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A SECOND LOOK AT THE ZERO BASIS HOAX

by J. Clifton Fleming Jr.

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The author notes that a section 351 transferor of encumbered property who issues a note to the transferee equal to the encumbering debt is simply acquiring property (transferee stock in this case) with seller financing. Under orthodox tax doctrine, he explains, the section 351 transferor should get basis credit for the note and the analysis that leads to this basis credit should also prevent gain recognition under section 357(c). Thus, he concludes, orthodox doctrine yields the same conclusion as Lessinger v. Commissioner but avoids both Lessinger's tortured interpretation of the code and the need to advance the dubious theory that a debtor has a basis in his or her own debt.

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In "The Zero Basis Hoax," Kenneth P. Brewer recently argued that a taxpayer who transfers both property and debt in a section 351 exchange should be permitted to avoid section 357(c) gain by giving the transferee corporation a note equal to the amount by which the assumed debt exceeds the basis of the transferred property. I agree, but for different reasons than those advanced by Mr. Brewer. Some simple examples will highlight our areas of agreement and disagreement.

Assume that Alice proposes to acquire all of X Corporation's stock in exchange for Whiteacre, which is worth $1,000 and is encumbered by a $500 mortgage. Also assume that Alice has a $100 basis in Whiteacre and that section 357(b) is inapplicable. By proceeding with her plan, Alice will engage in a section 351 exchange and recognize $400 of gain under section 357(c). However, the following example shows that a sophisticated, creditworthy Alice easily can avoid this result.

Example 1. Alice gives her $400 personal note to a bank and receives $400 of borrowed cash. She transfers the loan proceeds plus Whiteacre to X in exchange for all of X's stock. The $400 of cash is added to Alice's $100 Whiteacre basis. Thus, the total basis in the assets transferred by Alice ($400 + $100 = $500) exactly equals the amount of the liability ($500) that she has transferred to X and she has no section 357(c) gain.

Suppose, however, that the bank will not lend $400 to Alice, but that she is still legally and economically capable of contracting a bona fide $400 debt. She might proceed as follows:

Example 2: Alice transfers Whiteacre to X and also gives X her $400 personal note that bears a market rate of interest. After issuing the note, Alice's net worth still exceeds $400. X issues all of its stock to Alice.

The only difference between Examples 1 and 2 is that in Example 2, X has assumed the role played by the bank in Example 1. However, Alice is merely making a debt-financed acquisition of the X stock and the income tax law generally makes no distinction between (1) third-party financing used to acquire an

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3(c) Liabilities in Excess of Basis. —
(1) In General. — In the case of an exchange —
(A) to which section 351 applies, ... if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be. Section 357(c)(1).

U.S. cash, whether obtained by borrowing or otherwise, has a face amount basis for section 357(c) purposes. See Lessinger v. Commissioner, 872 F.2d 519, 528 (2d Cir. 1989); Raich v. Commissioner, 46 T.C. 604, 605, 607, 611 (1966); See also Focht v. Commissioner, 68 T.C. 223, 225 (1977), acq. 1980-2 C.B. 1; Thatcher v. Commissioner, 61 T.C. 28, 30, 33 (1973), aff'd and rev'd on other grounds, 533 F.2d 1114 (9th Cir. 1976).
COMMENTARY / SPECIAL REPORT

asset, and (2) seller financing used to acquire the same asset. Therefore, Example 2 ought not to produce a different result from Example 1 merely because the creditor in Example 2 is the issuer (seller) of the X stock instead of a third party. Accordingly, Alice should not have section 357(c) gain in Example 2.  

Kenneth P. Brewer asserted in 'The Zero Basis Hoax' that both the reasoning and the result of Lessinger are correct; in my view, only Lessinger's outcome is right.

Nevertheless, the commissioner and the Tax Court have held to the contrary by insisting that in Example 2, Alice has made a section 351 transfer to X of a zero-basis note plus Whiteacre in exchange for X stock and X's assuming, or taking subject to, the Whiteacre mortgage. Under this view, the $500 mortgage exceeds Alice's total basis in the transferred assets (zero for the note and $100 for Whiteacre) by $400 and this excess amount is section 357(c) gain.

In Lessinger v. Commissioner, the Second Circuit adopted an approach that rejects the IRS-Tax Court view and says that Alice has no section 357(c) gain in Example 2. The Second Circuit reaches this result by first agreeing with the IRS that Alice transferred two items to X in the Example 2 exchange — (1) a $400 note, and (2) Whiteacre — but the court then insists that X takes a $400 basis in Alice's note and that X's basis in the note, not Alice's zero basis, is used for purposes of determining whether Alice has section 357(c) gain. These interpretive gymnastics lead to the conclusion that the total basis in the transferred property is $500 for section 357(c) purposes, so that Alice has no section 357(c) gain from transferring the $500 mortgage to X.

