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CONTRIBUTIONS, DISTRIBUTIONS, AND ASSUMPTION OF LIABILITIES: CONFRONTING ECONOMIC REALITY

Karen C. Burke*

I. INTRODUCTION

To combat a relatively arcane international tax-shelter abuse, Congress recently amended sections 357 and 362 governing contributions of encumbered property to a corporation.¹ The 1999 amendments were designed primarily to shut down attempts to create artificial basis by manipulating the liability assumption rules. Under one form of this tax-shelter gambit, a tax-indifferent party (e.g., a foreign corporation or tax-exempt entity) might cross-collateralize a liability of \$100 with three zero-basis assets (each worth \$100) and transfer each asset separately to three wholly-owned U.S. subsidiaries, subject to the same \$100 liability.² Under a literal reading of the relevant statutory provisions, each U.S. subsidiary would be deemed to assume the entire \$100 liability and thus would be entitled to increase the basis of the contributed property from zero to \$100, even though the transferor incurred no U.S. tax as a result of the liability assumption.³ Such transactions created duplicative or overstated basis in the transferee's hands, thereby resulting in excessive depreciation or mismeasurement of income.⁴

Although it is far from clear that the targeted tax shelters were immune from successful challenge under prior law, the recent statutory amendments were intended to more accurately reflect the underlying economics of these corporate

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¹See Miscellaneous Trade and Technical Corrections Act of 1999 ("1999 Act"), Pub. L. No. 106-36, § 3001(a)(1), (b), (d)(2)-(5), 113 Stat. 127, 181-84. Congress intended the amendments to apply to transfers after October 18, 1998. *Id.* § 3001(e), 113 Stat. at 184. The legislation was projected to raise revenue of \$187 million over the period 1999-2008. See JOINT COMM. ON TAXATION, 106TH CONG., ESTIMATED REVENUE EFFECTS OF S. 262, THE "MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 1999," SCHEDULED FOR MARKUP BY THE SENATE COMMITTEE ON FINANCE ON JANUARY 22, 1999, at 1 (Comm. Print 1999).

²See Dep't of Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals 138 (July 1999), available at <http://www.ustreas.gov/taxpolicy/library/ctswhite.pdf>. For an earlier description of the proposal, see STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1999 BUDGET PROPOSAL 157-60 (Comm. Print 1998) [hereinafter FY1999 BUDGET PROPOSAL DESCRIPTION]. See also *Comments Regarding Liability Assumption Provisions in IRS Restructuring Bill*, 98 TAX NOTES TODAY 127-10, ¶¶ 14-16 (June 23, 1998) [hereinafter *ABA Comments*].

³See I.R.C. § 357(c) (defining gain attributable to liabilities in excess of basis); I.R.C. § 362(a) (noting that basis is increased by transferor's gain recognized). Under this mechanical reading, the obvious economic flaw is the failure to apportion the cross-collateralized liability among the assets in a reasonable manner. See *infra* notes 70-75 and accompanying text.

⁴See STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS 10 (Comm. Print 2001) [hereinafter GENERAL EXPLANATION].

transactions.⁵ The amended liability assumption rules rely on a facts-and-circumstances test based on the parties' expectations concerning ultimate responsibility for payment of liabilities secured by contributed property.⁶ A transferor is deemed to be relieved of a recourse liability encumbering contributed property only if the transferee agrees to, and is expected to, satisfy the liability.⁷ By contrast, a nonrecourse liability is deemed to be assumed by the transferee except to the extent that the transferor agrees to satisfy the liability and retains other property securing the liability.⁸ In addition to redefining the meaning of an assumption, the 1999 legislation modified the basis adjustment provisions of section 362 to prevent inflation of the basis of contributed property. Even if amended sections 357 and 362 adequately address concerns related to abusive tax shelters, they will inevitably complicate a broad range of nonabusive transactions. Moreover, Congress suggested that Treasury consider extending the amended liability assumption rules to other provisions of the Code.⁹

This article offers a critical assessment of the recent amendments to the liability assumption rules of section 357 and corresponding basis provisions of section 362. Part I explores the divergence between the former liability assumption rules and the "economic benefit" doctrine of the section 1001 regulations. Part II focuses on the technical definition of assumption of recourse and nonrecourse liabilities under amended section 357(d). Part III examines the corollary basis provisions of section 362, as modified to reflect the section 357(d) liability assumption rules. Part IV argues that by logical extension the amended liability assumption rules could also apply to corporate distributions of encumbered property, an area overlooked by Congress. The conclusion suggests that Congress should exercise caution in extending section 357(d) principles and reconsider the approach of ad hoc anti-abuse measures.

II. FORMER LIABILITY ASSUMPTION RULES: MISGUIDED REFORM?

A. Overview

Under the nonrecognition provisions of section 351(a), a transferor recognizes no gain or loss when property is contributed to a controlled corporation solely in

⁵See *id.*; see generally Mark A. Banks-Golub, *Recent Amendments to Code Sec. 357: Congress Responds to "Artificial Basis Creation,"* 78 TAXES 19, 19-23 (May 2000); John A. Bogdanski, *Section 357(d)—Old Can, New Worms,* 27 J. CORP. TAX'N 17, 17-28 (2000); Michael J. Kliegman & Jeannette A. Martin, *Whose Liability Is It Anyway? The Impact of Recent Amendments to Section 357,* 91 J. TAX'N 341, 341-48 (1999); Lee Sheppard, *Tinkering with Assumption of Liabilities,* 84 TAX NOTES 1348, 1348-51 (Sept. 6, 1999).

⁶See *infra* notes 62-65 and accompanying text.

⁷See I.R.C. § 357(d)(1)(A).

⁸See I.R.C. § 357(d)(1)(B), (d)(2).

⁹See I.R.C. § 357(d)(3). In addition to the changes to section 357, the 1999 Act also struck the reference to taking "subject to" liabilities from sections 351(h)(1), 358(d)(1), 368(a)(1)(C), and 368(a)(2)(B). Selective provisions outside subchapter C incorporate the section 357(d) definition of assumption of liabilities. See I.R.C. § 1031(d) (like-kind exchanges); I.R.C. § 584(h)(3) (transfers to regulated investment companies).

exchange for qualified stock.¹⁰ If the contributed property is subject to liabilities, however, the transferor may recognize a limited amount of gain under section 357(c). The former liability assumption rules were administratively simple; they arguably departed from economic reality, however, to the extent that they treated a transferor as relieved of liabilities without any corresponding economic benefit. While purporting to remedy this defect, the revised liability assumption rules unfortunately introduce additional complexity and uncertainty.

Section 357(a) provides that assumption of liabilities is not generally treated as boot in nonrecognition exchanges but instead reduces the transferor's exchanged basis in qualified stock, as determined under section 358.¹¹ In the case of assumed liabilities in excess of the transferor's aggregate basis in the transferred property, however, section 357(c) provides an important exception to nonrecognition treatment: such excess liabilities give rise to gain from a sale or exchange of the transferred property.¹² Although the legislative history is sparse,¹³ section 357(c) is widely perceived as performing two functions: (1) it provides a mechanical backstop to the subjective rules of section 357(b) relating to assumption of liabilities for tax-avoidance purposes and (2) it prevents the creation of negative basis under section 358.¹⁴

Prior to its amendment in 1999, former section 357(c) essentially treated a transfer of property subject to excess liabilities as a deemed sale of such property for an amount equal to the underlying liabilities.¹⁵ The deemed-sale rule of former section 357(c) departed significantly, however, from the general principles of section 1001 applicable to liabilities assumed or taken subject to in connection with an actual sale of property. The section 1001 regulations treat a seller as relieved of recourse liabilities secured by property only if the purchaser agrees to pay the liability (regardless of whether the seller is actually released from the liability).¹⁶ To avoid potential double-counting, a seller's amount real-

¹⁰See I.R.C. § 351(a).

¹¹See I.R.C. §§ 357(a), 358(a)(1), 358(d)(1). Enacted in 1939, the predecessor of section 357(a) was intended to reverse the Supreme Court's holding in *United States v. Hendler* that a transferee's assumption of liabilities in connection with a corporate reorganization triggers gain to the transferor. See Revenue Act of 1939, ch. 247, § 213(a), 53 Stat. 862, 870 (enacting section 112(k)); *United States v. Hendler*, 303 U.S. 564 (1938).

¹²See I.R.C. § 357(c).

¹³Section 357(c) was added by the 1954 Code. See H.R. REP. NO. 83-1337, at A129-A131 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4267-69; S. REP. NO. 83-1622, at 270 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4908. The legislative history suggests that Congress viewed section 357(c) as functioning in a manner analogous to the recapture provisions. See S. REP. NO. 83-1662, at 270, reprinted in 1954 U.S.C.C.A.N. at 4908 (illustrating the operation of section 357(c)).

¹⁴See, e.g., Colleen Martin, Note, *Lessinger and Section 357(c): Why a Personal Guarantee Should Result in Owen Taxes*, 10 VA. TAX REV. 215, 217-19 (1990). By requiring immediate gain recognition, section 357(c) prevents the transferor's exchanged basis in qualifying stock from being reduced below zero under section 358. See George Cooper, Comment, *Negative Basis*, 75 HARV. L. REV. 1352, 1358-60 (1962) (arguing that section 357(c) was enacted solely to prevent negative basis).

¹⁵See FY 1999 BUDGET PROPOSAL DESCRIPTION, *supra* note 2, at 158 (noting that "present law treats the taxpayer as having sold the asset for an amount equal to the relieved liability").

¹⁶See Reg. § 1.1001-2(a)(1), -(a)(4)(ii).

ized does not include unassumed recourse liabilities to which the transferred property is subject.¹⁷ By contrast, the section 1001 regulations treat a transfer of property that secures a nonrecourse liability as relieving the transferor of the liability, triggering gain equal to the excess of the nonrecourse liability over the transferor's basis in the transferred property.¹⁸

In comparison to section 1001, the deemed-sale rule of former section 357(c) arguably failed to distinguish properly between recourse and nonrecourse liabilities. Treasury regulations interpreted former section 357(c) as requiring recognition of gain regardless of whether the transferor was economically relieved of a recourse liability secured by contributed property.¹⁹ Case law suggested that economic benefit was irrelevant in determining whether a transferor should be treated as relieved of recourse liabilities for purposes of triggering section 357(c) gain.²⁰ Although there was no clear definition of when property should be considered "transferred subject to a liability," section 357(c) apparently treated recourse and nonrecourse liabilities alike.²¹ Courts rejected taxpayers' arguments that the "subject to" language of former section 357(c) should be read as referring exclusively to nonrecourse liabilities secured by the transferred property and not assumed by the transferee.²²

B. Economic Benefit Approach

The apparent conflict between the principles of sections 1001 and 357(c) led some commentators to urge that the latter provision be clarified to apply only to

¹⁷See 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, 303 (1994) (concluding that the unassumed debt "would improperly double up the transferor's income"). For example, assume that A sells land worth \$200, subject to a recourse liability of \$50, to B for \$200 cash; B does not agree to pay the debt. Because the debt is not treated as discharged for purposes of section 1001, A's amount realized is only the \$200 cash. If A were instead treated as receiving both the \$200 cash and \$50 discharge of indebtedness, A's amount realized would be overstated.

