory note as a reduction of the

⁹ See, e.g., 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, 91 (2004) ("[I]t is incumbent upon Congress to amend section 351(d) to provide that stock issued in exchange for a shareholder promissory note shall not be considered issued in exchange for property."); Ted J. Tierney, *Peracchi: Magicians in the Ninth Circuit Court?*, 26 S.U. L. REV. 197, 223–24 (1999) (arguing that a multi-factor test is appropriate to determine whether the contributed note represents valid indebtedness, and if the note is genuine, the taxpayer should avoid section 357(c) gain because the taxpayer's basis will be increased to offset any excess liabilities).

¹⁰ See Lazar, *supra* note 9, at 91. Accordingly, the separate-transaction theory removes stock issued for self-created shareholder promissory notes from the purview of section 351.

¹¹ See *infra* Part III.A (discussion of the separate-transaction theory).

¹² See, e.g., Elliott Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 TAX L. REV. 159, 195 (1984).

¹³ See *infra* Part III.B (discussion of the open-transaction theory).

¹⁴ See *infra* Part III.B (discussion of the open-transaction theory).

liabilities assumed by the corporation, satisfies the Four Criteria.¹⁵ Instead of analyzing whether the note increases basis in the transferred assets, the liability-offset theory suggests that the self-created note should reduce, or offset, the amount of liabilities assumed by the transferee corporation. If the note represents valid indebtedness, the liability-offset theory reflects the intent of lawmakers, recognizes the economic substance of the transaction, and avoids problematic issues that arise from giving the note basis in the hands of the corporation or the shareholder. Furthermore, the liability-offset theory allows for the appropriate tax treatment when the shareholder makes payments on the note and when the corporation subsequently factors the note.¹⁶ The liability-offset theory helps explain why the tax-free treatment in *Peracchi* is correct, even though the court's reasoning is flawed.

Part II of the Article briefly reviews the tax rules governing corporate formation. It explains the rationale for section 351 nonrecognition and the section 357(c) exception to the nonrecognition rule. It also reviews the case law and rulings that have considered the proper tax treatment of a contributed self-created note. Finally, it recounts legislative developments that help inform the analysis of the liability-offset theory. Part III presents and critiques the separate-transaction and open-transaction theories of *Peracchi*, and illustrates how they fail to satisfy the Four Criteria. Part IV presents the liability-offset theory and illustrates how it satisfies the Four Criteria and presents a better way to consider contributed self-created notes. Part V concludes.

II. Tax Rules Governing Corporate Formation

The analysis of the proper tax treatment of contributed self-created notes begins with a brief review of the tax rules governing corporate formation. The formation rules and the policy supporting the rules lay the groundwork for analyzing the *Peracchi* decision and commentary that criticizes it. Although *Peracchi* generally receives top billing in discussions about contributed self-created notes, it is one of several cases that consider the issues raised by such contributions. Those cases provide a nice review of the development of the law

¹⁵Other commentators have presented varying forms of a liability-offset theory as a means of addressing contributed self-created promissory notes. See, e.g., Steven Quiring, *Section 357(c) and the Elusive Basis of the Issuer's Note*, 57 TAX LAW. 97, 119 (2003) ("Rather than looking to the note for basis in order to avoid section 357(c) gain, the note may be considered a means of allocating the liabilities between the shareholder and the corporation.").

¹⁶Commentators proposing versions of the liability-offset theory prior to this Article have argued that the note is not a transferrable asset in the corporation's hands. See 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, 321 (1994) (arguing that when the contributed note is used to reduce the amount of debt assumed or taken subject to for purposes of section 357(c), "[t]he note should not be an independently transferrable asset of the corporation"); Quiring, *supra* note 15, at 124 ("Any action taken by the corporation that violates this model, such as selling the note . . . would serve as evidence that the debt really was assumed by the corporation."). In contrast, this Article argues that the note can offset the liabilities assumed and nevertheless still be transferrable by the corporation. See *infra* Part IV.B.

governing contributed self-created notes. Finally, examining section 357(d) provides a good analogy for analyzing contributed self-created notes.

A. *Corporate Formation Under Section 351*

Section 351 generally allows shareholders of controlled corporations (existing or in formation) to contribute property to the corporation in exchange for corporate stock without recognizing gain or loss.¹⁷ The justification for this nonrecognition rule is that contributions to a controlled corporation are “merely a change in the form of ownership, like moving a billfold from one pocket to another.”¹⁸ Consequently, tax law views a contribution of property to a controlled corporation as a change in the form of legal ownership and generally does not tax the transaction. Because a contribution to a controlled corporation is a mere change in ownership, any unrecognized gain or loss should survive the change of ownership form.

The basis rules of sections 358 and 362 preserve the unrecognized gain or loss at both the shareholder and corporate level. Section 358 provides that the shareholder's basis in stock received as part of a section 351 transaction is generally equal to the basis the shareholder had in the contributed property.¹⁹ This “exchanged basis”²⁰ is subject to an upward adjustment for gain the shareholder recognizes, and a downward adjustment for money or other property the shareholder receives from the corporation. Thus, the law preserves any gain or loss the shareholder does not recognize upon contribution.²¹

Section 362 provides that the corporation shall take a basis in the contributed property equal to the basis the shareholder had in the property, increased by gain the shareholder recognizes on the contribution.²² Unrecognized gain thus also survives in the basis a corporation takes in contributed property. As a result, section 351 grants nonrecognition on contributions to controlled

¹⁷ See I.R.C. § 351. Absent the nonrecognition rule of section 351, shareholders contributing property to a controlled corporation would recognize any gain or loss realized on the transaction. See I.R.C. §§ 61(a)(3), 1001(c); see also Reg. § 1.1002-1(c) (stating that section 351 is an exception to the general recognition requirement of section 1001(c)). Under section 351, nonrecognition treatment is given only to contributions made to “controlled corporations.” See I.R.C. § 351(a) (stating that to qualify for nonrecognition the “person or persons” transferring property in return for stock must control the corporation immediately after the exchange); see also Reg. § 1.351-1. For purposes of section 351 transactions, control requires the contributing shareholder or shareholders to own “stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote” and “at least 80% of the total number of shares of all other classes of stock.” I.R.C. § 368(c).

¹⁸ *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998) (providing Judge Kozinski's explanation of section 351); see also Reg. § 1.1002-1(c) (stating that the underlying assumption behind the recognition exception of section 351 is that there is still a continuation of the old investment).

¹⁹ See I.R.C. § 358(a).

²⁰ See I.R.C. § 7701(a)(44).

²¹ See I.R.C. § 358(a).

²² See I.R.C. § 362(a). The basis the corporation takes in the contributed assets is referred to as a “transferred basis.” See I.R.C. § 7701(a)(43).

corporations, but sections 358 and 362 preserve the unrecognized gain both inside and outside of the corporation. The subsequent taxable transfer of either the stock or contributed property will trigger gain or loss recognition. As a result, a contribution of property to a corporation creates a second gain, but section 362(e)(2)(A) prevents the creation of a second loss.²³

The nonrecognition and basis rules work together to accomplish the purpose of corporate tax law. Tax law seeks to not affect the decision to incorporate. By allowing tax-free formations of and contributions to controlled corporations tax law does not discourage the mere change in the form of ownership. Thus, the law allows business owners to form corporations tax-free, but it taxes subsequent transactions that remove assets from the pre-formation business. Rules governing contributions of encumbered property and self-created notes must comprehend these fundamental purposes of corporate tax law; they should not deter the formation of corporations or contributions to them.

B. *Shareholder Liabilities and Section 357*

Tax law generally provides that amount realized includes liability from which a transferor is relieved as part of a transfer.²⁴ Nonetheless, the section 351 nonrecognition rules apply generally, even if the corporation assumes liabilities of the contributor.²⁵ Section 357 governs corporate assumptions of contributing shareholder liability and deviates from the general rule that requires a transferor to include liability relief in amount realized.²⁶ If a corporation assumes a shareholder's liabilities as part of a section 351 transaction, section 357(a) provides generally that the liability relief is not money or other property received on the exchange.²⁷ For purposes of computing shareholder basis, the corporate formation rules treat liabilities assumed by the corporation as money received on the exchange, which results in a downward adjustment to

²³ See I.R.C. § 362(e)(2)(A). When property with a net built-in loss is contributed to a corporation, section 362(e)(2)(A) generally limits the corporation's basis in such property to the property's fair market value at contribution, preventing a second built-in loss.

²⁴ See *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1 (1947); Reg. § 1.1001-2(a).

²⁵ Congressional intent to facilitate, or at least not discourage, business incorporation can be found in the nonrecognition rule of section 351. See *supra* Part II.A (discussion of section 351). The nonrecognition rule is generally extended to liability relief associated with a section 351 transaction under section 357. See *infra* Part II.B (discussion of section 357). See also Lazar, *supra* note 9, at 46 (stating that Congress adopted section 351 and its Code predecessor in part because requiring gain when the disposition of property is merely a change in form interferes with necessary business operations).

²⁶ See I.R.C. § 357.

²⁷ See I.R.C. § 357(a). The general rule of section 357(a) is subject to two major exceptions in sections 357(b) and 357(c). See I.R.C. § 357(b) (providing that when the liability assumption by the corporation is to avoid taxation, or when the assumption does not otherwise have a valid business purpose, the assumption will be treated as money received by the transferor); I.R.C. § 357(c).

the shareholder's stock basis.²⁸ The basis adjustment helps preserve the double gain created under sections 358 and 362.

Section 357(c) provides an exception to the favorable tax treatment in section 357(a).²⁹ That exception requires the contributing shareholder to recognize gain if the corporation assumes liabilities in excess of the aggregate adjusted basis of contributed properties.³⁰ Section 357(c) and the basis rules in section 358 work together to prevent the shareholder from taking negative basis in stock received on the contribution. The prevention of negative basis is often cited as a primary reason for section 357(c).³¹ Thus, section 357(c) is not an anti-abuse rule that otherwise requires gain recognition. Instead, it embraces corporate tax law's disdain for negative basis. The rule can produce inequitable tax results.

Commentators have referred to section 357(c) as an unsophisticated taxpayer's "trap for the unwary,"³² forcing less sophisticated taxpayers to recognize gain that they could potentially avoid through various planning techniques. Commentators, practitioners, taxpayers, and the courts have, however, continuously engaged in lively debate about when and how a taxpayer is able to avoid section 357(c), suggesting the trap may affect sophisticated taxpayers as well.³³ These debates, the hardships created when section 357(c) forces taxpayers to recognize gain absent a corresponding economic benefit, and the inefficiency that results when taxpayers adjust business arrangements to avoid section 357(c) suggest that the general understanding of the scope of section 357(c) is unsatisfactory.