Kenneth P. Brewer asserted in "The Zero Basis Hoax" that both the reasoning and the result of Lessinger are correct. In my view, only Lessinger's outcome is right. Lessinger's contention that section 357(c) gain is calculated by reference to the transferee corporation's basis for property received in a section 351 exchange, instead of by reference to the transferor's basis, is a departure from the prevailing understanding of section 357(c) and seems contrary to legislative history. Moreover, the express carryover basis command of section 362 is violated by Lessinger's holding that X takes Alice's note with a face amount basis, even though X received the note in a carryover basis exchange to which section 362 applies and even though the Lessinger opinion frankly acknowledges that Alice had no basis in the note that could carry over to X. Thus, Lessinger reaches the proper result in Example 2, but it does so with a rationale that tortures the statute. Furthermore, the torturing is unnecessary because the right answer can be obtained by applying orthodox doctrine. Under settled tax principles, a buyer who acquires property with seller financing is effectively treated as if she had borrowed the financed amount from the seller and then paid it to the seller in cash. Accordingly, the buyer's basis in the acquired property includes any purchase money debt owed to the seller. When this principle is applied in Example 2, it is clear that Alice should be treated as borrowing $400 from X and then transferring the borrowed funds plus Whiteacre to X in a section 351 exchange for all of the taxpayer's costs and expenses.


(a) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN SURPLUS. — If property was acquired on or after June 22, 1954, by a corporation —

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies . . . , then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the extent that the transaction is a sale or exchange for which gain is recognized.

See Mays v. Commissioner, supra note 5. A debtor is simply without basis in his or her obligation. Taxpayers only have basis in their assets. If Alice does have a basis in her note, that basis is zero. Brewer asserts that Alice has a $400 basis in her note because she incurred $400 of liability by issuing the note. See supra note 1, at 459-60. This assertion is contrary to all direct authority on the matter. See Lessinger, supra note 4, at 525; Rev. Rul. 68-629, supra note 7; Alderman v. Commissioner, supra note 8; Cummings, "The Silent Policies of Conservation of Tax Basis and Their Corporate Applications," 48 Tax L. Rev. 113, 121 n. 52 (1992). Furthermore, prevailing doctrine holds that the issuer of a note has no gain from the exchange of the note for the loan proceeds because the issuer's offsetting repayment obligation negates gain. Commissioner v. Tufts, 461 U.S. 300, 307 (1983). This rationale presupposes a zero basis for the issuer in the note. If the issuer had a face amount basis, as Brewer contends, then this basis, not the offsetting repayment obligation, would prevent gain recognition by the issuer.

See Mays v. Commissioner, supra note 5.

See Mays v. Commissioner, supra note 5; Reg. section 1.1001-2(c) Example 1. See also Commissioner v. Tufts, supra note 13, at 307-309.
the X stock. This means that Alice transferred property with $500 of basis to X ($100 of basis in Whiteacre and $400 of borrowed cash) and that she had no section 357(c) gain — the correct result. Stated differently, the zero basis hoax does not lie in a failure to treat Alice’s note as having a basis; it lies in a failure to treat Alice like any other taxpayer who issues purchase money debt to a seller. When Alice is seen as an issuer of a purchase money note, then it is appropriate to treat her as transferring loan proceeds with a face amount basis, not a zero basis instrument, to X in Example 2. Thus, an analysis of Alice’s transactions under orthodox doctrine causes Examples 1 and 2 to have the same outcomes. This is highly desirable, since these examples are economically equivalent for Alice and many others can freely elect between Examples 1 and 2.18

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The law under section 357(c) is in an unfortunate state. The IRS and the Tax Court impose the wrong outcome in Example 2, and the only decision that reaches the right result, Lessinger, employs flawed reasoning that casts doubt on the correctness of that result. I am hopeful that the IRS and the courts will come to the understanding that Alice has no section 357(c) gain in Example 2 and that the orthodox treatment of seller-financed transactions provides a ready rationale for this conclusion without torturing the statute.

Of course, if Alice can avoid section 357(c) in Example 2 by the simple expedient of issuing a personal note, then section 357(c) is rendered vestigial. This raises the question of whether section 357(c) play, any useful role in subchapter C. If there were no section 357(c) and if Alice did not transfer her $400 note to X, section 358 clearly would give Alice a negative $400 basis for her X stock in Example 2. The only purpose of section 357(c) is to avoid this negative basis result by creating $400 of recognized gain, which is added to Alice’s stock basis by section 358(a)(1)(B), thus giving her a zero basis in Example 2 if she does not issue her note to X. There is, however, no compelling reason why the tax system should not provide Alice with deferral of gain and a $400 negative basis, which would be recognized as gain when she disposes of the stock, instead of a $400 currently recognized gain and a zero stock basis. Section 357(c) does not serve a useful function and should be replaced by a regime that would assign Alice a $400 negative basis for her X stock in Example 2 if she did not issue her $400 note to the corporation.20

18Thus, Alice includes the $400 purchase money debt in her section 358 stock basis and X takes a $400 basis in the note, so that X has no gain when the note is paid.

17Of course, the note should be ignored if the facts indicate that Alice does not intend to pay it. Ferrell v. Commissioner, 50 T.C. 1154, 1186 (1988). However, this article assumes that the note is a bona fide obligation that would give rise to discharge of indebtedness income if it were forgiven by X.

16The preceding points are argued more extensively in Spragens & Fleming, Tax Aspects of Forming and Operating Closely Held Corporations, sections 3.64-3.66 (Shepard’s/McGraw-Hill 1992).

19$100 (basis in Whiteacre (section 358(a)(1))) - 500 (mortgage on Whiteacre (section 358(a)(1)(A)(ii), (d)(1))) = ($400).

20This argument is more extensively developed in Fleming, “The Highly Avoidable Section 357(c); A Case Study in Traps for the Unwary and Some Positive Thoughts About Negative Basis,” 16 Journal of Corporation Law 1, 22-32 (1990).