¹⁸See Reg. § 1.1001-2(a)(4)(i).

¹⁹See Reg. § 1.357-2(a). The legislative history describes pre-1999 law as suggesting that it was "not necessary to consider whether, as a practical matter, the transferor has been relieved of the transferred liability." See FY1999 BUDGET PROPOSAL DESCRIPTION, *supra* note 2, at 159. *But cf.* Cummings, *supra* note 17, at 301 (explaining pre-1999 law in terms of the transferor's failure to prove that contributed property was not transferred subject to liabilities).

²⁰See, e.g., *Rosen v. Commissioner*, 62 T.C. 11, 19 (1974), *aff'd mem.*, 515 F.2d 507 (3d Cir. 1975) (noting that "there is no requirement in section 357(c)(1) that the transferor be relieved of liability"); *Owen v. Commissioner*, 881 F.2d 832, 835 (9th Cir. 1989) (noting that "section 357(c)'s plain language makes no special provision for transfers not resulting in an economic benefit to the transferor"). For an apparently contrary interpretation of section 357(c), see *Easson v. Commissioner*, 33 T.C. 963, *rev'd in part and aff'd in part*, 294 F.2d 653 (9th Cir. 1961), and *Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir. 1983).

²¹See I.R.C. § 357(c) (1994). By analogy to "wraparound mortgages," the transferee may be treated as not having assumed a liability (or taken the property subject to a liability) that the transferor agrees to pay. See, e.g., *Prof'l Equities, Inc. v. Commissioner*, 89 T.C. 165, 179-81 (1987) (permitting seller to exclude from amount realized any "subject to" liabilities which the seller agrees to pay); see also Cummings, *supra* note 17, at 303-06.

²²See *Owen*, 881 F.2d at 836 (rejecting taxpayer's contention that "section 357(c)'s categories of (1) assumed liabilities and (2) liabilities to which the transferred property is subject are mutually exclusive"). The court noted that, under the taxpayer's argument, the "subject to" language of former section 357(c) would be limited to "nonrecourse, unassumable liabilities." *Id.*

“liabilities treated as [an] amount realized under section 1001.”²³ The proposed clarification was intended specifically to reverse authority requiring recognition of section 357(c) gain when the transferor received no corresponding economic benefit.²⁴ Accordingly, recourse liabilities would be treated as assumed by the transferee only to the extent that the transferor was economically relieved of such liabilities.²⁵ Liabilities not treated as assumed would be disregarded for purposes of determining the amount of boot received and the transferor’s basis in qualifying stock.²⁶

The section 1001 approach and the underlying economic benefit doctrine derive from the Supreme Court’s dicta in *Crane v. Commissioner*.²⁷ In clarifying the scope of the *Crane* rule, *Commissioner v. Tufts* indicated that symmetry requires inclusion of nonrecourse liabilities in amount realized, regardless of the fair market value of the underlying property.²⁸ The rationale for triggering *Tufts* gain upon a disposition of property subject to a nonrecourse liability is that the transferor must account for the prior tax benefits arising from inclusion of debt in basis when there is no longer any reason to treat the transferor as liable to repay the debt.²⁹ In the case of recourse liabilities, however, a disposition of the property does not necessarily extinguish the transferor’s personal liability; hence, the amount realized under section 1001 generally includes only recourse liabilities that the purchaser agrees to pay.

Former section 357(c) may be viewed as establishing an administrative presumption that a transfer of property to a controlled corporation represents an appropriate time to trigger gain recognition attributable to excess recourse liabilities. Such treatment reflects the likelihood that a creditor will proceed first against the transferred property securing the liability, even if the transferor is not released from such liability. Because the subsequent transfer is merely a convenient occasion to require an accounting for the earlier tax-free receipt of borrowed funds, the economic benefit to the transferor on the contribution is irrelevant.³⁰ Moreover, section 351 exchanges between corporations and their shareholders pose special problems of relatedness that may justify a deemed assumption rule analogous to former section 357(c).³¹ As an economic matter,

²³See *ABA Comments, supra* note 2, ¶ 17.

²⁴See *id.* (referring to the “uncertainty flowing from *Owen* and the [regulation’s] imprecision”).

²⁵See *id.* ¶¶ 21-23; H.R. 2676, 105th Cong. § 3301A(b) (1998) (proposing section 357(c)(4)(A)).

²⁶In effect, unassumed recourse liabilities would be treated in the same manner as “excludable liabilities,” *i.e.*, liabilities that would have given rise to a deduction if paid directly by the transferor. See I.R.C. §§ 357(c)(3), 358(d)(2).

²⁷331 U.S. 1, 14 n.37 (1947) (suggesting that relief of nonrecourse liabilities might not constitute an amount realized if the transferor received no economic benefit).

²⁸See *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983) (rejecting *Crane*’s narrow “economic benefit theory”).

²⁹See William D. Andrews, *On Beyond Tufts*, 61 TAXES 949, 954 (1983) (“What is involved, functionally, is simple basis accounting for the debt.”).

³⁰See Charlotte Crane, *Toward a Theory of the Corporate Tax Base: The Effect of a Corporate Distribution of Encumbered Property to Shareholders*, 44 TAX L. REV. 113, 122 n.30 (1988).

³¹See Elliott Manning, *The Issuer’s Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 TAX L. REV. 159, 162 (1984) (suggesting the “relationship approach” in analyzing contribution of a shareholder’s note to a controlled corporation).

such relatedness is likely to make it impossible to determine how the transferor and transferee have allocated responsibility for payment of the debt.³²

For example, assume that A transfers property with a zero basis and a fair market value of \$60, subject to a \$50 recourse liability, to X in exchange for all of X's stock; X does not formally assume the recourse liability. If A remains personally liable for the debt, X should "pay" A the full unencumbered value of the property; thus, A's X stock should be worth \$60.³³ A recognizes no gain attributable to liabilities relieved, but A's built-in gain of \$60 is fully preserved in the X stock (\$60 fair market value less zero basis). If X is expected to pay the unassumed debt, however, A's X stock should logically be worth only the net value of the transferred property (\$10), and X should be treated as taking the property subject to the \$50 recourse liability. Accordingly, A recognizes section 357(c) gain of \$50, and A's remaining built-in gain of \$10 is preserved in the X stock (\$10 fair market value less zero basis).³⁴ If the transfer does not trigger section 357(c) gain, however, \$50 of A's built-in gain potentially disappears.³⁵

The difficulty of ascertaining the parties' subjective intent may help explain judicial reluctance in the section 351 context to enter into a factual inquiry concerning whether a bona fide assumption has taken place.³⁶ The desire to avoid difficult problems of proof and complex retroactive adjustments may justify the deemed assumption rule of former section 357(c). While such a mechanical rule inevitably yields economically inaccurate results in certain cases, it nevertheless permits simplified accounting for liabilities in connection with section 351 contributions of encumbered property. As the tax-shelter abuses demonstrate, however, anti-abuse measures may be required to prevent intentional manipulation of such a simplifying rule.³⁷

C. Confusion in Case Law

The legislative history of the 1999 Act refers to *Lessinger v. Commissioner*³⁸

³²See Cummings, *supra* note 17, at 302-03 (explaining the presumption of section 357(c) in terms of the control relationship between the transferor and transferee).

³³See 1 BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.06[2], at 3-27 n.99 (7th ed. 2000). The unassumed liability should be disregarded for purposes of determining A's basis in the X stock. See *supra* note 26 and accompanying text.

³⁴Under section 358, A's basis in the X stock is zero (zero basis of contributed property increased by \$50 gain recognized and reduced by \$50 liabilities assumed).

³⁵Consistent with the parties' treatment of the recourse liability as not assumed by the transferee, A should apparently be treated as receiving a constructive distribution of \$50 when X eventually repays the recourse liability. Alternatively, A could be required to recognize \$50 of section 357(c) gain retroactively. See *infra* notes 66-67 and accompanying text.

³⁶See ABA Comments, *supra* note 2, ¶¶ 23-27.

³⁷For example, the partnership anti-abuse rules recognize that certain provisions of subchapter K are intended to promote administrative convenience or other goals; to prevent tax-motivated manipulation of these simplifying rules, the section 701 regulations employ a proper-reflection-of-income test. See Reg. § 1.701-2(a)(3). Congress considered but did not enact proposals aimed at tightening the tax avoidance test of section 357(b); see, e.g., STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL 199-201 (Comm. Print 1999) [hereinafter FY2000 BUDGET PROPOSAL DESCRIPTION].

³⁸872 F.2d 519 (2d Cir. 1989).

and *Peracchi v. Commissioner*³⁹ as contributing to uncertainty under former section 357(c).⁴⁰ Neither case supports the conclusion, however, that former section 357(c) was fundamentally flawed. In *Lessinger* and *Peracchi*, the parties stipulated that the transferee corporation had assumed excess recourse liabilities in connection with a contribution of encumbered property. Thus, the primary issue was whether contribution of a shareholder's personal note in the amount of such excess liabilities was sufficient to negate any section 357(c) gain. Not surprisingly, the government rejected this assertion, relying on authority that an obligor's own note has a zero basis.⁴¹

Based on a circular reading of sections 357(c) and 362, the Second Circuit in *Lessinger* held that the taxpayer did not recognize gain attributable to relief of excess liabilities.⁴² While some commentators viewed the *Lessinger* outcome sympathetically,⁴³ the Second Circuit's opinion was widely conceded to be indefensible as a matter of statutory interpretation.⁴⁴ By contrast, the Ninth Circuit majority in *Peracchi* expressly held that the taxpayer had a basis in his own note equal to its face value,⁴⁵ potentially undermining the integrity of section 357(c).⁴⁶ In a footnote, the majority sought belatedly to limit operation of its opinion to the particular facts in *Peracchi*.⁴⁷ Far from resolving the zero-basis controversy, the *Peracchi* majority extended an open invitation to further litigation concerning proper valuation of a shareholder's own obligation.

³⁹143 F.3d 487 (9th Cir. 1998).

⁴⁰See FY2000 BUDGET PROPOSAL DESCRIPTION, *supra* note 37, at 198-99 (arguing that, as a result of such uncertainty, "some taxpayers may be reluctant to engage in legitimate transactions or may restructure them"). *But see* Seggerman Farms, Inc. v Commissioner, 308 F.3d 803 (7th Cir. 2002) (rejecting the notion of an "emerging equitable interpretation" of section 357(c) based on *Lessinger* and *Peracchi*; secondary liability as guarantors not sufficient to prevent section 357(c) gain).

⁴¹See *Alderman v. Commissioner*, 55 T.C. 662, 665 (1971); Rev. Rul. 1968-629, 1968-2 C.B. 154, 155.

⁴²While agreeing that the taxpayer had no basis in his own note, the Second Circuit in *Lessinger* held that basis for purposes of section 357(c) had to be determined by reference to the basis of the corporation, which arguably acquired the obligation with a fair-market-value basis. *See* 872 F.2d at 525-26.