Commentators agree generally that taxpayers can employ two different methods to avoid the negative tax treatment of section 357(c) nonrecognition.³⁴ First, a taxpayer may contribute additional cash or property to the corporation so that the aggregate adjusted basis of the contributed properties

²⁸ See I.R.C. § 358(d).

²⁹ See I.R.C. § 357(c).

³⁰ See I.R.C. § 357(c).

³¹ See, e.g., Lazar, *supra* note 9, at 53 ("The most common rationale for section 357(c) is that it prevents a taxpayer from having a negative basis in the stock received pursuant to a section 351 exchange.").

³² See, e.g., 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, 31 (1990).

³³ Other articles discussing *Peracchi*, *Lessinger*, and avoiding section 357(c) gain include the following: John A. Bogdanski, *Corporate Debt, Shareholder Debt: Lessons from Leavitt and Lessinger*, 16 J. CORP. TAX'N 348 (1990); Cummings, *supra* note 16; Fleming, *supra* note 32; John F. Hernandez, *Using Shareholder Notes to Eliminate Section 357(c) Gain: Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989), *Correct Result, Wrong Reason*, 20 MEMPHIS ST. U. L. REV. 355 (1990); Susan Kalinka, *Peracchi: What Is the Right Result?*, 59 LA. L. REV. 871 (1999); Lazar, *supra* note 9; Megaard & Megaard, *supra* note 8; Quiring, *supra* note 15; Tierney, *supra* note 9; Jon R. Wadsworth, *A Metaphor a Day Keeps the Tax Man Away: Peracchi v. Commissioner*, 27 W. ST. U. L. REV. 467 (1999-2000).

³⁴ See Lazar, *supra* note 9, at 55.

is equal to or exceeds the liabilities assumed by the corporation.³⁵ Second, a taxpayer may remain liable for a portion of the liabilities such that the amount of liabilities assumed by the corporation is equal to or less than the aggregate adjusted basis of the transferred properties.³⁶ Generally, a contributor of property secured by recourse debt may remain liable for the transferred debt by agreeing that the corporation is not to pay the debt, and by ensuring that the corporation “pays the fair unencumbered market value to the [contributor] for the property.”³⁷ Thus, a taxpayer can avoid section 357(c) gain either by contributing more property to increase the basis of contributed property (the basis-increase method), or by remaining liable for a portion of the liability and reducing the amount of liability assumed (the liability-offset method).

A third method used to avoid section 357(c) gain, contributing a self-created note, has raised considerable controversy. If the contribution of a self-created note is similar to contributing more property or money, or is similar to offsetting liability assumed, either the basis-increase method or the liability-offset method would be an appropriate method for analyzing the contribution of a self-created note. Courts and commentators have, for the most part, relied upon variations of the basis-increase method, focusing on whether, for purposes of section 351, the note has sufficient basis to “eliminate the gap between the basis of the property transferred and the amount of liabilities assumed.”³⁸ The basis-increase method as applied by the courts disregards the effect a self-created note has on liabilities assumed, and strains traditional accounting and tax principles by allowing a contributor to generate basis by creating his own obligation. This Article argues the better approach is to apply a liability-offset theory, which would treat the contributed self-created note as a reduction in liabilities assumed by the corporation. It builds on observations by some commentators who have recognized that the contribution of a bona fide note has the same effect as “a note given by the [contributor] to a

³⁵ See *id.*; see also *Peracchi v. Commissioner*, 143 F.3d 487, 493 (9th Cir. 1998) (stating that to avoid section 357(c) gain “Peracchi could have borrowed \$1 million from a bank and contributed the cash to [the corporation] along with the [contributed] properties”).

³⁶ See Lazar, *supra* note 9, at 55. For an example where a taxpayer avoids section 357(c) gain by retaining personal liability, see *infra* Part II.D.

³⁷ BITTKER & EUSTICE, *supra* note 8, ¶ 3.06[2]. The amount of liabilities assumed by the transferee corporation affects the amount “paid” by the corporation for the underlying property, and thus alters the economics of section 351 transactions. For example, if A transfers property worth \$1000 and subject to \$250 of recourse liability in exchange for all of the stock of a corporation, the amount of liability assumed will alter the value of stock received. Economically, A will only be willing to engage in this transaction in return for either (1) \$750 of stock and the corporation’s assumption of the \$250 of recourse liability, or (2) \$1000 of stock. See, e.g., *id.* at n.99. The tax law should generally follow economics to the extent possible, and section 357(d) strives to meet this goal by providing that recourse liability is only assumed by a transferee corporation if the corporation agrees to pay the liability and is expected to pay the liability. See I.R.C. § 357(d); see also *infra* Part II.D (discussing section 357(d)).

³⁸ Lazar, *supra* note 9, at 55.

bank or other third party before the [section] 351 exchange to raise cash to reduce the liabilities to which the transferred property is subject.”³⁹ The following review illustrates the evolution of the law governing the contribution of self-created notes. The evolution has led to the *Peracchi* decision, which embraces the basis-increase method.

C. *Judicial and Regulatory Interpretations of Section 357(c)*

Originally, the Service and courts did not allow taxpayers to count a contributed self-created note as basis of contributed property. In Revenue Ruling 1968-629, the Service first considered whether a shareholder in a section 351 transaction could avoid section 357(c) gain by contributing a self-created note to a corporation in an amount equal to the excess of the liabilities assumed by the corporation over the aggregate basis of the contributed property.⁴⁰ In its analysis, the Service first determined that the transferor had a zero cost basis in the note under section 1012.⁴¹ After concluding that the transferor did not have a basis in the note, the Service found that issuing the note “did not increase the basis of the assets transferred.”⁴² The Service did not consider whether the self-created note should affect the amount of liability assumed by the corporation. As a result, the liabilities assumed by the corporation exceeded the taxpayer’s basis in the assets, and the self-created note did not help the shareholder avoid section 357(c) gain.⁴³

In *Alderman v. Commissioner*, the Tax Court followed the Service’s ruling and held that the contribution of a self-created note in a section 351 transaction did not eliminate section 357(c) gain.⁴⁴ The Tax Court also held that the corporation took a transferred zero basis in the note under section 362.⁴⁵ In finding that the Aldermans must recognize section 357(c) gain despite the contribution of the self-created note, the Tax Court stated that “[t]o conclude otherwise . . . would effectively eliminate section 357(c) from the [Code because] it would be a relatively simple matter to execute a note so that the adjusted basis would always exceed liabilities.”⁴⁶ This statement by the Tax Court disregards the economic reality of contributing a promissory note and treats section 357(c) as an anti-abuse provision. Thus, the court deviated from

³⁹ BITTKER & EUSTICE, *supra* note 8, ¶ 3.06[4][b]; see also *Peracchi*, 143 F.3d at 493 (discussing the possibility of a taxpayer borrowing cash from a bank and contributing that borrowed cash in a section 351 transaction to eliminate section 357(c) gain).

⁴⁰ See Rev. Rul. 1968-629, 1968-2 C.B. 154.

⁴¹ See *id.* (stating that under section 1012, the basis of property is its cost, and the transferor did not incur a cost in making the note).

⁴² *Id.*

⁴³ *Id.* The Service’s theory in Revenue Ruling 1968-629 for dealing with shareholder promissory notes and section 357(c) gain has been termed the “zero-basis theory,” or the “zero-basis hoax” by detractors. See Quiring, *supra* note 15, at 101 (citing Kenneth P. Brewer, *The Zero Basis Hoax*, 63 TAX NOTES (TA) 457, 458 (Apr. 25, 1994)).

⁴⁴ 55 T.C. 662 (1971).

⁴⁵ *Id.* at 665.

⁴⁶ *Id.*

the overall purposes of the rules governing contributions to corporations.

The Tax Court's holding in *Alderman* and the Service's ruling in Revenue Ruling 1968-629 failed each of the Four Criteria. First, the court required the contributor to recognize taxable gain on contribution, even though the contributor had no economic gain. Second, the court required the transferee corporation to take a zero basis in the note. Third, the corporation's zero basis meant the corporation would subsequently be taxed on each payment made by the contributor, effectively putting the corporation in a worse position than if the taxpayer had not contributed the note.⁴⁷ Finally, by giving the corporation a zero basis in the note, the *Alderman* decision failed to provide for the proper tax results from the corporation's subsequent disposition of the note. The corporation's disposition of the note would most likely generate gain to the corporation equal to the full amount realized from the sale. This violates the purposes of the corporate formation rules.

Nevertheless, following the Tax Court's ruling in *Alderman*, the "major issues dealing with section 357(c) seemed to be settled."⁴⁸ While section 357(c) occasionally produced harsh results for the contributor, it was not a provision that shareholders could generally avoid.⁴⁹ Subsequent decisions in *Lessinger v. Commissioner* and *Peracchi v. Commissioner* revealed, however, that the issue was not settled.⁵⁰ Both the Second Circuit in *Lessinger*, and the Ninth Circuit in *Peracchi*, held that a shareholder could effectively avoid section 357(c) gain by contributing a self-created note in an amount equal to or exceeding the excess liabilities assumed over the adjusted basis of the contributed properties.⁵¹ The rationale in *Lessinger* is somewhat confusing; the court in *Peracchi* adopted the basis-increase method.

In *Lessinger* (1989), the Second Circuit agreed with precedent that the creator of a note does not have a basis in that note.⁵² Nevertheless, the court found that the statutory language did not adequately address the situation if the shareholder's obligation had a discernable value to the transferee corporation.⁵³ The court concluded that when a shareholder remains personally liable to the corporation through the contribution of a self-created note, the basis referred to in section 357(c) is "the transferee's basis in the obligation, which is [the note's] face amount."⁵⁴ Thus, the court did not explicitly adopt

⁴⁷ See Lazar, *supra* note 9, at n.110 (arguing that giving the corporation zero basis in the note "would place the corporation in a worse tax position" than if the Aldermans had not contributed the note, but instead made subsequent section 118 taxable contributions to the corporation).

⁴⁸ Quiring, *supra* note 15, at 101.

⁴⁹ See *id.*

⁵⁰ See *id.*; *Peracchi v. Commissioner*, 143 F.3d 487, 487 (9th Cir. 1998); *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989).

⁵¹ *Peracchi*, 143 F.3d at 496; *Lessinger*, 872 F.2d at 526.

⁵² *Lessinger*, 872 F.2d at 525 (arguing that the contributor could not have a basis in the self-created note because the note represented a liability to him, not an asset).