⁴³See, e.g., Kenneth P. Brewer, *The Zero Basis Hoax*, 63 TAX NOTES 457, 458 (1994); J. Clifton Fleming, *A Second Look at the Zero Basis Hoax*, 64 TAX NOTES 811, 812 (1994). *But see* George K. Yin, Letter to the Editor, *Was Lessinger Decided Correctly? More on Zero Basis*, 65 TAX NOTES 131, 131 (1994) (suggesting that the argument for deferral is less persuasive if the *Lessinger* transaction is viewed as a constructive distribution).

⁴⁴See Cummings, *supra* note 17, at 287 ("As virtually all commentators have pointed out, the Second Circuit's analysis is surely incorrect.").

⁴⁵Writing for the majority, Judge Kozinski excused the taxpayer's admittedly "imperfect attention to his obligations." 143 F.3d 487, 495 (9th Cir. 1998). To determine the value (and hence basis) of the shareholder's note, Judge Kozinski resorted to the convenient fiction of enforcement by a third-party creditor in the event of the corporation's bankruptcy. *Id.* at 493. By contrast, the Tax Court concluded that the corporation's enforcement of the note was "highly unrealistic." *Peracchi v. Commissioner*, 71 T.C.M. (CCH) 2830, 2833, 1996 T.C.M. (RIA) ¶ 96,191, at 1428.

⁴⁶The function of section 357(c) is not undermined if the transferee in fact pays the note to the corporation. *See* 1 BITTKER & EUSTICE, *supra* note 33, ¶ 3.06[4][b], at 3-35.

⁴⁷143 F.3d at 494 n.15 ("[W]e limit our holding to cases where the note is in fact worth approximately its face value."); *see also id.* at 493 n.14 (noting that valuation depended on corporation's exposure to "non-trivial risk of bankruptcy").

The underlying premise of the government's zero-basis argument is that contribution of a related party's note is an inappropriate time to extend basis credit, given uncertainty concerning eventual payment.⁴⁸ For example, the partnership regulations expressly apply an open-transaction approach with respect to partner notes, deferring valuation of such notes until a subsequent disposition by the partnership to a third party or principal payments by the partner who issued the note.⁴⁹ Deferring the valuation event preserves an appropriate degree of skepticism toward a related party's promise to make future payments.⁵⁰ It might have been possible to avoid the uncertainty arising from the *Lessinger* and *Peracchi* decisions if the government had better articulated the rationale for the zero-basis argument.⁵¹ While the recent legislative changes apparently moot the *Lessinger/Peracchi* zero-basis controversy, they were clearly not intended to address this problem.⁵² Instead, they were driven by the perceived need to address tax-shelter abuses involving artificial basis creation.

III. REDEFINING ASSUMPTION OF LIABILITIES

A. Overview

The 1999 Act left much of the existing statutory framework intact, but struck the reference in section 357(a) to a transferee "acquir[ing] . . . property subject to a liability."⁵³ Under current law, section 357(a) refers only to liabilities of the transferor that are assumed by another party to the exchange.⁵⁴ Likewise, excess liabilities for purposes of section 357(c) are now defined as the sum of assumed liabilities in excess of the total basis of contributed property.⁵⁵ Simultaneously, Congress amended section 357(d) to provide a technical definition of "assump-

⁴⁸See Manning, *supra* note 31, at 193-95 (suggesting that contribution of a shareholder note should be treated as open transaction because of relationship between transferor and transferee); Cummings, *supra* note 17, at 315-19 (analyzing reasons for treating shareholder note as contingent debt).

⁴⁹Thus, if a promissory note is contributed to a partnership by a partner who is the maker of such note, the partner's capital account is increased only when there is a taxable disposition of the note by the partnership or the partner makes principal payments on the note. See Reg. § 1.704-1(b)(2)(iv)(d)(2).

⁵⁰On a disposition, the substitution of an independent creditor renders payment of the note sufficiently certain to permit the contributing partner's capital account to be increased by the amount of the obligation. By contrast, the lack of such assurance helps to explain strict interpretation of section 357(c). See *ABA Comments, supra* note 2, ¶ 27 ("The strictness of most of the prior interpretations of section 357(c) no doubt [has] stemmed from suspicions about who would pay the liabilities.").

⁵¹See Cummings, *supra* note 17, at 317 (noting that the zero-basis argument is only a shorthand expression for the underlying problem, *i.e.*, the related status of the parties). The zero-basis controversy may also illustrate the untoward consequences when appellate courts intervene in "a field beset with invisible boomerangs." *Arrowsmith v. Commissioner*, 344 U.S. 6, 12 (1952) (Jackson, J., dissenting).

⁵²See *ABA Comments, supra* note 2, ¶ 23 (noting need for a separate administrative or legislative solution for zero-basis problem); Cummings, *supra* note 17, at 293-96 (discussing whether shareholder's contribution of own note should be treated as separate transaction or "integrated" with section 351 transaction to avoid section 357(c) gain).

⁵³See I.R.C. § 357(a) (1999).

⁵⁴See I.R.C. § 357(a).

⁵⁵See I.R.C. § 357(c).

tion."⁵⁶ While acknowledging that "factual uncertainty" would remain, Congress expected that the new provisions would "increase . . . legal certainty" and reduce the potential for abusive results that do not conform to economic reality.⁵⁷

B. Recourse Liabilities

Section 357(d) treats a recourse liability as having been assumed only if, based on all the facts and circumstances, the transferee "has agreed to, and is expected to, satisfy such liability" (or portion thereof), regardless of whether the transferor has been relieved of the liability.⁵⁸ For example, assume that A transfers property with a basis of zero and a fair market value of \$100,000, subject to a recourse liability of \$20,000, to X in a section 351 transaction. Under prior law, X would be deemed to assume the recourse liability, and A would recognize \$20,000 of section 357(c) gain. By contrast, under section 357(d)(1)(A), A is no longer treated as relieved of the liability unless X agrees to, and is expected to, satisfy such liability. Thus, a transfer of property subject to excess recourse liabilities no longer triggers section 357(c) gain if the transferor remains solely liable.⁵⁹

In effect, section 357(d)(1)(A) codifies the economic benefit theory underlying the section 1001 regulations.⁶⁰ 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. To avoid section 357(c) gain, the shareholder should instead agree to indemnify the corporation to the extent of any unassumed excess recourse liabilities secured by the contributed property.⁶¹ The language of section 357(d)(1)(A) is not identical, however, to the section 1001 rule with respect to discharge of recourse indebtedness. 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.⁶²

The expectation test gives rise to numerous ambiguities.⁶³ If the transferee

⁵⁶See I.R.C. § 357(d).

⁵⁷FY2000 BUDGET PROPOSAL DESCRIPTION, *supra* note 37, at 199.

⁵⁸See I.R.C. § 357(d)(1)(A).

⁵⁹By contrast, a nonrecourse liability encumbering contributed property continues to be treated as assumed by the transferee, except as provided in section 357(d)(2). See I.R.C. § 357(d)(1)(B), (d)(2); see also *infra* notes 70-77 and accompanying text.

⁶⁰Even without a statutory change, Treasury could have achieved a similar result by amending the section 357 regulations to incorporate the economic benefit approach of section 1001.

⁶¹The legislative history indicates that no assumption occurs if the transferor "remains solely liable [for a recourse liability] without a right of contribution against the transferee" or "indemnifies the transferee against the possibility of foreclosure." See FY1999 BUDGET PROPOSAL DESCRIPTION, *supra* note 2, at 158.

⁶²The expectation test did not appear in the initial version of the legislation. See H.R. 2676, 105th Cong. § 3301A(b) (1998) (proposing section 357(c)(4)(A)).

⁶³See Bogdanski, *supra* note 5, at 22-23 ("Even a cursory reading of the new language brings up the obvious question of whose expectations are relevant. Expected by whom? The transferor, the transferee, or both? What if their views differ?").

agrees to satisfy a liability, the legislative history indicates that the transferee is presumed to meet the expectation test, absent contrary facts.⁶⁴ If the expectations of the transferor and transferee differ, it is not clear whose expectations should control. Perhaps the expectations of third-party creditors should also be significant, although the statute apparently contemplates only an agreement between the transferor and transferee.⁶⁵ Often, subsequent events may occur that are inconsistent with the parties' initial treatment of liabilities secured by contributed property. For example, responsibility for the debt may be allocated to one party, even though another party eventually pays interest or principal.

Treasury has authority to issue regulations specifying basis and other consequences arising from subsequent transactions involving assumed liabilities, including payment of the liabilities.⁶⁶ If the transferee corporation later pays a recourse liability that was not treated as assumed under section 357(d), the transferor should apparently be required either to recognize section 357(c) gain retroactively or to report a section 301 distribution when the personal liability is relieved.⁶⁷ A deemed section 301 distribution, which triggers ordinary income to the extent of available earnings and profits, may result in harsher tax consequences than retroactive gain recognition under section 357(c). Under sections 357 and 358, the transferor is permitted to recover basis before recognizing any gain attributable to boot from liability relief. Moreover, section 357(c) gain is treated as gain from a sale or exchange of the underlying property.

Section 357(d)(1)(A) treats the transferor as retaining any recourse liabilities secured by contributed property unless the transferee specifically agrees to satisfy such liabilities. The default rule of nonassumption may seem surprising, particularly given the risk of deemed dividend treatment if the transferee later satisfies the underlying liability. Well-advised taxpayers will carefully monitor any subsequent debt payments to ensure consistency with the parties' initial treatment of the liability. By contrast, the deemed assumption rule of former section 357 was arguably efficient to the extent the parties generally expected that the underlying debt would be repaid from the property itself or from corporate earnings. Such efficiency was further enhanced by the ease with which knowledgeable parties could structure transactions to avoid adverse consequences from a deemed assumption—for example, by borrowing and contributing cash to the corporation to offset excess recourse liabilities that otherwise would trigger section 357(c) gain.⁶⁸

⁶⁴See GENERAL EXPLANATION, *supra* note 4, at 10.

⁶⁵By contrast, the section 752 regulations require that a creditor be aware of a partner's assumption of a partnership's obligation and be able to enforce directly the assuming partner's obligation. See Reg. § 1.752-1(d)(2). The creditworthiness of the transferor and transferee may also be relevant. *But see* Reg. § 1.752-2(b)(6) (except in abusive situations, partners are generally deemed to discharge their obligations).

⁶⁶See GENERAL EXPLANATION, *supra* note 4, at 10-11.

⁶⁷See Bogdanski, *supra* note 5, at 28 (noting that later payment may call into question the validity of the parties' earlier agreement).

⁶⁸When a shareholder borrows outside the corporation and contributes the borrowed cash rather than the shareholder's own note, the third-party transaction mitigates problems of valuation and enforceability.

By imposing a facts-and-circumstances test, section 357(d) requires closer attention to the related-party status of the transferor and transferee.⁶⁹ Given the nature of that relationship, however, it may be unrealistic to expect to ascertain reliably the manner in which the parties have actually allocated the economic burden of liabilities encumbering transferred property. By contrast, former section 357 was arguably intended precisely to avoid the need for such inquiry in routine transactions. While section 357(d)(1)(A) is perhaps technically more precise than the former liability assumption rule, it is likely to give rise to increased uncertainty and complexity. 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.