⁵³ *Id.*

⁵⁴ *Id.* at 526.

the basis-increase method (which would have given the shareholder basis in the note), but it considered the corporation's basis in the note. The major flaw in the Second Circuit's analysis is that the court determined the basis of the contributed note from the transferee corporation's perspective and not the shareholder's perspective.⁵⁵ It is difficult to understand how a transferee corporation could have a face-value basis in a contributed note. Section 362(a) grants the corporation a transferred basis (*i.e.*, the shareholder's basis) in property received and the court determined that the contributor's basis in the note was zero.⁵⁶ Consequently, commentators have strongly criticized the *Lessinger* reasoning for ignoring the basis rules that apply to section 351 transactions and granting the corporation a section 1012 cost basis in the note.⁵⁷ That criticism reveals that the result fails the second of the Four Criteria—it is inconsistent with existing basis rules.

Even though the criticism of the *Lessinger* opinion is well founded, the Second Circuit introduced an important "economic benefit test to the section 357(c) analysis."⁵⁸ The court adopted this test in part because of the Lessingers' contention that they "realized a gain in neither an 'accounting nor economic sense.'"⁵⁹ As a result, the *Lessinger* court's "decision to reverse the Tax Court seems based on its belief that the taxpayer did not in fact realize a gain from the transaction."⁶⁰ The court found that the Lessingers did not realize an economic benefit because the liability to the corporation was real and potentially enforceable by the corporation's creditors.⁶¹ If a shareholder has not economically benefited through liability relief, then requiring gain recognition is arguably inconsistent with congressional intent to minimize the tax consequences recognized upon corporate formation.⁶² Thus, despite the shortcomings of the *Lessinger* opinion, the court's incorporation of economic realities into the section 357(c) analysis provided an important addition to the self-created note issue.⁶³ Nonrecognition is a theoretically sustainable conclusion, based upon the economic realities of the transaction—if the shareholder's economic

⁵⁵ See Hernandez, *supra* note 33, at 365 ("The fundamental flaw in the Second Circuit's approach is its determination of the basis of the shareholder's note from the transferee-corporation's perspective, while adhering to the commonly accepted methodology for determining basis, for all other purposes, under the purview of section 362.").

⁵⁶ See *Lessinger*, 872 F.2d at 525. The *Lessinger* court's holding is the result of a circular reading of the basis rules in section 351 transactions. If a contributor has a zero basis in a note transferred to a corporation in a section 351 transaction, the corporation necessarily must have a transferred basis of zero in that note pursuant to section 362. On the other hand, if the corporation is found to have a face-value basis in the contributed note (as found in *Lessinger*), then the contributor necessarily must also have a face-value basis in the contributed note because the corporation's basis in property received is computed from the transferor's basis.

⁵⁷ See Quiring, *supra* note 15, at 110.

⁵⁸ See *id.* at 111.

⁵⁹ Hernandez, *supra* note 33, at 362 (citing *Lessinger*, 872 F.2d at 522–23).

⁶⁰ Quiring, *supra* note 15, at 111.

⁶¹ See *Lessinger*, 872 F.2d at 527.

⁶² See, *e.g.*, Hernandez, *supra* note 33, at 372.

⁶³ See Quiring, *supra* note 15, at 111–12.

situation does not change, the shareholder should not recognize gain or loss. Thus, the opinion satisfied the first of the Four Criteria. The decision did not, however, adequately address the basis rules, so it failed the second criterion.

In *Peracchi* (1998), the Ninth Circuit departed from the Second Circuit's reasoning in *Lessinger* and explicitly used the basis-increase method to hold that a shareholder does not recognize gain on the contribution of a self-created note.⁶⁴ The court determined that section 357(c) contemplates measuring the basis of the property contributed in the hands of the taxpayer, not the corporation.⁶⁵ Notably, however, the court found that the taxpayer had a basis in a self-created note equal to the note's face value.⁶⁶ The Ninth Circuit found that the note represented genuine indebtedness by referencing the note's bona fides and full transferability and the enforceability by third-party creditors.⁶⁷ After determining that the note was not a sham, the court reasoned that whether the creator of a note incurs a cost in creating it depends on whether there is a significant enough possibility that the note would be enforced through bankruptcy or third-party creditors.⁶⁸ The court found that *Peracchi*'s obligation on the note was not conditioned upon the corporation remaining solvent, and thus the note represented "a new and substantial increase in *Peracchi*'s investment in the corporation."⁶⁹

The *Peracchi* decision resolves the *Lessinger* basis problem by finding that the maker of a note takes a basis in the note equal to the note's face value. That finding provides consistency with the corporate-formation basis rules. To reach this result, the court recognized that the "basis of property shall be the cost of such property"⁷⁰ and accordingly asked, "[w]hat does it cost *Peracchi* to write the note and contribute it to his corporation?"⁷¹ Arguably the cost to create a note is nominal, including materials and perhaps professional fees. The cost should never approach the face value of the notes. Critics are therefore quick to point out that promises to pay are generally liabilities and not property, and the creator of a note should not have a basis in the

⁶⁴*Peracchi v. Commissioner*, 143 F.3d 487, 494 n.17 (9th Cir. 1998).

⁶⁵*Id.*

⁶⁶*See id.* at 494–95. Importantly, the Ninth Circuit limited its holding to situations where (1) the contributor's credit warrants the note being worth the note's face value, and (2) the corporation receiving the note is "subject to a nontrivial risk of bankruptcy or receivership." *See id.* at 493–94 nn.14–15.

⁶⁷*Id.* at 495.

⁶⁸*Id.* at 493.

⁶⁹*Id.* In the *Peracchi* opinion, Judge Kozinski supports the court's result by using an economic analysis very similar to the "cash analogy" for shareholder notes and 357(c) gain. *See* Quiring, *supra* note 15, at 115 ("The core of the cash analogy approach is that a note should be treated the same as cash.").

⁷⁰*Peracchi*, 143 F.3d at 492 (quoting I.R.C. § 1012).

⁷¹*Id.* at 492.

promise to pay.⁷² Nonetheless, the court held that the creator's basis in a contributed self-created note equals the note's face value.⁷³

Generally, a self-created liability produces section 1012 cost basis in property acquired using the liability.⁷⁴ Section 1012 does not create basis in the self-created note. Instead the purchaser takes a basis in the acquired property "because the law assumes that [the] . . . obligation will be paid or directly enforced by the seller and thus gives the obligor advance basis for the promise of future payment."⁷⁵ Most commentators believe, however, that even if a self-created note is treated as a purchase money obligation for purposes of section 351, it does not appear that the note should generate immediate basis similar to a section 1012 purchase.⁷⁶ The primary shortcoming of the *Peracchi* decision is the grant of section 1012 cost basis equal to the face value of a self-created note.

The *Peracchi* decision does not appear to meet the Four Criteria. First, giving the contributing shareholder basis in the contributed self-created note does not necessarily recognize the economic substance of the transaction. The note does not create a new or separate asset in the shareholder's hands. Second, tax law generally does not give the creator of a note a basis in the note, so *Peracchi* appears to reach a result that is inconsistent with general tax principles. Third, the basis-increase method in *Peracchi* may cause problems when the shareholder makes payments on the note, or if the corporation sells the note.⁷⁷

An alternative view of *Peracchi*, however, brings the theory closer to the liability-offset theory proposed in this Article. The Ninth Circuit found that Peracchi's self-created note increased his investment in the corporation and the law should credit Peracchi for this additional investment.⁷⁸ From an economic perspective, the contributed note reduces the liability assumed by the corporation, increasing the corporation's net capital. Generally, net capital grows by increasing assets or decreasing liabilities. Thus, an alternative view of the Ninth Circuit's finding that Peracchi's note increased his investment in the corporation is that his investment increased corporate net capital by

⁷² See, e.g., Megaard & Megaard, *supra* note 8, at 73 ("[A] shareholder obligation should not be treated as a contribution of property with a cost basis equal to its face amount. . . . [I]n the hands of the shareholder-transferor the obligation is a liability—not property with a zero basis or any other basis.").

⁷³ See *Peracchi*, 143 F.3d at 494–95.

⁷⁴ See Megaard & Megaard, *supra* note 8, at 73.

⁷⁵ *Id.*

⁷⁶ See *id.* (arguing that a contributed self-created note should instead "be treated as a contingent obligation to make future capital contributions that is given in an open purchase transaction, which generates basis to the transferor only when it is paid").

⁷⁷ For example, because the shareholder already has basis in stock and the corporation already has basis in the note, the law would have to develop a method for accounting for the payments that would not distort the transaction.

⁷⁸ See *Peracchi*, 143 F.3d at 493 ("[The note] represents a new and substantial increase in Peracchi's investment in the corporation.").

decreasing the corporation's assumed liabilities. Viewed from this perspective, the Ninth Circuit's conclusion becomes aligned with the theory that the note is best viewed as offsetting the corporation's liability assumption.⁷⁹ The court's failure to fully develop that view created difficulties and confusion.

In summary, both the Second and Ninth Circuits reached the same general conclusion—a shareholder may avoid section 357(c) by contributing a self-created note in a section 351 transaction. The outcomes are, however, based on different reasoning, which leaves the law somewhat unsettled in this area.⁸⁰ Both opinions are the result of a questionable application of the law, but both opinions also reach a result that is sympathetic to the taxpayer who does not realize an economic gain on the transaction. Subsequent legislation in a related area suggests that the liability-offset theory is a better approach to dealing with contributions of self-created notes.

D. *Liability-Offset Under Section 357(d)*

In 1999, Congress changed the law governing contributions of encumbered property to a corporation by modifying sections 357 and 362.⁸¹ These changes codify a liability-offset theory, but they do not directly address contributions of self-created notes. This Article suggests that the principles in 357(d) should extend to contributions of self-created notes. Historically, section 357(c) required a shareholder to recognize gain when (1) the corporation acquired property subject to a liability that exceeded the basis of the property transferred, or (2) the corporation assumed a liability in excess of the transferred property's basis.⁸² The amendments to section 357 removed the reference to the transferee corporation acquiring property subject to a liability for purposes of determining section 357(c) gain.⁸³ Thus, section 357, as amended, applies solely to liabilities assumed by the corporation.

The amendments to section 357 also added section 357(d), which clarifies when a transferee corporation is deemed to assume a liability as part of a section 351 transaction. Accordingly, liability assumption has become "a term of art [under current law], which includes some, but not all, situations in which property is 'taken subject to' a liability."⁸⁴ Under section 357(d), whether a corporation assumes a liability depends in part on whether the liability is recourse or nonrecourse.⁸⁵ In general, the law considers a corporation to assume a nonrecourse liability "any time that the asset subject to such

⁷⁹ See *infra* Part IV (discussing the liability-offset theory).

⁸⁰ See Lazar, *supra* note 9, at 76.

⁸¹ See Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(b), 113 Stat. 127, 182-84.

⁸² See John A. Bogdanski, *Section 357(D)—Old Can, New Worms*, 27 J. CORP. TAX'N 17, 17 (2000).

⁸³ See *id.* at 18.