C. Nonrecourse Liabilities

Section 357(d) does not alter the default rule that a transfer of property subject to a nonrecourse liability generally relieves the transferor of the liability, consistent with *Tufts* principles. Under prior law, however, it was unclear how nonrecourse liabilities secured by more than one asset should be allocated.⁷⁰ The government's apparent unwillingness to permit an allocation of such liabilities among encumbered assets may have indirectly encouraged tax-shelter promoters to exploit the resulting uncertainty. Rather than direct Treasury to provide regulatory guidance, Congress chose to address the problem of cross-collateralized nonrecourse liabilities by amending section 357.⁷¹

Under the original version of the 1999 legislation, cross-collateralized nonrecourse liabilities were required to be allocated ratably based on the relative fair market values of the acquired and nonacquired assets (determined without regard to section 7701(g)).⁷² The mandatory proration approach was apparently abandoned in response to objections that it might not correspond to parties' economic arrangements.⁷³ In some circumstances, it may be unrealistic to treat multiple assets securing a single nonrecourse liability as bearing a proportionate share of the total liability based on their relative fair market values. A more flexible approach would allow the parties to allocate a cross-collateralized liability among the encumbered assets in any reasonable manner, subject to a fair-

⁶⁹See *ABA Comments, supra* note 2, ¶ 27.

⁷⁰The Service initially ruled that a transfer of multiple assets did not give rise to section 357(c) gain when a "subject to" recourse liability was allocated between two contributed assets securing the liability. See P.L.R. 1987-30-063 (Apr. 29, 1987). The Service subsequently revoked its own prior ruling and refused to permit allocation of cross-collateralized liabilities. See P.L.R. 1990-32-006 (Apr. 26, 1990) (revoking prior ruling without explanation); T.A.M. 1996-40-001 (Nov. 29, 1994) (rejecting proration approach).

⁷¹Unlike section 357(d), the section 1001 regulations do not provide any special rule for nonrecourse liabilities secured by more than a single asset.

⁷²See FY1999 BUDGET PROPOSAL DESCRIPTION, *supra* note 2, at 158; H.R. 2676, 105th Cong. § 3301A(b) (1998) (proposing section 357(c)(4)(B)).

⁷³See *ABA Comments, supra* note 2, ¶ 19.

market-value limitation.⁷⁴

The 1999 Act establishes a deemed assumption rule for cross-collateralized nonrecourse liabilities that may be varied by agreement. If a nonrecourse liability is secured by both acquired and nonacquired assets, section 357(d)(1)(B) presumes that the transferee has assumed the entire amount of the nonrecourse liability. Under the special rule of section 357(d)(2), the amount of the liability treated as assumed is reduced by the portion of such liability that an owner of other nonacquired assets securing the same liability agrees with the transferee to, and is expected to, satisfy.⁷⁵ The retained portion of the liability may not exceed the fair market value of non-acquired assets also subject to the same liability (determined without regard to section 7701(g)).

For example, assume that a nonrecourse liability of \$500 is secured by two zero-basis parcels, Asset #1 (worth \$200) and Asset #2 (worth \$800). In a section 351 transaction, A contributes Asset #1 to X but retains Asset #2. Under a mandatory proration rule, X would be treated as assuming \$100 of the nonrecourse liability, that is, one fifth of the \$500 nonrecourse liability based on the relative fair market values of the two assets. Under the special rule of section 357(d)(2), however, the parties are free to allocate the nonrecourse liability in a different ratio. For example, if A agrees to, and is expected to, satisfy \$450 of the nonrecourse liability, X is deemed to assume only \$50 of the liability. If the parties fail to specify any particular allocation of the nonrecourse liability, the default rule of section 357(d)(1)(B) applies.

The presumption that the transferee has assumed the entire amount of nonrecourse liabilities secured by both acquired and nonacquired assets may lead to anomalous results. In the above example, the default rule would treat X as assuming the entire \$500 nonrecourse liability, even though the fair market value of the contributed property (Asset #1) is only \$200. Accordingly, A would recognize \$500 of section 357(c) gain. Prior to 1999, X's basis in the contributed property would apparently also be increased, under section 362, from zero to \$500 to reflect the entire section 357(c) gain recognized by A.⁷⁶ Thus, the basis of the contributed property in X's hands could potentially be increased above its fair market value.⁷⁷

By analogy to section 752(c), a more sensible approach might be to impose a fair-market-value limitation on the amount of nonrecourse liabilities deemed

⁷⁴The liability-sharing rules of subchapter K adopt such a flexible approach. See Reg. § 1.752-3(b)(1). Under the section 752 regulations, an allocation method is deemed unreasonable if it allocates a nonrecourse liability to a particular asset in excess of its fair market value (determined without regard to section 7701(g)). See Reg. § 1.752-3(b)(1).

⁷⁵The reference to an "owner" of other property is presumably intended to permit a person other than the transferor to agree to satisfy a portion of the liability encumbering the transferred property.

⁷⁶See I.R.C. § 362(a) (stating transferee's basis in contributed property increased by the amount of gain recognized by the transferor).

⁷⁷The 1999 Act amended section 362 to prevent an increase to the basis of contributed property above its fair market value as a result of section 357(c) gain. See Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(b)(2), 113 Stat. 127, 182-83; I.R.C. § 362(d)(1); see also *infra* notes 97-104 and accompanying text.

assumed by the transferee.⁷⁸ Consistent with section 752(c), the nonrecourse liability of \$500 would be treated as an obligation of X only to the extent of the fair market value of the contributed property.⁷⁹ Accordingly, X would be deemed to assume only \$200 of the nonrecourse liability, the amount not in excess of the fair market value of Asset #1. For purposes of determining X's transferred basis in Asset #1, A would be deemed to recognize hypothetical section 357(c) gain of \$200 (\$200 liabilities relieved less zero basis). Under section 362, X would be entitled to increase the basis of Asset #1 to \$200 to reflect A's hypothetical section 357(c) gain.⁸⁰ Thus, X's basis in the contributed property would be limited to its fair market value.

In the partnership context, the fair-market-value limitation of section 752(c) has been described as intended to prevent inflation of the basis of contributed property in the partnership's hands.⁸¹ Section 752(c) should not be construed, however, as limiting the amount of liabilities of which the transferor is relieved.⁸² In the case of the transferor, the fair market value of the contributed property should be irrelevant for purposes of determining *Tufts* gain.⁸³ Hence, A should be deemed to be relieved of the entire nonrecourse liability of \$500, even though X is treated as assuming only \$200 of the liability. When applicable, a fair-market-value limitation on the amount of liabilities assumed by the transferee would give rise to a disparity between the transferor's section 357(c) gain and the transferee's section 362 basis adjustment. Thus, X would be entitled to only a \$200 basis increase in the contributed property, even though A is required to recognize \$500 of gain. Of course, A could avoid recognizing section 357(c) gain by agreeing to satisfy the excess portion of the nonrecourse liability to the extent of the fair market value of property retained by A and secured by the same liability.

There are sound policy reasons to treat the transferor and transferee asymmetrically with respect to the amount of liabilities relieved and assumed.⁸⁴ The

⁷⁸See I.R.C. § 752(c) (treating a nonrecourse obligation as a liability of the owner only to the extent of the fair market value of encumbered property).

⁷⁹The fair-market-value limitation should not apply if the discounted present value of the debt (although not its face amount) is less than the fair market value of the contributed property, e.g., because the liability bears a low rate of interest in comparison to the prevailing interest rate.

⁸⁰Consistent with the section 1001 regulations, X's amount realized on a subsequent sale should include only the portion of the nonrecourse liability (\$200) taken into account for basis purposes under section 362. See Reg. § 1.1001-2(a)(3).

⁸¹See *Tufts*, 461 U.S. at 316. See also Andrews, *supra* note 29, at 958 n.52; Karen C. Burke, *Partnership Formation Under the Temporary Section 752 Regulations: A Reply and Further Discussion*, 69 TAXES 116, 125 (1991).

⁸²See Andrews, *supra* note 29, at 959.

⁸³In the case of recourse liabilities, the total fair market value of the transferred assets will usually exceed the amount of liabilities assumed. If recourse liabilities are assumed in excess of the fair market value of the transferred assets, however, the transferor may be treated as receiving a constructive distribution. See Yin, *supra* note 43. Alternatively, the transferor may be required to recognize additional gain attributable to assumed recourse liabilities in excess of fair market value (and basis). See *supra* notes 38-47 and accompanying text.

⁸⁴See Andrews, *supra* note 29, at 956 (noting that consistency does not generally require treating the transferee as taking the property subject to the full amount of the liabilities of which the transferor is relieved).

transferee can be analogized to a purchaser whose basis in the acquired property should normally not exceed its cost. Preventing inflation of the transferee's basis above fair market value is necessary to avoid excessive depreciation or misstatement of income.⁸⁵ Generally, a purchaser's basis in acquired property should reflect its cost, regardless of the amount of gain recognized by the seller. The nonrecognition policy underlying section 351 contemplates that any built-in gain or loss inherent in contributed property will be preserved in the hands of both the transferor and transferee. Any gain recognized by the transferor normally results in a corresponding increase in the transferee's transferred basis, preventing such gain from being taxed again in the transferee's hands.⁸⁶ Prior to the 1999 legislation, neither the statute nor the regulations expressly prohibited a section 362 adjustment that would cause the basis of contributed property to exceed its fair market value. Gain recognition by the transferor should not serve as a justification, however, for allowing the transferee to take an inflated basis in contributed property.⁸⁷ While a section 752(c) approach would prevent basis inflation in the hands of the transferee, Congress has apparently chosen a different approach under section 362.

IV. PREVENTING BASIS INFLATION

A. Overview

In 1999, Congress amended the basis provisions of section 362 to prevent creation of artificial basis. Under section 362(d)(1), the transferee's basis in contributed property may not be increased above fair market value (determined without regard to section 7701(g)) by reason of assumption of liabilities.⁸⁸ Simultaneously, section 362(d)(2) further limits basis adjustments attributable to assumption of cross-collateralized nonrecourse liabilities.⁸⁹ If the transferor is a tax-exempt entity or a foreign entity not subject to U.S. tax, section 362(d)(2) provides that the transferee's basis increase in the contributed property is determined as if the transferee had assumed only a ratable portion of such liabilities based on the relative fair market values of the acquired and non-acquired assets. Although the special rule of section 362(d)(2) is unlikely to affect most non-abusive transactions, the fair-market-value limitation under section 362(d)(1) is much more widely applicable.

B. Anti-Tax-Shelter Provision: Section 362(d)(2)

The purpose of section 362(d)(2) is to prevent artificial inflation of the transferee's basis in acquired property as a result of section 357(c) gain recog-

⁸⁵See, e.g., *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3d Cir. 1988); *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976).

⁸⁶See I.R.C. § 362(a).

⁸⁷See GENERAL EXPLANATION, *supra* note 4, at 10 (criticizing interpretations of prior law that arguably might result "in assets having a tax basis in excess of their value").

⁸⁸See I.R.C. § 362(d)(1).