⁸⁴ *Id.*

⁸⁵ See I.R.C. § 357(d).

liability is transferred to the corporation.”⁸⁶ On the other hand, a corporation assumes recourse liabilities only when, as determined by the facts and circumstances of the situation, the corporation agrees to, and is expected to, satisfy the liability—whether or not the transferor has been relieved of the liability.⁸⁷ The following discussion focuses on the corporation’s assumption of recourse liabilities.⁸⁸

While the change to section 357 informs the analysis of *Peracchi* and incorporation transactions in general, this effect was not Congress’s goal in modifying the law.⁸⁹ Instead, Congress designed the modifications in section 357 to “combat a relatively arcane international tax-shelter abuse”⁹⁰ where foreign corporations attempted to create artificial basis by manipulating the liability-assumption rules.⁹¹ Nevertheless, the amendments to section 357 and the addition of section 357(d) effectively codify part of the economic benefit arguments set forth by the Second Circuit in *Lessinger*.⁹² The *Lessinger* court found that taxing a shareholder who has not recognized a corresponding benefit would amount to taxing “truly phantom gain.”⁹³ Because current law

⁸⁶Lazar, *supra* note 9, at 60; see also I.R.C. § 357(d)(1)(B).

⁸⁷See I.R.C. § 357(d)(1)(A).

⁸⁸Shareholders have more difficulty retaining a share of nonrecourse liability that does not already encumber property. Imagining a situation that would compel a shareholder to take personal liability for a recourse loan is difficult. Therefore, this discussion does not consider the application of the liability-offset theory to nonrecourse liabilities.

⁸⁹The legislative history of the amendments to section 357 states that both *Lessinger* and *Peracchi* contributed to uncertainty surrounding section 357(c). See STAFF OF J. COMM. ON TAX’N, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2000 BUDGET PROPOSAL 198–99 (Comm. Print 1999).

⁹⁰Karen C. Burke, *Contributions, Distributions, and Assumption of Liabilities: Confronting Economic Reality*, 56 TAX LAW. 383, 383 (2003) (citing Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(a)(1), (d)(2)–(5), 113 Stat. 127, 181–84).

⁹¹*Id.* To illustrate the international tax-shelter abuse targeted by Congress, imagine a foreign parent corporation not subject to U.S. tax with two U.S. subsidiaries and two zero-basis assets each subject to a single \$200 liability. Under former law, if the foreign parent separately transferred each zero-basis asset to each subsidiary, the subsidiaries would be entitled to a step-up in basis equal to the full amount of the liability (\$200) because the assets were “subject to” the debt. See, e.g., Bogdanski, *supra* note 82, at 20. The results of this transaction would be an overstated basis by the U.S. subsidiaries without the transferor corporation incurring U.S. taxable gain as a result of the liability relief. See *id.*

⁹²See, e.g., Burke, *supra* note 90, at 391 (“In effect, section 357(d)(1)(A) codifies the economic benefit theory underlying the 1001 regulations.”). The section 1001 regulations state that the “sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability.” Reg. § 1.1001-2(a)(4)(ii). Thus, the transferor only includes the liability in his amount realized when he has received the economic benefit of the other party agreeing to pay that liability. While similar in intent and in theory, the section 1001 regulations are not identical to the language of section 357(d)(1)(A) with regard to recourse liabilities. See Burke, *supra* note 90, at 391 (“The section 1001 regulations require merely that the transferee agree to pay the underlying recourse liability, while section 357(d) provides that the transferee must also be ‘expected to’ pay such liability.”).

⁹³*Lessinger v. Commissioner*, 872 F.2d 519, 527 (2d Cir. 1989).

requires the transferee to agree to, and be expected to, pay the recourse liability to effect an assumption, current law is much less likely to tax gain, unless the shareholder recognizes a corresponding economic benefit.

An example illustrates the effect of section 357(d). Derek and Alex decide to open and operate a sporting goods store, Legends Equipment, Inc. Their business model provides that Derek will be the two-thirds majority shareholder, and Alex will own the other one-third of Legends's shares. To capitalize Legends, Derek contributes \$400,000 cash in exchange for 200 shares of Legends common stock, and Alex contributes all of the business assets and liabilities of his sole proprietorship. At the time of contribution, Alex's sole proprietorship has \$150,000 of recourse liabilities and assets with a fair market value of \$300,000. The assets have an adjusted basis of \$100,000.⁹⁴ In exchange for his contribution, Alex receives 100 shares of Legends common stock. Finally, in order to obtain the desired ownership ratio, the parties agree that the corporation will be liable for only \$100,000 of Alex's liabilities, and Alex will repay the remaining \$50,000 balance.⁹⁵ The parties execute an agreement that complies with section 357(d), stating that the corporation does not agree to, nor is it expected to, satisfy \$50,000 of Alex's liabilities.⁹⁶

Derek and Alex's transaction is not unexpected in business practice. Parties often incorporate businesses by transferring liabilities and property to the corporation. Moreover, Derek and Alex's structure accomplishes their economic objectives. Because Alex retained \$50,000 of liabilities the net value of his contribution to the corporation was \$200,000, which accurately reflects the parties' ownership arrangement when balanced against Derek's \$400,000 cash contribution.⁹⁷ In fact, if Legends were to assume any amount of liabilities other than \$100,000, Alex and Derek would not accomplish their economic objectives.

Under former section 357, Alex and Derek would have had more difficulty accomplishing their business objectives if one party contributed liabilities in excess of basis. As stated above, former section 357(c) appeared to apply whenever a corporation acquired "property subject to a liability" in excess of the basis of the properties transferred.⁹⁸ Thus, under prior law, Alex may have

⁹⁴The \$100,000 adjusted basis in the business assets transferred is a reflection of the assets' initial cost adjusted by depreciation deductions Alex took on the property under section 168 of the Code. See I.R.C. § 1016(a)(2) (requiring a downward adjustment to basis for depreciation deductions taken). The liabilities would not give rise to deductions if paid.

⁹⁵Disclaiming \$50,000 of the recourse debt allows Derek to be the two-thirds majority shareholder and Alex the one-third minority shareholder. Derek's contribution of \$400,000 cash to Legends indicates that Alex needs to make a net contribution of \$200,000 in order to comply with the parties' economic agreement. But, Alex's contribution of \$300,000 in properties and the corporation's assumption of \$150,000 of liabilities yields a net value contribution of only \$150,000. Thus, Legends expressly disclaims \$50,000 of the liability to yield the proper business arrangement and a \$200,000 net value contribution by Alex.

⁹⁶See I.R.C. § 357(d).

⁹⁷See *supra* note 95 (discussing the economic realities of the Legends incorporation).

⁹⁸See I.R.C. § 357(c)(3) (1988); Bogdanski, *supra* note 82, at 18.

recognized \$50,000 of gain, even though he was not relieved of liabilities exceeding the aggregate basis of the properties he contributed to the corporation.⁹⁹ Currently, however, section 357(c) applies only if a corporation actually assumes liabilities in excess of basis.¹⁰⁰ Because Legends does not assume \$50,000 of Alex's liabilities, Alex's liability relief equals the basis of property he contributed, and he should not recognize any gain on the contribution.¹⁰¹ Alex will take a zero basis in his Legends stock because the \$100,000 liability the corporation assumes reduces the \$100,000 basis Alex had in his business assets.¹⁰² This result reflects the economic intent of the parties.

Tax law must also contemplate the future payment of the assumed and unassumed liability for section 357(d) to work well. If, pursuant to section 357(d), a transferee corporation only assumes a portion of the transferor shareholder's liabilities, the tax accounting for the unassumed liabilities should remain the shareholder's responsibility.¹⁰³ Some commentators suggest this becomes problematic if the agreement is broken and the corporation ultimately pays off the liability. Corporate tax law should treat liability repayments by the corporation as "constructive distributions to the shareholder under section 301—dividends to the extent of the earnings and profits of a C corporation or former C corporation."¹⁰⁴ Furthermore, the corporation's payment of the liability would call into question the original liability disclaimer agreement. This may give rise to deemed section 357(c) gain by the transferor on the original section 351 transaction, instead of a distribution under section 301.¹⁰⁵ A review of the accounting treatment of a section 357(d) transaction and subsequent transactions will illustrate the effectiveness of section 357(d) and foreshadow the application of the liability-offset method to contributed self-created notes.

Corporate tax law is not bound by the accounting treatment a transaction receives, but a modified version of the accounting treatment helps illustrate the economic aspects of the transaction. The analysis uses journal entries that

⁹⁹Because Alex contributed properties to Legends with an adjusted basis of \$100,000 "subject to" liabilities of \$150,000, the liability relief deemed by former section 357(c) of \$150,000 would have exceeded the basis of the properties transferred by \$50,000. *See Lazar, supra* note 9, at 56 ("Prior to 1999, it appeared to be well-settled law that retaining personal liability for debts transferred to a controlled corporation did not reduce the amount of liabilities transferred to such corporation in order to prevent the application of section 357(c)."); *see also* Megaard & Megaard, *supra* note 8, at 74 (arguing that the court had generally "applied [s]ection 357(c) mechanically without examining whether the transferor has really been relieved of the transferred debts").

¹⁰⁰*See* I.R.C. § 357(a).

¹⁰¹Because Legends assumes \$100,000 of liabilities, and Alex's aggregate basis in the properties transferred is equal to \$100,000, Alex should not recognize any section 357(c) gain.

¹⁰²*See* I.R.C. § 358(d)(1).

¹⁰³*See* Bogdanski, *supra* note 82, at 28.

¹⁰⁴*Id.*

¹⁰⁵*See id.* (stating that it is unclear how far the Service would be allowed to look back in "determining relevant parties' agreement and expectation").

rely upon the tax basis of assets instead of GAAP's fair market value. These journal entries will help analyze the application of the liability-offset theory to contributed self-created notes. Because the corporation assumes a portion of Alex's liabilities, the analysis focuses on the tax accounting treatment for Alex and the corporation with respect to the liabilities the corporation assumes and those it does not assume. Before the contribution Alex had \$150,000 of liabilities and assets worth \$300,000, in which he had a \$100,000 adjusted basis. Alex remained liable for \$50,000 of the liabilities following the contribution. Upon contribution to the corporation, Alex would debit liabilities \$100,000 and credit business assets \$100,000. Alex received stock in which Alex would take a zero basis. Alex's journal entry for the contribution would be as follows:

Alex's Treatment of Contribution

Liabilities	\$100,000	
Legends Stock	\$0	
Business Assets		\$100,000

The corporation received assets and incurred liabilities. The corporation's journal entry would be as follows:

Corporation's Treatment of Alex's Contribution

Business Assets	\$100,000	
Liabilities		\$100,000

Even though this entry appears to indicate the corporation received nothing of value from Alex, recall that the value of the property Alex contributed exceeded the amount of the liability encumbering the property. Thus, Alex contributed something of value to the corporation. Alex's economic situation remains significantly similar to his situation before the contribution.

Journal entries also help illustrate the effect subsequent payments of the liabilities by Alex or the corporation would have on the parties. If Alex were to pay the \$50,000 of liabilities for which he remained liable, he would reduce his cash and liabilities by that amount. The journal entries would be as follows:

Alex's Subsequent Payment of Retained Liabilities

Liabilities	\$50,000	
Cash		\$50,000

Alex's payment of that liability would not affect the corporation because Alex's liability was to a third party.

If the corporation paid all or a portion of the \$100,000 liability it assumes, it would have the following journal entries to show a reduction in cash and liabilities:

Corporation's Payment of Liabilities

Liabilities	\$100,000	
Cash		\$100,000

Because the corporation assumed \$100,000 of Alex's liability, Alex was no longer liable for that portion of the liability and the corporation's payment would not affect Alex's tax situation.

Borrowing by the corporation would generally be routine and the tax treatment fairly straight forward. The corporation may decide to use the property Alex contributed as collateral for another loan and therefore borrow \$50,000 against the property. That will give the corporation an additional \$50,000 of cash and \$50,000 liability. The following journal entry illustrates the loan from the corporation's perspective (the loan would not affect Alex).

Corporation's Borrowing Against Contributed Property

Cash	\$50,000	
Liabilities		\$50,000

The transactions that deserve closer attention are those that affect Alex and the corporation directly. If the corporation were to directly repay all, or a portion, of the liability for which Alex remained liable, a portion of that repayment would be equivalent to the corporation making a distribution to Alex and Alex repaying the loan. Assume for example, that the corporation repays \$50,000 of liability for which Alex remained liable. Such a payment would be a deemed distribution by the corporation to Alex, followed by Alex's repayment of the loan. The following journal entries illustrate the transaction.

Deemed Corporate Distribution

Owner's Equity	\$50,000	
Cash		\$50,000

Deemed Receipt by Alex

Cash	\$50,000	
Income		\$50,000

Loan Repayment by Alex

Loan	\$50,000	
Cash		\$50,000

Section 301 would govern the tax treatment of that deemed distribution. If the corporation has earnings and profits, the distribution should be a dividend to Alex. Otherwise it would be a return of Alex's capital or a return on his capital.¹⁰⁶

If Alex directly repaid all, or a portion, of the corporation's \$100,000 liability, the transaction would be deemed a contribution by Alex followed by a deemed repayment to the corporation.¹⁰⁷ That transaction would increase Alex's basis in his corporate stock and reduce the corporation's liability. Tax law easily addresses this type of transaction.

¹⁰⁶ See I.R.C. § 301(c)(1), (2).

¹⁰⁷ This assumes that the distribution is in excess of Alex's basis in his Legends stock. See I.R.C. § 301(c).

Deemed Contribution to Corporation Alex

Stock	\$100,000	
Cash		\$100,000

Corporation

Cash	\$100,000	
Owner's Equity		\$100,000

Deemed Payment by Corporation

Debt	\$100,000	
Cash		\$100,000

Those several journal entries help illustrate the nature of a section 357(d) transaction and subsequent transaction between Alex and the corporation. Understanding the nature of the transaction helps establish the proper tax treatment for each aspect of the various transactions. Taxing the contribution, the assumption of a portion of the liabilities, and the repayment of the liabilities are not difficult tasks once the nature of the transaction is clear. The discussion below illustrates that a contributed self-created note has the same effect and can be accounted for similarly under the liability-offset theory—but first consider why shareholders would consider using self-created notes after the enactment of section 357(d).

If section 357(d) provides an easy planning opportunity that helps taxpayers avoid the perils of section 357(c), the question arises whether taxpayers need the option of self-created notes to avoid the section 357(c) trap. Prior to the enactment of section 357(d), taxpayers could only reduce the amount of liability assumed by the corporation with a self-created note. In theory, the introduction of section 357(d) and the removal of the “subject to” language in section 357 should reduce the need for shareholders to create notes to eliminate section 357(c) gain.¹⁰⁸ Instead, shareholders contributing properties with excess recourse liabilities could agree that the corporation is not assuming liabilities in excess of the transferred basis of the assets. In this manner, section 357(d) is a welcome addition to the Code, preserving the nonrecognition framework of section 351 transactions and reducing the potential for taxpayers to recognize gain absent a corresponding economic benefit.

On the other hand, section 357(d) contains ambiguity,¹⁰⁹ so relying upon it for planning purposes is not always simple or certain. First, in order for a corporation to assume a recourse liability, the corporation must be “expected to” satisfy the liability.¹¹⁰ If the corporation and the transferor reach an agreement for the corporation to satisfy a recourse liability, the law creates

¹⁰⁸ See, e.g., Bogdanski, *supra* note 82, at 26 (“Section 357(d) may signal an end to the debate [over shareholders reducing section 357(c) gain] . . . at least as to recourse debt.”); Burke, *supra* note 90, at 391 (“As a practical matter, it is no longer necessary for shareholders to furnish their own obligations to offset excess recourse liabilities. Thus, section 357(d) should generally eliminate the *Lessinger/Peracchi* zero-basis controversy.”).

¹⁰⁹ See Burke, *supra* note 90, at 391.

¹¹⁰ See I.R.C. § 357(d)(1)(A).

a presumption that the transferee corporation will meet the section 357(d) expectation test.¹¹¹ “If the expectations of the transferor and the transferee corporation differ,” however, the law is not clear about which party’s expectations should control.¹¹² Moreover, the expectations of the third-party creditor should also help determine which party is expected to pay, but “the statute apparently contemplates only an agreement between the transferor and the transferee.”¹¹³

In addition, determining when a shareholder has actually been relieved of a liability for purposes of section 357(d) may be difficult. For example, in *Seggerman Farms v. Commissioner*, the Tax Court held that personal guarantees of corporate debt were not economic outlays and were thus insufficient to eliminate section 357(c) gain.¹¹⁴ The Tax Court decided *Seggerman* under prior law, but it stated that the personal guarantees executed by the taxpayers would be insufficient under current law to avoid section 357(c) gain.¹¹⁵

As an alternative to personally guaranteeing the excess liability, commentators have argued that the most effective method for avoiding section 357(c) gain under current law is to (1) execute an agreement between the corporation and the shareholders providing that “the shareholders and not the corporation will satisfy” the excess liabilities, and (2) execute an agreement requiring the shareholder to indemnify the corporation against the consequences of foreclosure on the property to satisfy the liability.¹¹⁶ The shareholder’s indemnity agreement should provide further evidence the corporation did not assume all of the shareholder’s liability, but it also closely resembles the shareholder guarantee deemed ineffective in *Seggerman Farms*.¹¹⁷

The facts and circumstances test employed in section 357(d) creates uncertainty because it requires ascertaining the allocation of economic burdens between related taxpayers.¹¹⁸ Even with an agreement between the parties as to the amount of debt the transferee corporation is assuming, the parties may have difficulty determining the actual liability relief of a related transferor.¹¹⁹ Shareholders may be able to avoid those ambiguities by contributing a self-created note. Furthermore, some lenders may resist arrangements that do not make corporations primarily responsible for a liability. The shareholder’s note will help avoid any problems resulting from such resistance. Thus, despite the changes in the law since *Peracchi*, shareholders may seek to avoid the potential

¹¹¹ See Burke, *supra* note 90, at 392.

¹¹² See *id.*

¹¹³ *Id.*

¹¹⁴ 81 T.C.M. (CCH) 1543, 2001 T.C.M. (RIA) ¶ 17, *aff’d*, 308 F.3d 803 (7th Cir. 2002).

¹¹⁵ *Id.*

¹¹⁶ See Bogdanski, *supra* note 82, at 26; Burke, *supra* note 90, at 391.

¹¹⁷ See Bogdanski, *supra* note 82, at n.26 (discussing a shareholder’s indemnity as “tantamount to a shareholder guarantee”).

¹¹⁸ See Burke, *supra* note 90, at 393.

¹¹⁹ See *id.* (“Because there is no objective measure of whether a related transferor has been relieved of a liability, regardless of the parties’ agreement, the economic benefit model of section 1001 may be misplaced in the context of section 351 transfers.”).

problems of section 357(c) and 357(d) by contributing a self-created note to the corporation.

In summary, *Peracchi*, the changes made to section 357(c), and the enactment of section 357(d) have brought the law much closer to preserving the economic intent of the shareholders as compared to the law that existed before *Peracchi*. Executing an agreement limiting the corporation's assumption of all recourse liabilities in excess of basis is likely the most direct way to avoid section 357(c) gain. Section 357(d) thus eases planning difficulty and helps eliminate a trap for the unwary. Unfortunately, the requirements of section 357(d) produce some uncertainty for taxpayers. Thus, for business purposes, and possibly at the behest of third-party creditors, some taxpayers may still wish to contribute self-created notes to preserve the parties' economic objectives and avoid section 357(c) gain. In those situations, the law should accord with section 357(d)—the shareholder's note demonstrates that the shareholder has retained liability equal to the amount of the note, and correspondingly the amount of liabilities assumed by the corporation should be reduced. Viewing the contribution of a self-created note as a liability retained by the shareholder helps resolve problems inherent in existing theories of *Peracchi*. The next Part illustrates how the liability-offset theory, as opposed to other theories, should apply to contributed self-created notes.

III. Existing Theories on Section 357(c) Gain and Shareholder Notes

The *Lessinger* and *Peracchi* decisions attracted significant attention and criticism. As the discussion above suggests, some commentators felt sympathetic to the taxpayers' situations, but most thought the cases were wrongly decided.¹²⁰ Commentators have presented two main theories as recommendations for solving problems they recognize in the *Peracchi* decision. Unfortunately, neither of the proposed theories has adequately addressed the issue from both an economic and tax perspective. To be complete, a theory directing the tax treatment of contributed self-created promissory notes and section 357(c) should comport with the nonrecognition goal of section 351 transactions to the extent possible, and also preserve the economic intent of the taxpayers to the extent possible. In short, a theory on contributed self-created promissory notes and section 357(c) should satisfy the Four Criteria.¹²¹

¹²⁰ See, e.g., Quiring, *supra* note 15, at 97 ("[The *Lessinger* and *Peracchi*] decisions performed a valuable service by reexamining the troublesome zero-basis theory adopted in *Alderman*, but neither one has replaced it with an entirely satisfactory rationale."); Tierney, *supra* note 9, at 198 (arguing that *Peracchi* was decided incorrectly "because the Peracchis did not create genuine debt when they transferred the personal promissory note to the corporation"). But see John A. Bogdanski, *Section 358 and Crane—A Reply to My Critics*, 57 TAX LAW. 905, 905–06 (2004) ("[T]he *Peracchi* court got [the analysis of contributing shareholder notes to avoid section 357(c) gain] mostly right, [while] the Second Circuit in *Lessinger* reached the correct result for the wrong reason.").