⁸⁹See I.R.C. § 362(d)(2).

nized by a tax-indifferent party.⁹⁰ Absent section 362(d)(2), section 357(d) would be inadequate to prevent the type of tax-shelter abuses targeted by Congress. For purposes of determining the transferor's section 357(c) gain and the transferee's section 362 basis adjustment, however, the amount of liabilities assumed may no longer match.⁹¹

Assume that a foreign corporation (FC) owns two assets, Asset #1 with a basis of \$50 and a fair market value of \$100 and Asset #2 with a basis of \$5 and a fair market value of \$25; both assets secure a single nonrecourse liability of \$80. FC contributes Asset #1 to X, a wholly-owned U.S. subsidiary; FC does not agree with X to satisfy any portion of the nonrecourse liability. Under section 357(d)(1)(B), X is deemed to assume the entire \$80 nonrecourse liability, triggering gain of \$30 to FC (\$80 liability less \$50 basis of Asset #1). Thus, X would normally be entitled to increase the basis of Asset #1 from \$50 to \$80. Assuming FC does not pay any U.S. tax on the section 357(c) gain, however, the special rule of section 362(d)(2) limits the basis increase in X's hands to the amount of gain FC would have recognized if the \$80 nonrecourse liability were allocated ratably between the two assets based on their relative fair market values. A prorata allocation would assign \$64 of the liability to Asset #1 (\$100/\$125) and \$16 of the liability to Asset #2 (\$25/\$125). Under section 362(d)(2), X's basis increase is limited to \$14 (\$64 assigned liability less \$50 basis of Asset #1).⁹²

Section 362(d)(2) applies only if a tax-indifferent party recognizes section 357(c) gain attributable to nonrecourse liabilities secured by both acquired and non-acquired assets. Read literally, however, the statutory language of section 362(d)(2) arguably sanctions a basis increase in excess of the amount of section 357(c) gain actually recognized. In the preceding example, assume that FC contributes Asset #2 (rather than Asset #1) and agrees to remain liable for \$70 of the nonrecourse liability. Under section 357(d)(2), X is deemed to assume only \$10 of the nonrecourse liability, triggering section 357(c) gain of \$5 to FC (\$10 liability less \$5 basis of Asset #2), and X should be entitled to a basis increase of \$5 in Asset #2. If section 362(d)(2) applies, however, X's basis increase is apparently determined as if FC had recognized gain of \$11, *i.e.*, one fifth of the liability (\$16) less the basis of Asset #2 (\$5).

Clearly, such a literal reading produces an absurd result: X's basis increase (\$11) exceeds the amount of section 357(c) gain actually recognized by FC (\$5). The problem is that sections 357(d) and 362(d) employ different measures to determine the amount of liabilities assumed. In enacting section 362(d)(2), Congress intended to prevent basis inflation by imposing a prorata allocation method to determine the transferor's hypothetical gain.⁹³ The statute should specify that

⁹⁰See GENERAL EXPLANATION, *supra* note 4, at 10.

⁹¹See Banks-Golub, *supra* note 5, at 21.

⁹²The amount of liabilities assumed for purposes of determining the transferee's basis adjustment (\$64) is \$16 less than the amount of liabilities of which the transferor is relieved (\$80).

⁹³See GENERAL EXPLANATION, *supra* note 4, at 10.

the hypothetical gain recognized by the transferor (for purposes of determining the transferee's basis adjustment under section 362(d)(2)) may be less than but not more than the actual gain recognized under section 357(c). Nevertheless, a technical correction may be necessary to achieve this result.

Section 362(d)(2) would be unnecessary if cross-collateralized nonrecourse liabilities were always allocated in accordance with the relative fair market values of acquired and non-acquired assets securing the same liabilities.⁹⁴ Allowing greater flexibility in allocating nonrecourse liabilities under section 357(d) increases the need to police the corresponding basis adjustments under section 362. Section 362(d)(2) applies only for purposes of determining the basis of contributed property, not the amount of liabilities assumed by the transferee. Under prior law, it was unnecessary to specify the amount of liabilities assumed by the transferee, because the transferee's transferred basis reflected the basis of the contributed property increased by any section 357(c) gain recognized by the transferor.⁹⁵ Under section 1001, the amount of liabilities assumed by the transferee may be important upon a subsequent disposition of the property. Consistent with the section 1001 regulations, the transferee's amount realized on a subsequent disposition should presumably include only those liabilities actually taken into account in determining the transferred basis of the contributed property.⁹⁶ Because of the potential mismatch of liabilities assumed for purposes of sections 357(d) and 362(d), however, the consequences under section 1001 should be clarified.

C. Fair-Market-Value Limitation: Section 362(d)(1)

Section 362(d)(1) provides an overall limitation on section 362 basis adjustments when assumption of liabilities (recourse or nonrecourse) triggers recognition of section 357(c) gain. Under section 362(d)(1), the basis of contributed property may never be increased above its fair market value (determined without regard to section 7701(g)) as a result of section 357(c) gain.⁹⁷ Except as a general anti-abuse measure, Congress failed to explain the underlying purpose or operation of the fair-market-value limitation.⁹⁸ The enactment of section 362(d)(1) may exacerbate existing flaws in the allocation of basis adjustments

⁹⁴See *supra* notes 72-73 and accompanying text.

⁹⁵See I.R.C. § 362(d)(2) (flush language) (limitation applies only "for purposes of determining basis under [section 362](a) and (b)"). Under prior law, the amount of liabilities assumed by the transferee matched the liabilities of which the transferor was relieved: while section 357 governed the consequences to the transferor, section 362 determined the basis consequences to the transferee by reference to the transferor's gain recognized.

⁹⁶See Reg. § 1.1001-2(a)(3).

⁹⁷Presumably, Congress was not concerned that the basis of contributed property might be inflated as a result of recognized gain attributable to non-liability boot (e.g., cash), as the transferee generally would not pay an amount in excess of the fair market value of contributed property.

⁹⁸See GENERAL EXPLANATION, *supra* note 4, at 10; Kliegman & Martin, *supra* note 6, at 8-9 (suggesting that section 362(d)(1) is intended to reflect case law imposing a fair-market-value limitation on a purchaser's basis in property acquired with nonrecourse financing).

attributable to section 357(c) gain.⁹⁹

Assume that A contributes the following assets to X corporation in exchange for stock:

Assets	Basis	FMV	Percentage of Gross FMV	Percentage of Appreciation
Land	\$10	\$40	20%	33.33%
Building	40	100	50%	66.67%
Inventory	<u>75</u>	<u>60</u>	<u>30%</u>	
Total	\$125	\$200	100%	100%

In addition, X assumes unsecured liabilities of A in the amount of \$135.¹⁰⁰ Under the aggregate approach of section 357(c), A's total gain is determined by comparing the total amount of liabilities relieved and the total basis of the transferred assets. Thus, A recognizes \$10 of section 357(c) gain (\$135 liabilities assumed less \$125 basis). Under the section 357 regulations, the *character* of A's gain is determined by allocating the recognized gain among the assets ratably based on their relative fair market values.¹⁰¹ Accordingly, the gain is allocated 20% to the land (\$2), 50% to the building (\$5), and 30% to the inventory (\$3). The allocation method prescribed by the section 357 regulations is obviously flawed because it ignores unrealized appreciation or depreciation inherent in the contributed property. Thus, it produces the anomalous result of allocating gain to an ordinary income asset (inventory) with a basis in excess of fair market value.¹⁰²

⁹⁹See generally Joel Rabinovitz, *Allocating Boot in Section 351 Exchanges*, 24 TAX L. REV. 333 (1969); Benjamin J. Cohen & Ronald E. Whitney, *Revisiting the Allocation of Boot in Section 351 Exchanges*, 48 TAX LAW. 959 (1995).

¹⁰⁰For simplicity, it is assumed that the liabilities are not directly allocated to any of the transferred assets. In the case of a secured liability, the issue is whether there should be a direct allocation of section 357(c) gain to the extent that the secured liability exceeds the tax basis of the encumbered asset. See Rabinovitz, *supra* note 99, at 345 (arguing that, but for a contrary inference in the regulations, "it would seem obvious that [secured liabilities] should be allocated entirely to the assets to which they adhere"); Cohen & Whitney, *supra* note 99, at 1005-06 (following Rabinovitz in supporting a direct allocation of section 357(c) gain attributable to excess secured liabilities).

¹⁰¹See Reg. § 1.357-2(b). The Service requires cash and other boot received under section 351(b) to be allocated ratably among the transferred assets in proportion to their fair market value. See Rev. Rul. 1968-55, 1968-1 C.B. 140; Rev. Rul. 1985-164, 1985-2 C.B. 117. The asset-by-asset approach is intended to prevent offsetting of recognized gains and unrecognized losses that would otherwise result under an aggregate approach. The tension between the asset-by-asset approach under section 351(b) and the aggregate approach under section 357(c) is responsible for much of the complexity in allocating liabilities. See Cohen & Whitney, *supra* note 99, at 970.

¹⁰²See Rabinovitz, *supra* note 99, at 360; Cohen & Whitney, *supra* note 99, at 990. For an argument that section 357(c) gain should be treated entirely as capital gain attributable to the stock received in the exchange, see John D. Fredericks, *The Character of Section 357(c) Gain: Why the Underlying Regulation is Capable of Producing Absurd Results*, 48 TAX LAW. 167 (1994). Courts have generally declined to follow the approach of Regulation section 1.357-2, albeit without much discussion. See, e.g., *Rosen v. Commissioner*, 62 T.C. 11, 19-20 (1974), *aff'd without pub. op.*, 515 F.2d 507 (3d Cir. 1975) (finding it "only logical" that gain should be allocated to asset subject to depreciation); *Raich v. Commissioner*, 46 T.C. 604, 611 (1966) (allocating gain among appreciated assets).

If the same allocation method is used to apportion the transferee's basis increase among contributed assets, the assets end up with the following bases in the transferee's hands: land (\$12), building (\$45), and inventory (\$78).¹⁰³ Prior to the 1999 changes, \$3 of the upward basis adjustment would thus be assigned to the inventory even though it had declined in value. Section 362(d)(1) cures this problem by preventing any adjustment that would increase the disparity between the inventory's basis and fair market value. It is unclear, however, whether the disallowed portion of the basis adjustment simply disappears or may be reallocated to other appreciated property. Because the impermissible basis adjustment results solely from the flawed allocation method under the section 357 regulations, reallocation would not undermine the purpose of section 362(d) to prevent inflation of basis above fair market value.¹⁰⁴

A more sensible allocation method would focus on the relative appreciation inherent in the contributed assets rather than their relative fair market values.¹⁰⁵ Under this method, A's recognized gain of \$10 would be allocated 33.33% to the land (\$3.33) and 66.67% to the building (\$6.67), and X would take a transferred basis of \$13.33 in the land and \$46.67 in the building. No basis adjustment would be permitted to the inventory which has declined in value.¹⁰⁶ Allocating section 362 basis adjustments in accordance with relative appreciation is consistent with the aggregate approach of section 357(c) and reduces the disparity between basis and fair market value of the acquired assets.¹⁰⁷

The analysis is similar if contributed property is subject to liabilities in excess of its fair market value and basis. Assume that A contributes the following assets to X corporation in exchange for stock:

<i>Assets</i>	<i>Basis</i>	<i>FMV</i>	<i>Nonrecourse Liabilities</i>
Land	\$10	\$40	\$40
Building	40	100	195
Inventory	<u>75</u>	<u>60</u>	
Total	\$125	\$200	\$235

¹⁰³Although the section 357 regulations address only the consequences to the transferor, the allocation of the transferee's basis increase should presumably be determined in a similar manner. See Reg. § 1.357-2(a), -2(b); Rabinovitz, *supra* note 99, at 365 (noting that the basis of each asset in the transferee's hands should be equal to the transferor's basis in the asset, increased by the transferor's recognized gain allocable to such asset).

¹⁰⁴Congress was apparently unaware of the flaws inherent in the allocation method under the existing section 357 regulations; the fair-market-value limitation under section 362 was aimed at perceived tax-shelter abuses.

¹⁰⁵See Rabinovitz, *supra* note 99, at 361-65. Under the partnership rules, basis adjustments are generally determined under a refined version of the suggested approach. See Reg. § 1.755-1 (allocation of basis adjustments under sections 734(b) and 743(b)).

¹⁰⁶Thus, A's recognized gain would consist exclusively of capital gain and section 1231 gain rather than a combination of such gain and ordinary income.

¹⁰⁷In the above example, assume that the building is subject to a secured liability of \$50; X assumes the secured liability and unsecured liabilities of A in the amount of \$85. If section 357(c) gain is allocated directly to encumbered assets to the extent of the excess, if any, of secured

A recognizes section 357(c) gain of \$110 (\$235 liabilities relieved less \$125 basis). Under section 362(d)(1), the basis of the contributed assets may not be increased above fair market value as a result of A's recognized gain. Because the total appreciation inherent in the contributed assets is only \$90, \$20 of the potential basis adjustment apparently disappears.¹⁰⁸ The remaining adjustment of \$90 is sufficient to increase the basis of the two appreciated assets (the land and building) to fair market value.¹⁰⁹ Although this allocation respects the fair-market-value limitation of section 362(d)(1), it produces a greater basis step-up than if the contributed property were not subject to liabilities in excess of fair market value.¹¹⁰

To illustrate, assume that the assets are transferred subject to a single nonrecourse liability in the amount of \$200 (rather than \$235). In this case, A recognizes section 357(c) gain of \$75 (\$200 liability relieved less \$125 basis). The section 362 basis adjustment is allocated \$25 to the land (1/3) and \$50 to the building (2/3) in accordance with their relative appreciation; thus, X takes a transferred basis of \$35 in the land and \$90 in the building. Following allocation of the section 362 basis adjustment, the land and building have combined unrealized appreciation of \$15 (\$140 fair market value less \$125 transferred basis). The \$15 of unrealized appreciation in the land and building mirrors the \$15 of built-in loss inherent in the inventory. The result is appropriate because, under the aggregate approach of section 357(c), A recognizes only \$75 of gain attributable to relief of liabilities (\$90 built-in gain inherent in the land and building offset by the \$15 built-in loss inherent in the inventory).¹¹¹ The basis adjustment under section 362 should not exceed \$75 merely because A recognizes additional section 357(c) gain attributable to relief of liabilities in excess of the fair market value of the contributed property.

The difficulty is that the fair-market-value limitation of section 362(d)(1) applies to the amount of the basis step-up in the hands of the transferee rather than the amount of liabilities assumed by the transferee. If the transferee's

liabilities over the tax bases of such assets, the entire \$10 gain should be treated as attributable to the building. See *supra* note 100.

¹⁰⁸Under the flawed allocation method of the section 357 regulations, the basis adjustment of \$110 (before application of the fair-market-value limitation) would be allocated 50% to the building (\$55), 20% to the land (\$22), and 30% to the inventory (\$33); the entire \$33 basis adjustment allocable to the inventory would potentially disappear.

¹⁰⁹The \$90 adjustment is allocated in accordance with the relative appreciation in the land (1/3) and building (2/3). See *infra* notes 146, 149 (discussing allocation of secured liabilities in excess of fair market value of encumbered property).

¹¹⁰As explained below, the section 362(d)(1) limitation apparently allows an additional basis increase of \$15 (allocable to the land and building) which mirrors the \$15 of built-in loss inherent in the inventory.

¹¹¹The operation of section 357(c) should be compared with the tax consequences if A received \$200 cash (rather than \$200 relief of liabilities). The cash boot would be allocated among the assets in accordance with their relative fair market values, and A would recognize gain equal to the difference between the basis of each asset and its allocable share of the boot. See Rev. Rul. 1968-55, 1968-1 C.B. 140. Thus, A would recognize total gain of \$90 (allocable \$30 to the land and \$60 to the building) and the basis of the contributed assets would be increased accordingly.

assumption of liabilities were limited to the aggregate fair market value of contributed property, the hypothetical section 357(c) gain would not exceed the total built-in appreciation in the contributed property. Under this approach, the hypothetical section 357(c) gain and corresponding section 362 basis adjustment would be limited to \$75 (\$200 liabilities assumed less \$125 basis), the same result as if the total liabilities encumbering the contributed property were \$200. Thus, the excess basis of the inventory (\$15) would not reduce the remaining built-in gain in the land and building (\$15). Although Congress clearly intended to prevent inflation of the basis of contributed property, this goal might have been more appropriately accomplished by imposing a fair-market-value limitation on the liabilities assumed by the transferee. As both a conceptual and a practical matter, such a fair-market-value limitation seems preferable to the approach of section 362(d)(1)(A).

V. DISTRIBUTIONS OF ENCUMBERED PROPERTY: SHOULD SECTION 357(d) PRINCIPLES APPLY?

A. Overview

Assumption of liabilities is important in connection with distributions of property from a corporation as well as contributions of property to a corporation. Recently-issued regulations under section 301 extend the liability assumption rules of section 357(d) to distributions of encumbered property to shareholders.¹¹² Under sections 311(b) and 336(b), relief of liabilities in connection with distributions of encumbered property may also trigger recognition of corporate-level gain.¹¹³ Although Congress did not consider the impact of the amended liability assumption rules on the distribution provisions, conforming amendments are necessary to restore parity between contributions and distributions of encumbered property.¹¹⁴

B. Section 301 Distributions

Congress had barely shut down section 357(c) abuses before it became necessary to address the issue of artificial losses in connection with distributions of encumbered property.¹¹⁵ While such transactions were cast in a variety of forms, typically taxpayers acted through a partnership (P) to contribute cash to a foreign corporation (FC) in exchange for common stock; FC acquired securities with borrowed funds and distributed the encumbered securities to P, which was secondarily liable for the bank debt. Even though FC was expected ultimately to repay the borrowing from other assets, the parties asserted that the net amount of

¹¹²See Reg. § 1.301-1(g).

¹¹³See I.R.C. §§ 311(b), 336(a)-(b).

¹¹⁴Similarly, Congress failed to extend section 357(d) principles to distributions of encumbered property pursuant to a corporate reorganization. See I.R.C. § 361(c)(2)(C); but see I.R.C. § 368(a)(1)(C), (2)(b).

¹¹⁵See Notice 1999-59, 1999-2 C.B. 761; see also Lee A. Sheppard, *Treasury Shuts Down the Boss Tax Shelter*, 85 TAX NOTES 1351 (Dec. 13, 1999).

the section 301 distribution was zero, *i.e.*, the fair market value of the securities reduced by the underlying debt.¹¹⁶ Upon a subsequent disposition (or deemed disposition)¹¹⁷ of the common stock (now worth zero), the parties hoped to claim an artificial loss equal to the value of their original investment.¹¹⁸

Under section 301(b)(2), the amount of a section 301 distribution is generally reduced (but not below zero) by liabilities assumed by the shareholder or taken subject to in connection with the distribution. By analogy to the case law interpreting former section 357, a mechanical reading of section 301(b)(2)(B) arguably provided support for the position that a distributee should be treated as assuming a liability encumbering distributed property even though the primary obligor was not released from the liability. Despite a paucity of authority interpreting section 301(b)(2)(B), at least one case rejected such a literal reading of the statute. In *Maier v. Commissioner*,¹¹⁹ the court refused to take a liability into account for purposes of section 301 because it found that the parties did not actually treat the distributed property as security for the liability.¹²⁰ Rather than relying on *Maier*, Notice 1999-59 invoked the economic substance doctrine to attack artificial losses generated by abusive section 301 transactions.¹²¹

In issuing the amended section 301 regulations, Treasury indicated that the lack of specific guidance under section 301(b)(2) had encouraged taxpayers to interpret existing law in a manner that “fail[ed] to reflect the true economics of certain transactions.”¹²² Henceforth, the amount of a section 301 distribution is reduced only to the extent that the distributee assumes, within the meaning of section 357(d), liabilities encumbering the distributed property.¹²³ For example,

¹¹⁶See I.R.C. § 301(b)(2) (reduction for liabilities assumed). For example, assume that P contributes \$100 in exchange for common stock of FC, and that FC distributes securities worth approximately \$100 to P, subject to bank debt of \$100. If the bank debt reduces the amount of the distribution to zero, no portion of the distribution constitutes a dividend or reduction of stock basis under section 301(c).

¹¹⁷A deemed disposition of the common stock could be triggered by an elective change in the classification of FC (an LLC) from a corporation to a partnership. See Reg. § 301.7701-3(c)(1)(i), -(g)(1)(ii).

¹¹⁸P's tax loss would equal the excess of P's unreduced basis in FC's stock (\$100) over the post-distribution value of the stock (zero). The claimed tax loss assumes that FC's later payment of the debt does not constitute a constructive dividend, even though P is released from its secondary liability. See generally Lee A. Sheppard, *Another Corporate Tax Shelter, Another Court Decision*, 85 TAX NOTES 1229 (Dec. 6, 1999) (commenting on marketing of the section 301 tax shelter).

¹¹⁹See *Maier v. Commissioner*, 69-1 U.S.T.C. ¶ 9194 at 83,891 (W.D. Mo. 1969).

¹²⁰See *id.* at 83,894 (mortgage encumbering distributed property was not a “liability” within the meaning of section 301(b)(2)); see Sheppard, *supra* note 118, at 1234 (arguing that secondary liability of distributee in the section 301 tax shelter was “just a device worked out by the bank in collusion with the tax-shelter promoter to achieve a particular tax result”).

¹²¹See Notice 1999-59, 1999-2 C.B. 761, *citing* ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999). The Service's emphasis on the lack of economic substance and the contrived nature of the various transactional steps obviated the need to address directly the problem of interpreting the liability assumption rules of section 301.

¹²²T. D. 8924 (Preamble), 66 Fed. Reg. 723, 724 (2001) [hereinafter Preamble] (noting that “[f]or reasons similar to those that motivated the enactment of section 357(d), these interpretations are inappropriate for purposes of section 301”).