¹²¹ See *supra* Part I.

This Article divides the *Peracchi* criticism into two general theories. The Article labels the first the separate-transaction theory, and the second the open-transaction theory. The following discussion illustrates that both theories deviate from the basis-increase method and the liability-offset method that apply generally to corporate contributions. Thus, they both create new approaches to analyze contributions to corporations.

A. *Separate-Transaction Theory*

The separate-transaction theory claims that a contributed self-created promissory note should not be property for purposes of section 351.¹²² Instead, the theory advocates treating any stock not issued for property as issued in a transaction separate from the contribution.¹²³ “This would [require] taxpayers to bifurcate transactions in which assets and liabilities are contributed to a corporation into (1) stock for property exchanges covered by section 351, and (2) other taxable exchanges.”¹²⁴

This theory eliminates some of the potential difficulties arising from the courts’ analyses in *Peracchi* and *Lessinger*. Specifically, a taxpayer who transfers a note to a corporation will receive a basis in the stock received from the corporation equal to the amount of the note, and the corporation will take a basis in the shareholder’s note equal to the face value of the note.¹²⁵ Section 351 will apply separately to the contributions of property. An example illustrates the separate-transaction theory. Assume that Andy transfers the assets of his sole proprietorship plus his own promissory note to form X Corp in a section 351 transaction. The transferred business assets have an aggregate fair market value of \$500,000 and an adjusted basis of \$150,000. Andy’s promissory note has a face value of \$150,000. In exchange for his contribution, Andy receives all of the common stock of X Corp, valued at \$350,000, plus X Corp’s assumption of \$300,000 of business liabilities.

The separate-transaction approach treats Andy as receiving \$150,000 of X Corp stock in exchange for his promissory note and the remaining \$200,000 of stock in exchange for the transferred business assets and X Corp’s liability assumption. Under the separate-transaction theory, Andy’s note does not factor into the section 357(c) analysis, so the debt assumed by the corporation will exceed the basis of the property Andy contributes. Accordingly, Andy recognizes \$150,000 of gain, the excess of the \$300,000 liabilities assumed by X Corp over his adjusted basis in the business assets. Andy takes a \$150,000 section 1012 cost basis in the stock he receives in exchange for his note and a

¹²² See Lazar, *supra* note 9, at 91 (“[I]t is incumbent upon Congress to amend section 351(d) to provide that stock issued in exchange for a shareholder promissory note shall not be considered issued in exchange for property.”).

¹²³ See *id.*

¹²⁴ *Id.*

¹²⁵ See *id.*

zero basis in the remainder of his X Corp stock.¹²⁶ In addition, X Corp takes a \$300,000 basis in the business assets and a \$150,000 section 1012 cost basis in the note.¹²⁷

The separate-transaction theory forces Andy to recognize section 357(c) gain even though he is in the same financial situation before and after the section 351 transaction. The transfer to the corporation is a mere change in legal ownership. Before forming X Corp, Andy had \$500,000 in assets, \$300,000 in liabilities, and built-in gain in his business assets of \$350,000.¹²⁸ Andy's net capital was \$200,000 before forming the corporation. After forming X Corp, Andy had \$350,000 in assets and \$150,000 in liabilities.¹²⁹ Thus, his net capital remained \$200,000 after the corporate formation. Nonetheless, Andy recognized \$150,000 of gain on the transaction and after forming X Corp, Andy's aggregate built-in gain in the assets he owns reduced from \$350,000 to \$200,000.¹³⁰ Consequently, the separate-transaction theory required Andy to recognize gain and altered his tax attributes, even though his economic situation did not change. Thus, the separate-transaction theory violates the first of the Four Criteria.

The separate-transaction theory sufficiently deals with many of the problems generated by the circuit court opinions of *Peracchi* and *Lessinger* by giving both the shareholder and the corporation basis consistent with statutory rules. Moreover, the separate-transaction theory minimizes problems related to the corporation's subsequent disposition of the note by giving the corporation basis equal to the fair market value of the note—thus avoiding illusory gain on a subsequent disposition.¹³¹ The separate-transaction approach does not, however, avoid the harsh results of section 357(c) gain. The shareholder contributing a promissory note under this approach may recognize gain with-

¹²⁶ Andy's basis in the remainder of his stock is calculated under section 358 as an exchanged basis of \$150,000, minus \$300,000 of debt assumed by X Corp, plus \$150,000 of gain recognized by Andy on the transaction.

¹²⁷ X Corp's basis is a transferred basis of \$150,000 under section 362(a), increased by the \$150,000 of gain recognized on the exchange by Andy.

¹²⁸ Andy's built-in gain at contribution is equal to \$350,000 because the contributed business assets have a fair market value of \$500,000 and an adjusted basis of \$150,000.

¹²⁹ The \$350,000 in assets is represented by Andy's stock ownership and the \$150,000 in liabilities is the note Andy issues to X Corp.

¹³⁰ After forming X Corp, Andy owns two different blocks of stock: \$200,000 of stock with a \$0 basis, and \$150,000 of stock with a basis of \$150,000. In the aggregate, the built-in gain in all X Corp stock owned by Andy is \$200,000.

¹³¹ Under the separate-transaction theory, X Corp would be able to sell Andy's note for face value immediately after receiving the note and not have to recognize gain. If the note had a zero basis in the corporation's hands, X Corp would apparently be forced to recognize gain equal to the fair market value of the note on subsequent disposition. See *Alderman v. Commissioner*, 55 T.C. 662, 665 (1971); *supra* text accompanying notes 42–46.

out receiving a corresponding economic benefit,¹³² and therefore the separate-transaction theory fails to satisfy all of the Four Criteria.

B. *Open-Transaction Theory*

The open-transaction theory for taxing the contribution of self-created notes suggests treating the issuance of the note as an open transaction between the parties instead of a transfer of property.¹³³ Advocates of the open-transaction theory argue that it is the best approach to deal with “the Service’s real concern—the difficult related-party aspect of the transaction.”¹³⁴ Under the open-transaction theory, neither the contributing shareholder nor the corporation is given basis in the note at the time of contribution.¹³⁵ Instead, the shareholder’s subsequent payment on the note creates basis that becomes a capital contribution or a stock subscription.¹³⁶

The open-transaction theory for contributed self-created notes mirrors the tax treatment that applies to partners who contribute self-created notes to partnerships.¹³⁷ Under partnership tax law,

if a promissory note is contributed to a partnership by a partner who is the maker of such note, such partner’s capital account will be increased with respect to such note only where there is a taxable disposition of such note by the partnership or where the partner makes principal payments on such note.¹³⁸

The partnership tax rules similarly deny the contributing partner basis in the partnership interest until the partner makes payments on the note.¹³⁹ Partnership tax, unlike corporate tax, mixes aggregate and entity views of taxation,¹⁴⁰ so it may be more suited to the open-transaction theory. The aggregate aspect of tax partnerships facilitates the open-transaction treatment because the contributing partner is a co-owner of partnership property for

¹³² See, e.g., *Lessinger v. Commissioner*, 872 F.2d 519, 526 (2d Cir. 1989) (“If Lessinger had a ‘gain’ from the incorporation, it did not show up in his personal balance sheet, let alone by way of economic benefit in his pocket.”).

¹³³ See Manning, *supra* note 12, at 195.

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ See Lazar, *supra* note 9, at 88.

¹³⁸ Reg. § 1.704-1(b)(2)(iv)(d)(2).

¹³⁹ See Rev. Rul. 1980-235, 1980-2 C.B. 229 (stating that a partner’s contribution of his own promissory note does not increase outside basis because the partner has a zero basis in his own written obligation until he actually makes payments on the note). The *Peracchi* decision does not overrule Revenue Ruling 1980-235 because the Ninth Circuit was careful to limit its holding to the circumstances of that case, and specifically declined to extend the holding to the partnership tax context. See Lazar, *supra* note 9, at n.210 (citing *Peracchi v. Commissioner*, 143 F.3d 487, 494 n.16 (9th Cir. 1998)).

¹⁴⁰ See Bradley T. Borden, *The Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717, 736–37 (2009).

some purposes.¹⁴¹ Even though the theory of partnership tax and corporate tax differ significantly, the open-transaction theory in the partnership regime nonetheless appears to provide comfort to some analysts. Unfortunately, the open-transaction doctrine causes problems in the corporate context.

While the open-transaction approach reduces related-party concerns between the shareholder and the corporation, the “solution is not without its own problems.”¹⁴² Critics of the theory have expressed concerns that delaying basis to the contributing shareholder will result in confusion if the corporation sells the note.¹⁴³ This suggests that the open-transaction theory fails the fourth criterion of the Four Criteria—the appropriate tax treatment of the corporation on the subsequent disposition of the contributed note. Additionally, problems may arise on the disposition of the shareholder’s shares before the shareholder pays the note in full.¹⁴⁴ The law would have to address the tax treatment of payments the shareholder makes on the note following the stock sale. That could create unnecessary complexity. Finally, a commentator has argued that if the open-transaction theory prevents recognition of gain, it fails to “address the primary concern of section 357(c)—that taxpayers should not have a negative basis in their stock investment.”¹⁴⁵ This indicates the open-transaction theory may also fail the second criterion. Thus, the open-transaction theory cannot adequately govern the contribution of self-created notes.

IV. The Liability-Offset Theory

Because existing law and theories fail to adequately address all of the issues presented by contributions of self-created notes, this Article recommends the liability-offset theory. The liability-offset theory, if fully developed, helps solve the *Peracchi* problem. Commentators have previously applied theories to *Peracchi* that help lead to the liability-offset theory.¹⁴⁶ This Article formalizes and expands upon earlier commentary to develop the liability-offset theory and analyze contributed self-created notes under section 357(c). Under the

¹⁴¹ See, e.g., I.R.C. § 704(c) (requiring the partnership to take into account pre-contribution gain or loss in allocating partnership tax items associated with contributed property).

¹⁴² See Lazar, *supra* note 9, at 87.

¹⁴³ See, e.g., Bogdanski, *supra* note 33, at 354. Alternatively, it may be possible to provide the corporation with basis in the note at the time of the sale, and the interposition of an independent creditor addresses concerns that generally arise in related-party transactions. See Quiring, *supra* note 15, at 118.

¹⁴⁴ See Quiring, *supra* note 15, at 118.

¹⁴⁵ Lazar, *supra* note 9, at 90 (“Applying the open transaction doctrine to the situation when, pursuant to a transaction governed by section 351, a corporation assumes liability in excess of the adjusted basis of the assets transferred, the shareholder who transfers his own promissory note in addition to such assets and liabilities would still receive stock in which his basis was less than zero.”).