¹²³Reg. § 1.301-1(g).

assume that X corporation distributes property with a basis and fair market value of \$4,000, subject to a nonrecourse liability of \$3,000. Under section 357(d)(1)(B), the distributee is treated as assuming the \$3,000 nonrecourse liability.¹²⁴ The result would be identical if the property were instead subject to a recourse liability of \$3,000, which the distributee agreed to, and was expected to, satisfy.¹²⁵ In each case, the amount of the distribution would be \$1,000 (\$4,000 fair market value less \$3,000 liability). If no assumption is deemed to occur under section 357(d), the distributee is treated as receiving a section 301 distribution equal to the fair market value of the encumbered property.¹²⁶

The amended section 301 regulations do not specify the potential tax consequences if the parties subsequently treat assumed liabilities in a manner inconsistent with their initial characterization. For example, if a distributee assumes a liability within the meaning of section 357(d), subsequent satisfaction of the liability by the distributing corporation may be treated as a constructive dividend.¹²⁷ Conversely, a deemed capital contribution may occur if a shareholder subsequently satisfies a liability, which the distributing corporation was expected to satisfy for purposes of section 357(d).¹²⁸ In this situation, the parties might have achieved a similar result if the distributing corporation initially paid the liability with funds supplied by the shareholder and then distributed the unencumbered property to the shareholder.¹²⁹

When appreciated property is distributed, earnings and profits are adjusted upward to reflect the built-in appreciation inherent in such property;¹³⁰ earnings and profits are then adjusted downward by the fair market value of the distributed property reduced by the amount of any liabilities assumed in connection with the distribution.¹³¹ If section 357(d) principles apply to section 301 distributions, it is important to clarify that the amount of liabilities taken into account for purposes of section 312 is determined in the same manner. Otherwise, the section 312 adjustment will no longer match the amount treated as a section 301 distribution under section 357(d) principles.¹³² Treasury should also address the effect of assumption of liabilities in excess of the fair market value of distributed

¹²⁴See I.R.C. § 357(d)(1)(B).

¹²⁵See I.R.C. § 357(d)(1)(A).

¹²⁶Regardless of the amount of liabilities assumed, the distributee takes a basis in the distributed property equal to its fair market value. See I.R.C. § 301(d).

¹²⁷See Preamble, *supra* note 122; *Enoch v. Commissioner*, 57 T.C. 781, 799 (1972) (finding constructive dividend where corporation discharged shareholder's personal liability).

¹²⁸See Preamble, *supra* note 122.

¹²⁹The distributee would be treated as receiving a section 301 distribution equal to the fair market value of the distributed property and would increase stock basis to reflect the actual or deemed capital contribution.

¹³⁰See I.R.C. §§ 312(a), (b).

¹³¹See I.R.C. § 312(c); Reg. § 1.312-3.

¹³²For example, assume that property with a basis and fair market value of \$4,000, subject to a liability of \$3,000, is distributed to a shareholder who does not assume the liability within the meaning of section 357(d). Although the amount of the section 301 distribution is clearly \$4,000, the charge to earnings and profits is arguably only \$1,000 (\$4,000 fair market value of distributed property reduced by \$3,000 "subject to" liability).

property. Under section 312(b)(1), earnings and profits are increased by the excess of the distributed property's fair market value over its adjusted basis.¹³³ To account properly for excess liabilities, the reference to fair market value should be clarified to take into account the deemed fair-market-value rule of section 311(b)(2).¹³⁴

C. Avoiding Corporate-Level Gain Recognition

To restore parity between contributions and distributions of encumbered property, section 357(d) principles should arguably be extended to sections 311(b)(2) and 336(b). Former section 311(c), the forerunner of current sections 311(b)(2) and 336(b), was enacted in 1954 to address tax-avoidance opportunities in connection with distributions of encumbered property.¹³⁵ Even prior to repeal of the *General Utilities* doctrine, a nonliquidating distribution of encumbered property triggered recognition of a limited amount of gain.¹³⁶ Under current law, the fair market value of distributed property is treated as not less than the amount of any liability encumbering the property. Thus, sections 311(b)(2) and 336(b) employ the fiction of a deemed sale of the distributed property for consideration equal to the transferor's liabilities relieved.¹³⁷ If the fair market value of the distributed property exceeds the underlying liability, sections 311(b)(2) and 336(b) are irrelevant.

Assume that X corporation distributes property with a basis and fair market value of \$150, subject to a recourse liability of \$200, in a nonliquidating distribution. Under section 311(b)(2), the fair market value of the distributed property is deemed to be \$200, and X recognizes gain of \$50. For purposes of determining corporate-level gain, it does not matter whether the liability is recourse or

¹³³See BITTKER & EUSTICE, *supra* note 33, ¶ 8.22[2], at 8-87 to 8-88 (noting that section 312(b)(1) might be read to limit the upward adjustment to earnings and profits to the excess of the actual fair market value (without regard to section 311(b)(2)) over the basis of the distributed property).

¹³⁴See I.R.C. §§ 311(b)(2), 336(b) (fair market value of property deemed to be not less than the amount of liabilities encumbering such property). For example, assume that a corporation distributes property with a basis of zero and a fair market value of \$10, subject to a nonrecourse liability of \$12. For purposes of section 312, the corporation would recognize gain of \$12 under section 311(b) (\$12 liability less zero basis); e&p would not be further adjusted because the net distribution is zero (the deemed fair market value less the amount of liabilities assumed). See Boyd C. Randall & Dave N. Stewart, *Corporate Distributions: Handling Liabilities in Excess of the Fair Market Value of Property Remains Unresolved*, 19 J. CORP. TAX 'N 55, 61-62 (1992).

¹³⁵The legislative history indicates the former section 311(c) (originally proposed as section 308(c)) was concerned with possible abuses in connection with corporate distributions of encumbered property similar to those addressed by section 357(c). See H.R. REP. NO. 83-1337, A91 (1954), reprinted in 1954 U.S.C.A.N. 4017, 4062; *Crane*, *supra* note 30, at 125 n. 43.

¹³⁶Former section 311(c) limited gain recognition to the difference between the distributed property's basis and the lesser of the liabilities relieved or the fair market value of the distributed property. See I.R.C. § 311(c). The fair-market-value limitation apparently reflected the economic benefit rule of *Crane*. See *Crane*, *supra* note 30, at 127 n.45.

¹³⁷See, e.g., George K. Yin, *Taxing Corporate Liquidations (and Related Matters) after the Tax Reform Act of 1986*, 42 TAX L. REV. 573, 587 (1987). See *id.* at 587 n.64 (noting that Congress apparently intended that an acquisition liability would be ignored to the extent such liability was never included in the corporation's basis in the distributed property).

nonrecourse. Extending section 357(d) principles to section 311(b)(2) would generally not affect corporate-level gain recognition when encumbered property is distributed subject to nonrecourse liabilities in excess of fair market value.¹³⁸ In the case of recourse liabilities, however, section 357(d)(1)(A) would allow the distributing corporation to avoid section 311(b)(2) gain by agreeing to satisfy the portion of the liability in excess of the distributed property's fair market value. For example, *X* could agree to remain liable for the excess \$50 of the recourse liability.¹³⁹ If the distributed property is foreclosed upon in the distributee's hands when its fair market value is \$150, *X* would be required to pay the deficiency of \$50.¹⁴⁰ Because *X* may still be required to satisfy the debt in excess of fair market value, there is apparently no reason to trigger section 311(b)(2) gain.

Under a deemed capital contribution model, *X* could also avoid recognition of section 311(b)(2) gain if the distributee agrees to, and is expected to, satisfy the excess \$50 of the recourse liability.¹⁴¹ The distributee's assumption of the excess recourse liability should arguably be treated as analogous to an actual contribution of cash; no section 311(b)(2) gain would be triggered because *X* would be deemed to use the capital contribution to satisfy the excess recourse liability immediately prior to the distribution.¹⁴² In the case of nonrecourse liabilities in excess of fair market value, however, recognition of corporate-level gain seems appropriate because there is insufficient assurance that the distributee will eventually satisfy such liabilities.¹⁴³ The deemed capital contribution model is inconsistent with the statutory fiction of a sale of the distributed property for consideration equal to the liabilities relieved.¹⁴⁴ Under section 357(d) principles, however, there does not seem to be any compelling reason to insist on the deemed sale model to the extent that the distributee agrees to, and is expected to, satisfy any recourse liabilities in excess of fair market value.

A corporate distribution may consist of multiple assets, only some of which are subject to liabilities in excess of fair market value. In this situation, the issue

¹³⁸The deemed fair-market-value rule would apply unless the distributing corporation agreed to satisfy the excess nonrecourse liability. See I.R.C. § 357(d)(2).

¹³⁹If the distributee agrees to, and is expected to, satisfy the remaining \$150 of the recourse liability, the net amount of the section 301 distribution is zero (\$150 fair market value less \$150 liability) and the distributee takes a fair-market-value basis in the distributed property.

¹⁴⁰By analogy, the section 704(b) regulations contemplate that a partner may be liable for a specific portion of a liability encumbering partnership property. See Reg. § 1.704-2(m), Ex. 1(vii).

¹⁴¹Alternatively, the shareholder could agree directly with the creditor to assume \$50 of the liability prior to the distribution; if the assumption is respected, section 311(b)(2) should be irrelevant. See *supra* note 65.

¹⁴²See *Crane*, *supra* note 30, at 115-16, 132 (treating a shareholder assumption as a deemed capital contribution); *id.* at 116 (arguing that deemed sale treatment, under section 336(b), "implies an unnecessarily strong notion of the values to be included in the corporation tax base and thus subject to double taxation").

¹⁴³See *id.* at 127.

¹⁴⁴Under a deemed capital contribution model, the assumption would presumably increase the shareholder's basis in stock when the liability is paid; the shareholder would be taxed on the fair market value of the distributed property, without reduction for any liabilities. Cf. I.R.C. § 301(b)(2) (value of distributed property reduced by liabilities assumed).

arises whether corporate-level gain should be determined under an aggregate approach or an asset-by-asset approach. Under former section 311(c), the Service applied an asset-by-asset approach to determine corporate-level gain; presumably, an asset-by-asset approach continues to apply for purposes of current sections 311(b)(2) and 336(b).¹⁴⁵ Under the Service's approach, secured liabilities are allocated directly to encumbered assets and unsecured liabilities are allocated in proportion to the gross fair market value of all of the assets distributed.¹⁴⁶ For example, assume that X corporation distributes two assets, both of which are worth \$100, in a nonliquidating distribution. Asset #1 has a basis of \$25 and is subject to a recourse liability of \$150; Asset #2 has a basis of \$100 and is unencumbered. Under an asset-by-asset approach, X would recognize section 311(b)(2) gain of \$125 attributable entirely to Asset #1 (\$150 deemed fair market value less \$25 basis). The asset-by-asset approach seems defective: gain from relief of liabilities may exceed the total gain that would result if the distributing corporation sold the underlying assets to a third party.¹⁴⁷

An aggregate approach would render the deemed fair-market-value rule irrelevant because the total amount of liabilities (\$150) does not exceed the total fair market value of the distributed assets (\$200). Under the general rule of section 311(b)(1), each asset would be treated as sold for its fair market value of \$100, triggering gain of \$75 attributable entirely to Asset #1. Thus, X would recognize the same amount of gain as if both assets were sold to a third party for total consideration of \$200, consisting of \$50 cash and \$150 relief of liabilities. The repeal of the *General Utilities* doctrine is intended to ensure that the distributing corporation will generally recognize the same amount of gain as if the distributed property were actually sold. An aggregate approach would apparently eliminate unintended disparities resulting from imperfect implementation of the deemed sale model.