¹⁴⁶ See Cummings, *supra* note 16, at 299 (“The correct analysis . . . is that the transferor’s obligation is not property for purposes of section 351 and the obligation . . . is relevant to the section 357(c) computation only if it reduces the transferor’s liabilities assumed . . .”); see also Quiring, *supra* note 15, at 119 (“A better theory is that the transfer of a shareholder’s own note will avoid section 357(c) gain by reducing the liabilities assumed or taken subject to.”).

liability-offset theory, the self-created note operates as “a means of allocating the liabilities between the shareholder and the corporation.”¹⁴⁷ Economic realities, which were first introduced into section 357(c) analysis by the Second Circuit in *Lessinger*, help explain the liability-offset theory. Substantively, the transferee corporation does not assume shareholder liabilities if one piece of paper says that a \$1,000 liability encumbers the transferred property and another says that the transferor will pay or otherwise be responsible for that \$1,000 liability.¹⁴⁸ The substance of those two papers keeps the liability with the shareholder. The form of the paper used to accomplish that task should not affect whether the shareholder retains liability.

The original example of Derek and Alex forming Legends Equipment, Inc. helps illustrate how the liability-offset theory could apply to contributions of self-created notes.¹⁴⁹ Their business model stated that Derek was to be the two-thirds majority shareholder, and Alex the one-third minority shareholder in Legends. To comply with this economic ownership ratio, the parties agreed that Alex would remain responsible for \$50,000 of the \$150,000 of recourse liabilities assumed by Legends.¹⁵⁰ Instead of executing an agreement with the corporation and perhaps lenders, suppose that Alex contributes a \$50,000 self-created note to Legends. Economically, this note is equivalent to the formal agreement Alex executed in the original example, pursuant to which he remained liable for a portion of the liability. Because Alex retains liability by contributing the note, the law should treat him the same as it would under section 357(d), had he used another method to retain liability. The liability-offset theory helps obtain that equity. The liability-offset theory treats Alex's \$50,000 note as offsetting the \$150,000 of liabilities assumed by the corporation, so Legends only assumes \$100,000 of liabilities for section 357(d) purposes. Under the liability-offset theory, the self-created note eliminates section 357(c) gain, comprehends Derek and Alex's business arrangement, and reaches the appropriate tax result on all aspects of the contribution and subsequent transactions that relate to the note or assumed liability.

Valid business reasons may prompt Alex to execute a note to the corporation in lieu of executing an agreement to retain responsibility for a portion of the liability. The note may provide a more formal documentation of the parties' liabilities in the face of the uncertain “facts and circumstances” test of section 357(d).¹⁵¹ Furthermore, Derek may prefer a note for money management purposes, such as facilitating the business liabilities of the corporation. For example, Alex's liabilities may represent obligations to numerous parties.

¹⁴⁷ Quiring, *supra* note 15, at 119.

¹⁴⁸ See Cummings, *supra* note 16, at 299.

¹⁴⁹ See *supra* text accompanying notes 94–102.

¹⁵⁰ Derek contributed \$400,000 cash to Legends, while Alex contributed \$300,000 in business assets and \$150,000 of liabilities. When Legends disclaims \$50,000 of the liabilities transferred, Alex's net contribution becomes \$200,000 and the parties' intended economic ownership ratio is reached.

¹⁵¹ See I.R.C. § 357(d)(1)(A).

Parsing through the obligations to decide which specific obligations Alex will pay and which the corporation will pay would likely be an administrative hassle that a single note may eliminate. If the corporation agrees to write checks for the obligations as they become due, the parties can centralize the administration of the payments to third parties and use the note to separately monitor Alex's responsibility for a portion of the liabilities.

Furthermore, a note may help avoid the troublesome issues that can arise on the future satisfaction of the underlying transferred liabilities. As discussed above, if Alex and Legends execute an agreement pursuant to which Legends assumes a portion of Alex's liabilities, the tax accounting for the liabilities not assumed should remain Alex's responsibility.¹⁵² If, however, the corporation in fact pays the liabilities Alex retained, the debt payments would be taxable distributions to Alex under section 301, or a return of Alex's capital.¹⁵³ The Service could also use the subsequent payment of the liabilities by the corporation to challenge the original liability-retention agreement. Consequently, the corporation's payment could give rise to a deemed gain on the original transfer under section 357(c).¹⁵⁴

Under the liability-offset theory, however, the corporation's payment of the underlying debt does not have adverse tax affects—so long as the shareholder contributes an offsetting note and the shareholder's note remains valid and enforceable. Economically, there can be no liability relief to the transferor when the corporation later pays the third-party liabilities in full. The corporation is primarily responsible for making payments on the liabilities to third parties, and the payments made by the shareholder on the self-created note correspondingly increase the corporation's assets and liabilities.¹⁵⁵

A. Corporate Formation and Alex's Note Repayment

Journal entries help illustrate how the liability-offset theory applied to contributed self-created notes is often similar to the section 357(d) results obtained if the corporation assumes a portion of the shareholder's liability. Upon formation, the corporation will assume \$100,000 of Alex's liabilities and receive \$100,000 of Alex's business assets (the \$50,000 note offsets the remaining portion of Alex's \$150,000 of liabilities). The journal entries upon formation would be as follows:

Alex's Treatment of Contribution

Liabilities	\$100,000	
Legends Stock	\$0	
Business Assets		\$100,000

¹⁵² See Bogdanski, *supra* note 82, at 28; *supra* text accompanying notes 103–07.

¹⁵³ See Bogdanski, *supra* note 82, at 28.

¹⁵⁴ See *id.*

¹⁵⁵ See *infra* Part IV.A (discussing the tax and accounting consequences of note repayment).

Corporation's Treatment of Contribution

Business Assets	\$100,000	
Liabilities		\$100,000

The liability-offset theory treats Alex as retaining a portion of the liability, so the corporation is deemed to assume less than the full amount of the liability. Consequently, the corporation does not report the note as an asset, and Alex retains \$50,000 of the liability and preserves his pre-contribution gain.

If Alex makes a payment on the note, his portion of the retained liability decreases. When the corporation receives a payment on the note from Alex, the corporation's liability offset decreases. The receipt of payment therefore increases the corporation's cash position and its liabilities. The following entries illustrate how Alex's payment affects him and the corporation:

Alex's Treatment of Note Payment

Liabilities	\$50,000	
Cash		\$50,000

Corporation's Treatment of Alex's Payment

Cash	\$50,000	
Liabilities		\$50,000

This approach differs from earlier versions of the liability-offset theory. Those earlier versions argued that the contributed self-created note transforms the corporation into an agent or conduit for the shareholder with respect to the third-party liability.¹⁵⁶ In other words, payments to the corporation by the shareholder on the note would be treated as if they were made directly to the third-party creditor.¹⁵⁷

The conduit theory also provides that if the corporation breaks from the original agreement by continuing to make payments on the third-party liability after the shareholder has fallen behind in payments, then the shareholder cannot credibly argue that the corporation did not assume all of the liability.¹⁵⁸ Substantively, however, the corporation's payments do not change the shareholder's liability, if the note is still valid and enforceable. The shareholder remains liable on the note held by the corporation, so the corporation's payment does not bestow upon the shareholder an economic gain that should result in taxation. Moreover, if the contributed note transforms the corporation into a conduit on the third-party liability, tax law cannot adequately address the corporation's subsequent disposition of the note—a violation of one of the Four Criteria.

¹⁵⁶ See Quiring, *supra* note 15, at 124.

¹⁵⁷ See *id.*

¹⁵⁸ See *id.* ("When a transferor falls behind in payments to the corporation, but the corporation continues to make payments to the outside creditor, then the transferor loses his justification for claiming that the liability was not actually assumed by corporation.").

Of course, to effectively offset the amount of liabilities assumed by the corporation, the note must represent valid indebtedness of the shareholder.¹⁵⁹ Thus, the corporation must enforce the note against the shareholder in the same manner a third-party creditor would enforce it.¹⁶⁰ Consequently, third-party standards should determine whether the note represents valid indebtedness and thus offsets the transferred liabilities.¹⁶¹ Any condition or discount in interest rate "that would cause a substantial discount to the note's value to a disinterested third party should disqualify the note."¹⁶² The shareholder's note should not be so significantly different from the underlying liability that the arrangement becomes a liability deferral for the shareholder.¹⁶³

B. Alex's Payment on and Corporate Disposition of the Note

Commentators who espoused early versions of the liability-offset theory have nonetheless argued that if the note reduces the amount of the transferor's liability assumed, "[t]he note should not be an independently transferrable asset of the corporation."¹⁶⁴ Under this reasoning, the note's basis to the corporation becomes irrelevant because the corporation is forbidden from selling the note.¹⁶⁵ The idea that the corporation should be forbidden from selling the shareholder's contributed note appears to be based on the premise that these previous theories treat the corporation as a conduit between the transferor and the original creditor.¹⁶⁶ Thus, the note is not a new obligation of the shareholder.¹⁶⁷

By contrast, the more complete version of the liability-offset theory treats the contributed note as offsetting the underlying debt, which provides economic consistency, without compromising the transferability of the note itself. Tax law should not force the shareholder to recognize gain when the shareholder does not receive a corresponding benefit from an economic standpoint. Here, the liability-offset theory complies with this goal by treating the note as off-

¹⁵⁹ See *id.* at 123 (arguing "that the burden of proof must be on the transferor to show" that the note in fact reduces the liabilities assumed by the corporation).

¹⁶⁰ Many commentators have expressed concern about the related-party nature of these transactions and argued that the notes should be dismissed as contingent or speculative debt. But see Bogdanski, *supra* note 120, at 909-10 ("Unfortunately for proponents of that view, the Code says no such thing. Given the wide array of statutory provisions explicitly denying tax benefits in certain specified types of related-party transactions, the absence of a provision automatically denying basis benefits for debt owed by controlling shareholders to their corporations is quite telling.").

¹⁶¹ See Quiring, *supra* note 15, at 124.

¹⁶² *Id.*

¹⁶³ See *id.* at 123. ("For example, the taxpayer should not be able to avoid recognizing section 357(c) gain by swapping a 20-year mortgage for his own note to the corporation payable over 99 years.").

¹⁶⁴ Cummings, *supra* note 16, at 321; see also Quiring, *supra* note 15, at 124.

¹⁶⁵ See Quiring, *supra* note 15, at 124.

¹⁶⁶ See *id.* at 122-23 ("The corporation may be seen not as a new creditor, but rather as a mere conduit between the transferor and the original creditor.").