Indeed, an aggregate approach might render section 336(b) virtually meaningless because the fair market value of a liquidating corporation's assets usually exceeds its total liabilities.¹⁴⁸ For example, assume that X distributes all of its

¹⁴⁵In Revenue Ruling 1980-283, 1980-2 C.B. 108, the shareholder received two assets, one of which was subject to liabilities in excess of basis (but not fair market value). The Service noted that former section 311(c) was enacted simultaneously with section 357(c), but only the latter referred expressly to the excess of aggregate liabilities over aggregate basis. See BITTKER & EUSTICE, *supra* note 33, ¶ 8.21[3], at 8-81, ¶ 10.05[2][a], at 10-29 (noting that the deemed fair-market-value rule of sections 311(b)(2) and 336(b) most likely applies on an asset-by-asset basis).

¹⁴⁶See *H&M Auto Electric, Inc. v. Commissioner*, 92 T.C. 1269, 1272-75 (1989) (applying Revenue Ruling 1980-283 under former section 311(c)). The allocation of unsecured liabilities in proportion to gross, rather than net, fair market value is problematic. See Rabinovitz, *supra* note 99, at 345 (allocating unsecured liabilities in accordance with net fair market value, *i.e.*, gross fair market value reduced by any secured liabilities encumbering the asset); Cohen & Whitney, *supra* note 99, at 984-86 (noting Service's failure to explain its position).

¹⁴⁷See *Crane*, *supra* note 30, at 139-42.

¹⁴⁸See *id.* at 139 (under an aggregate approach, "[section] 336(b) may have no meaning at all"). If a liquidating corporation's aggregate liabilities exceed the aggregate fair market value of its assets, the corporation is presumably insolvent. A liquidation of an insolvent corporation may be entirely outside section 336 because the shareholders receive no return on their equity. See BITTKER & EUSTICE, *supra* note 33, ¶ 10.21[2], at 10-63 (noting that section 332 does not apply to liquidation of insolvent subsidiary).

assets in complete liquidation. One of the distributed assets secures a recourse liability in excess of fair market value, while the other assets are unencumbered. The aggregate fair market value of the distributed assets, both encumbered and unencumbered, exceeds the amount of the recourse liability, which X's shareholders assume. Under an aggregate approach, the liquidating distribution triggers no section 336(b) gain: X has not been relieved of liabilities in excess of the total fair market value of the distributed property.¹⁴⁹ Because the aggregate approach produces the same result as if X sold the distributed assets to a third party, it does not appear to circumvent *General Utilities* repeal.¹⁵⁰

Nevertheless, an aggregate approach should not be permitted to undermine the loss disallowance rules of sections 311 and 336.¹⁵¹ Assume that X distributes the following assets in a nonliquidating distribution:

<i>Assets</i>	<i>Basis</i>	<i>FMV</i>	<i>Recourse Liabilities</i>
Asset #1	\$0	\$50	\$150
Asset #2	<u>100</u>	<u>50</u>	
Total	\$100	\$100	\$150

Under current section 311(b), X would be treated as relieved of the recourse liability secured by Asset #1, regardless of whether the distributee agrees to satisfy the liability. If corporate-level gain is determined under an aggregate approach modeled on section 357(c), X would recognize section 311(b)(2) gain of \$50 (\$150 liability less \$100 basis). Thus, the recognized gain attributable to Asset #1 would be offset by the unrecognized loss inherent in Asset #2. Such an aggregate approach should presumably be rejected as inconsistent with the loss disallowance rules which are intended to prevent the distributing corporation from using the excess basis associated with built-in loss assets.

Under a modified aggregate approach, the potential conflict with the loss disallowance rules may be eliminated. Under such an approach, the secured liability would be allocated first to Asset #1 to the extent of its fair market value (\$50). The portion of the secured liability in excess of the fair market value of the encumbered property would be treated in the same manner as an unsecured liability. Accordingly, the remaining liability (\$100) would be allocated among

¹⁴⁹The portion of the recourse liability in excess of the encumbered asset's fair market value should be treated in the same manner as an unsecured liability. See Cohen & Whitney, *supra* note 99, at 1006. If unsecured liabilities are allocated in proportion to net, rather than gross, fair market value, the entire excess liability would be allocated to the unencumbered assets. See *supra* note 146. This result seems correct, because X's shareholders will presumably assume the entire recourse liability only if the fair market value of the unencumbered assets is sufficient to satisfy the excess liability.

¹⁵⁰If instead the liability were nonrecourse, section 336(b) gain would nevertheless be triggered.

¹⁵¹See I.R.C. § 311(a) (disallowing recognition of loss on a current distribution); I.R.C. § 336(a) (allowing recognition of loss on a liquidating distribution except to the extent provided in sections 336(d) and 337). See also Crane, *supra* note 30, at 140-41 ("The asset-by-asset approach was the logical consequence of the statutory denial of losses (or, more specifically, the denial of the use of basis associated with loss property) and the need to preserve the character of any gain on a current distribution.").

the distributed assets in proportion to (but not in excess of) the net fair market value of such assets. Because the net fair market value of Asset #1 is zero (\$50 fair market value less \$50 allocated liability), \$50 of the liability would be allocated to Asset #2, reducing its net fair market value to zero. The unallocated \$50 of the liability should be treated as triggering an equivalent amount of gain under section 311(b).¹⁵² Thus, X would not be permitted to use the unrecognized loss inherent in Asset #2 to offset recognized gain from relief of liabilities.

The modified aggregate approach arguably approximates the results of an actual sale more closely than the asset-by-asset approach, while preserving the intended operation of the loss disallowance rules. If section 357(d) principles were extended to corporate distributions, the modified aggregate approach would generally eliminate corporate-level gain attributable to relief of recourse liabilities. In the preceding example, X could avoid section 311(b)(2) by agreeing to satisfy the unallocated \$50 of the recourse liability. Alternatively, X could agree to indemnify the distributee to the extent of the excess \$50 of the recourse liability secured by the distributed property.¹⁵³ On the other hand, if the distributee agrees to assume the entire recourse liability, X would recognize no section 311(b)(2) gain under a deemed capital contribution model.¹⁵⁴ Congress did not envisage that amending the liability assumption rules of section 357(c) could radically alter the treatment of corporate distributions of overencumbered property. Nevertheless, the piecemeal extension of section 357(d) to section 301 distributions is likely to foreshadow more extensive changes, unless Congress reconsiders the recent amendments.

VI. CONCLUSION

While the 1999 amendments were ostensibly intended to shut down sophisticated tax shelters, their impact may be felt chiefly in the case of routine section 351 exchanges that have nothing to do with tax shelters.¹⁵⁵ Despite apparent Congressional frustration over tax-shelter transactions, it is not clear that the basis-shifting transactions that prompted the 1999 amendments would have withstood judicial scrutiny under prior law. Even if a legislative fix were necessary, the economic benefit doctrine is likely to lead to additional complexity and uncertainty when property is transferred subject to excess recourse liabilities. The deemed assumption rule of former section 357 arguably represented a legitimate response to related-party transactions. By contrast, the expectation test allows taxpayers to achieve the same result as in *Lessinger* and *Peracchi* by merely agreeing to satisfy excess recourse liabilities at the outset. Perhaps ironically, the amended liability assumption rules are thus likely to make it easier to

¹⁵²To preserve the character of built-in gain, the \$50 gain should presumably be treated as attributable to Asset #1, the overencumbered asset. Because unencumbered Asset #2 is worth only \$50, it is economically unrealistic to allocate more than \$50 of the excess recourse liability to Asset #2.

¹⁵³See *supra* note 61 and accompanying text.

¹⁵⁴See *supra* notes 141-44 and accompanying text.

¹⁵⁵See Bogdanski, *supra* note 5, at 33.

avoid section 357(c) gain when recourse liabilities are involved.

Simultaneously, Congress amended section 362 to prevent artificial inflation of the transferee's basis in contributed property. Without section 362(d)(2), section 357(d) would be inadequate to prevent tax-indifferent parties from exploiting the flexible allocation rules for cross-collateralized nonrecourse liabilities. Prior to the 1999 amendments, there was no statutory limitation on increasing the basis of contributed property above fair market value as a result of section 357(c) gain. Congress never considered an alternative fair-market-value limitation modeled on section 752(c), which treats the transferee as assuming liabilities only to the extent of the fair market value of encumbered assets. While section 362(d)(1) serves a similar goal of preventing basis inflation, the flawed allocation method under the existing regulations is likely to have unintended consequences in many nonabusive section 351 exchanges. A more sensible approach would allocate section 362 basis adjustments in accordance with unrealized appreciation inherent in contributed assets rather than fair market value.

Despite the parallel treatment of liabilities in connection with contributions and distributions under pre-1999 law, Congress failed to extend the amended liability assumption rules to corporate distributions. Treasury's extension of section 357(d) principles to section 301 distributions was motivated by tax-shelter abuses. Logical consistency would seem, however, to require a uniform definition of assumption for purposes of both contributions and distributions. Although sections 311(b)(2) and 336(b) treat a distribution of overencumbered property as a deemed sale for an amount equal to the liabilities relieved, it is unclear whether an asset-by-asset approach or an aggregate approach should be applied. An aggregate approach is arguably more consistent with the goal of *General Utilities* repeal because it corresponds more closely to an actual sale when multiple assets are distributed. Coupled with an aggregate approach, extension of section 357(d) principles might effectively repeal sections 311(b)(2) and 336(b) with respect to most distributions of encumbered property.

The 1999 amendments illustrate the pitfalls of enacting targeted anti-abuse measures with inadequate attention to the need for consistency and coherence within a broader statutory framework. By responding to perceived abuses with piecemeal, ad hoc legislation, Congress inevitably adds to the complexity of the Code and potentially creates new loopholes.¹⁵⁶ Before abandoning the relatively simple deemed assumption rule of former section 357, Congress might have heeded the lesson of the 1984 directive to revise the partnership liability-sharing rules to more accurately reflect economic reality.¹⁵⁷ Rather than embodying a serious analysis of economic risk, the sophisticated but highly artificial section

¹⁵⁶Congress continues to tinker with the liability assumption rules. See Pub. L. 106-554, § 309, 114 Stat. 2763A-638 (2000) (enacting section 358(h)). To prevent duplication of built-in losses, section 358(h) requires the basis of the transferor's stock to be stepped down to fair market value to reflect certain deductible liabilities. See also I.R.S. Notice 2001-17, 2001 I.R.B. 730 (disallowing built-in losses in abusive transactions prior to enactment of section 358(h)).

¹⁵⁷See STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 250-51 (Comm. Print 1984).

752 regulations allocate liabilities based on a hypothetical liquidation in which all partnership assets become worthless and all partners are presumed to satisfy their obligations.¹⁵⁸ As subchapter K demonstrates, the illusion of economic reality may prove a disappointing substitute for administratively workable rules.

¹⁵⁸See Reg. § 1.752-2(b)(1) (constructive liquidation based on worst-case scenario); § 1.752-1(b)(6) (deemed-satisfaction rule). See generally Stephen G. Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 TAX LAW. 693, 714 (1990) (describing the regulatory emphasis on economic risk as "quite disingenuous").