¹⁶⁷ See *id.*

setting the liabilities assumed under section 357(c). Even though the note offsets liabilities assumed, it can be a transferrable asset of the corporation without violating general tax principles or the intent of section 357(c).¹⁶⁸

The modified version of the example of Derek and Alex helps illustrate the tax treatment of the corporation's transfer of the note. Assume Alex contributes a \$50,000 note to Legends instead of otherwise agreeing to retain \$50,000 liability on the note. If Alex later pays \$10,000 of principal on the note, Legends will have a simultaneous increase of cash and liabilities—just as if the corporation had borrowed \$10,000 from a third party. The receipt of cash increases the corporation's cash, and the reduction in liability offset increases the corporation's liabilities. The following journal entries illustrate how Alex's payment on the note affects Alex and the corporation:

Alex's Payment on the Note

Liability	\$10,000	
Cash		\$10,000

Corporation's Receipt of the Note Payment

Cash	\$10,000	
Liabilities		\$10,000

The note offsets the liability assumed, so the offset will equal \$40,000 following the principal payments. Subsequently, if Legends sells the note to a third party, the corporation receives cash, and the \$40,000 offset is removed. Legends, therefore, has \$40,000 more of cash, as well as \$40,000 in additional liabilities. Because Alex would remain liable for the note, the corporation's transfer would not directly affect Alex. The following entry illustrates that factoring the note does not generate tax consequences:

Corporation's Treatment of Factoring the Note

Cash	\$40,000	
Liabilities		\$40,000

If the corporation were to sell the note for less than the outstanding balance, it would have to account for the difference between cash received and the reduction in liability offset. In effect, the corporation's liabilities would increase by more than the cash it receives. That suggests that the corporation would incur a loss on the transfer for which it must account. Because Alex would remain liable for the note, the corporation's transfer of the note would not directly affect Alex. The focus therefore is solely on the corporation.

Corporation's Treatment of Factoring the Note for Less than Face Value

Cash	\$30,000	
Deduction/Loss	\$10,000	
Liability		\$40,000

¹⁶⁸ See, e.g., *id.* at 126 ("Even if section 357(c) thus encourages the issuance of notes instead of imposing gain, it still fulfills its purpose of preventing negative basis.").

The deduction or loss would relate to the increased liability. Perhaps the law should treat the \$10,000 as the cost of obtaining the \$30,000 loan.¹⁶⁹ If that is the case, the corporation may have to capitalize the amount and deduct it over the life of the loan.¹⁷⁰ These journal entries help illustrate that treating the contributed note as an offset helps account for the corporation's subsequent disposition of the note.

C. *Corporation's Payment of Liability in Full*

To be valid, the liability-offset theory must also account for the corporation's payment of the third-party liability in full. Assuming the corporation pays the liability in full before Alex makes a payment on the note, the payment will reduce the corporation's cash position more than it reduces the corporation's liability. The corporation's cash position would decrease \$150,000, but because of the liability offset, its liabilities would decrease only \$100,000. The law should treat the amount of excess cash paid over the liability reduction as a loan from the corporation to Alex. Following the payment, the corporation will have a note, which no longer offsets liability, so it will be deemed to be an asset.

Before the repayment, Alex was deemed to owe the third party \$50,000 as an offset to the total third-party liability. After the repayment, Alex is liable to the corporation for \$50,000, so his position does not change. In effect, the corporation's payment of the full liability is similar to the corporation repaying \$100,000 of liabilities and acquiring Alex's note from a third party for \$50,000. The journal entry would appear as follows:

Corporation's Full Repayment of Loan

Liabilities	\$100,000	
Note	\$50,000	
Cash		\$150,000

This discussion illustrates that a fully developed liability-offset theory satisfies the Four Criteria. It recognizes the economic arrangement and does not tax either Alex or the corporation on the contribution. It also accounts for the shareholder's subsequent payments on the contributed note, the corporation's disposition of the note, and the corporation's payment of the liability. Therefore, the liability-offset theory accomplishes the tasks the Four Criteria assign to it.

D. *Support in Other Areas of Tax Law*

Other areas of the law contemplate theories similar to the liability-offset theory and help justify its use. For example, the law governing wraparound mortgages supports the liability-offset theory.¹⁷¹ Generally, when a taxpayer

¹⁶⁹ See, e.g., *Wilkerson v. Commissioner*, 70 T.C. 240 (1978); Reg. § 1.263(a)-5(a)(9).

¹⁷⁰ See Rev. Rul. 1975-172, 1975-1 C.B. 145 (ruling that the costs of acquiring a loan "must be deducted ratably over the" entire duration of the loan).

¹⁷¹ See Quiring, *supra* note 15, at 119-20.

sells property encumbered by a mortgage, the installment sale regulations permit the seller to wrap an equivalent recourse obligation around the existing mortgage.¹⁷² In other words, a wraparound mortgage is an obligation given by the buyer that wraps around an existing mortgage, allowing the seller to continue to pay off the existing mortgage.¹⁷³ The installment rules provide that the seller's wrapped debt is not treated as assumed for purposes of computing gain.¹⁷⁴

Unfortunately, the Tax Court rejected the use of the wraparound mortgage rule for section 357(c) transactions in a footnote in the memorandum opinion of *Owen v. Commissioner*.¹⁷⁵ In affirming the result in *Owen*, the Ninth Circuit found that while the shareholder attempted to retain liability on the underlying debt by transferring his own promissory note, he nonetheless should recognize gain because the property remained subject to the existing debt.¹⁷⁶ The court also incorrectly stated that section 357(c) should apply regardless of whether the taxpayer receives an economic benefit as a result of the transfer.¹⁷⁷ This idea runs contrary to the economic-benefit test suggested by the Second Circuit in *Lessinger*, and is contrary to the economic realities test of the liability-offset theory.¹⁷⁸ The Tax Court issued the *Owen* opinion under the prior "subject to" language of section 357, suggesting the application of the wraparound mortgage rule is "ripe for re-examination by the courts."¹⁷⁹ The liability offset justifies such re-examination.

The law governing like-kind exchanges of encumbered properties also supports the liability-offset theory.¹⁸⁰ In general, section 1031 allows taxpayers to exchange properties of a like kind without recognizing gain.¹⁸¹ If, however, encumbered property is exchanged for unencumbered property under section 1031, the liability relief is treated as money received on the transaction, triggering gain recognition equal to the lesser of the boot or the realized gain on

¹⁷²Typically a wraparound mortgage is utilized to "allow an existing mortgage with favorable terms to stay in place and be paid off by the seller, rather than being assumed by the buyer or refinanced." Megaard & Megaard, *supra* note 8, at 76.

¹⁷³See Quiring, *supra* note 15, at 120.

¹⁷⁴See Megaard & Megaard, *supra* note 8, at 76 ("This result is conditioned on (1) the transferee not assuming the debt, (2) the transferor remaining solely liable to pay the debt, and (3) the transferee paying the gross value of the property to the transferor with a purchase money obligation secured by a wraparound mortgage.") (citing *Prof'l Equities Inc. v. Commissioner*, 89 T.C. 165 (1987)).

¹⁷⁵53 T.C.M. (CCH) 1480, 1484 n.19, 1987 T.C.M. (RIA) ¶ 87,375, at 1877 n.19, *aff'd*, 881 F.2d 832 (9th Cir. 1989). The Tax Court's "attempt to distinguish the installment sale situation, on the ground that it merely deals with the timing rather than the amount of gain recognition as under section 357(c), was unpersuasive." Megaard & Megaard, *supra* note 8, at 76.

¹⁷⁶See *Owen*, 881 F.2d at 835-36.

¹⁷⁷See *id.* at 835.

¹⁷⁸See Quiring, *supra* note 15, at 121-22.

¹⁷⁹*Id.* at 121.

¹⁸⁰See *id.* at 120.

¹⁸¹See I.R.C. § 1031(a).

the transaction.¹⁸² In Revenue Ruling 1979-44, the Service ruled that a taxpayer could avoid liability-relief boot by issuing a note to the other party to the exchange in an amount equal to the liability encumbering the transferred property.¹⁸³ "In so ruling, the Service necessarily determined that the note offset the debt . . . and that the other party did not in substance assume the burden of the debt."¹⁸⁴ Thus, in circumstances similar to transferring properties to a corporation, the Service has acknowledged that self-created notes may offset liability assumption.

V. Conclusion

The highly criticized circuit court opinions of *Lessinger* and *Peracchi* have produced numerous theories on the proper tax treatment of section 357(c) and contributed self-created notes. Unfortunately, none of these theories is wholly satisfactory. If a contributed self-created note is valid indebtedness of the shareholder, the ideal application of section 357(c) is that the contributed note reduces the liabilities assumed by the corporation, not that the note generates immediate basis to the obligor. Congress paved the way for this result through the introduction of section 357(d), which states that a transferee corporation does not assume liabilities unless the corporation agrees to pay the transferred liability and is actually expected to pay that liability. The shareholder's contributed self-created note should serve as evidence that the corporation is not agreeing to, or being expected to, pay the full amount of the underlying liability.

In contrast to other works that have advanced a form of the liability-offset theory, this Article argues that the self-created note can both offset the liabilities assumed by the corporation and nonetheless still be a transferrable asset of the corporation. As long as the contributed note is in the hands of the transferee corporation, it offsets the liability. If the corporation sells the note, the offset lifts, the corporation's liabilities increase, and the transfer is equivalent to the corporation borrowing additional funds. Because the purpose of section 357(c) is to prevent negative basis—but otherwise preserve section 351 nonrecognition treatment—tax law should avoid forcing the contributing shareholder to recognize gain, if the shareholder does not take negative basis in the stock. The corporation's disposition of the shareholder's note has no economic effect on the contributing shareholder; it simply changes the note's obligee. Without gain in an economic sense, the law should not impute taxable gain.

Moreover, restricting corporate alienability of the note does not have a

¹⁸² See I.R.C. § 1031(b), (d). Under current section 1031, whether a party assumes a liability is determined using the test for liability assumption in section 357(d). See I.R.C. § 1031(d) ("[W]here as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.").

¹⁸³ See Rev. Rul. 1979-44, 1971-1 C.B. 265.

¹⁸⁴ Cummings, *supra* note 16, at 307.

valid tax policy rationale when the note is properly viewed as offsetting corporate liabilities. From the corporation's perspective, if the note offsets the underlying liability, selling the note is equivalent to taking out a loan from a third party. As a result, the liability-offset theory becomes the most complete theory for analyzing the contribution of shareholder self-created notes as a means of avoiding section 357(c) gain because it (1) preserves the parties' economic substance of the transaction, (2) allows for the elimination of taxable gain absent a corresponding economic gain, (3) treats payments made by the shareholder on the note similar to the corporate borrowing, and (4) properly treats a subsequent disposition of the note by the transferee corporation.

