Liabilities in Excess of Basis in Corporate Reorganizations—When Should Gain Be Recognized?†

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In United States v. Hendler, *the Supreme Court held that the assumption and payment of the transferor corporation's indebtedness by the transferee was taxable to the transferor under the statutory provision relating to boot. Congress retroactively overturned the result in* Hendler *in enacting Section 112(k), the statutory predecessor to Section 357, and further expanded the assumption of liabilities provisions in the 1954 Code. In this article, the author focuses on one of the problems that remain in this area—when should gain be recognized when liabilities are in excess of basis.*

Recognition of Gain on Discharge of Transferor's Indebtedness

After creation of the reorganization provisions and prior to the decision in *United States v. Hendler*,[1] a corporation transferring assets (the "transferor" corporation) pursuant to a corporate reorganization[2] did not recognize gain on receipt of stock or securities in exchange for its property. Where the transferor received money or other property, it was required to recognize gain, unless it distributed the money or other property in pursuance of the plan of reorganization.[3]

In *Hendler,* the corporation receiving assets (the "transferee" corporation) assumed and paid off liabilities of the transferor, pursuant to

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1 303 U.S. 564 (1938), *rev'g* 91 F.2d 680 (4th Cir. 1937).

2 I.R.C. § 368.

3 Revenue Act of 1928, c. 852, 45 Stat. 791, § 112.

the plan of reorganization. The issue was whether the transferor corporation would recognize the gain resulting from the discharge of its indebtedness.

The Supreme Court treated the assumption and payment of the liabilities as though the payments had been made by the transferee directly to the transferor and then paid by it to the creditors.[4] Thus, said Mr. Justice Black for the Court, it was not stock or securities nor was it distributed to the transferor's stockholders in pursuance of the plan of reorganization, and so it was taxable to the transferor.[5]

The intent of Congress to facilitate corporate reorganizations was frustrated by the decision in *Hendler*. In addition to taxing the transferor upon assumption of liabilities, it made the "C" reorganization,[6] requiring the exchange of property for voting stock, virtually impossible.[7] As a result, Congress enacted what is now a part of Section 368(a)(1)(C),[8] which generally disregards the assumption of liabilities in determining whether the transfer was solely for voting stock, as well as Section 357(a) to allow nonrecognition to the transferor on the assumption.[9]

Under present law, then, generally a transferor in a reorganization does not recognize gain upon the assumption of liability by a transferee. As in the case of most nonrecognition provisions, this gain potential is preserved in the property received, namely, in the stock of the transferee. This is done by Section 358(d), which treats the assumption as money for this purpose, and Section 358(a)(1), which reduces the basis of the property received by the amount of money received.[10]

For example, if property with a basis of 10 and a fair market value of 30 were transferred for property with a fair market of 30 in a nonrecognition transaction (none of the 20 realized gain is recognized), the basis of the property received would be 10, the same as that of the property transferred. However, if the property transferred were subject to a liability of 5 (transferred in exchange for property with a fair mar-

[4] For a discussion of the *Hendler* case and the cases cited therein, see Surrey, "Assumption of Indebtedness in Tax-Free Exchanges," 50 Yale L.J. 1 (1940).

[5] Note 1 *supra* at 566.

[6] Corporate reorganizations described in Sections 368(a)(1)(A) through 368(a)(1)(F) are hereinafter referred to as "A" through "F" reorganizations, respectively.

[7] The assumption of liabilities would thus have been "boot."

[8] All statutory references are to the Internal Revenue Code of 1954, *as amended,* unless otherwise indicated.

[9] Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.55 (3d ed. 1971); I.R.C. (1939) § 112(k).

[10] See also I.R.C. §§ 357(c), 1031(d).

ket value of 25, presumably), the basis of the property received would be the basis of the property transferred, 10, less the 5 of liabilities, or 5. If the property received were thereafter sold for 25, the entire 20 of realized but unrecognized gain would be recognized at the time of that sale.

Suppose now that the same property had a basis of 20, a fair market value of 100, and was subject to a liability of 50. The property is exchanged for property with a fair market value 50. The gain realized is 80, since the amount of the liability is included in the amount realized.[11] If there is to be nonrecognition because of the reorganization provisions, the liability can be treated in several ways.

☐ *Method (1).* The entire 50 of the liability can be recognized to the transferor at once. The basis of the property received will be 20, and the remaining 30 of gain preserved in the property received. The Court adopted this method in *Hendler*; however, Congress promptly rejected it.

☐ *Method (2).* As in the example where the liability was less than the basis, the gain from assumption of the liability would not be recognized. The gain potential would be preserved in the property received by reducing its substituted basis of 20 by the amount of the liability, 50, giving it a basis of minus 30.[12]

☐ *Method (3).* The gain from assumption of the liability would not be recognized. The basis of the property received would be reduced, but not below zero, so as to avoid a negative basis. Thus, 30 of the gain potential from the discharge of the liability would be preserved in the property received, while the remaining 20 would escape taxation entirely. This method is suggested by one authority.[13]

☐ *Method (4).* The gain from assumption of the liability would not be recognized to the extent of the basis in the transferred property, here 20. This would reduce the basis in the property received to zero, thus preserving 50 of the gain potential. The remaining 30 of gain would be recognized upon the transfer. This would prevent the negative basis of Method (2) as well as the tax avoidance of Method (3). This method is assumed by another authority.[14]

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[11] Crane v. Comm'r, 331 U.S. 1 (1947); Woodsam Assoc. v. Comm'r, 198 F.2d 357 (2d Cir. 1952); see also Gavin S. Millar, 67 T.C. 656 (1977), *aff'd* 78-2 U.S.T.C. ¶ 9514 (3d Cir. 1978).

[12] One must be careful to distinguish between a negative basis, that is, a basis less than zero, and a basis which is merely less than the amount of a liability to which property is subject but is nevertheless not less than zero.

[13] Surrey, note 4 *supra*, at 19.

[14] Spears, "Mortgages in Excess of Basis," 11 So. Calif. Inst. on Fed. Tax. 883, 907 (1959).

Section 357(a) provides generally that in nonrecognition transfers, including Section 351 incorporations[15] and reorganizations protected by Section 361, the assumption of or taking subject to a liability shall not be considered as money or other property. An exception is made in Section 357(b) where the purpose is tax avoidance or there is no valid business purpose.

Section 357(c), added in 1954, requires recognition to the extent liabilities assumed exceed the basis of the property transferred, as per Method (4), in two situations: the Section 351 incorporation of assets[16] and the "D" reorganization (transfer of assets to controlled corporation).[17] However, Section 357(c) does not apply to the other types of reorganizations described by Section 368.

For clues as to the situation where Section 357(c) does not apply, one can look to cases involving facts arising prior to its effective date, as well as to the purposes for providing for nonrecognition in certain situations.

In *Jack L. Easson*,[18] the taxpayer had a building with a basis of 87, a fair market value of 320, and mortgaged for 247, and transferred it subject to the mortgage to a corporation which he had formed. The Tax Court held that the excess of the mortgage over the adjusted basis, or 160, was recognized at the time of the transfer. It rejected the concept of a negative basis in the stock, and, to escape the tax avoidance of Method (3), opted to tax the excess of the mortgage over basis and give the stock a zero basis, as per *Method* (4). It made reference to Section 357(c), which, as noted above, was enacted in 1954, saying that it merely clarified existing law.

The taxpayer appealed to the Ninth Circuit, which disagreed with the Tax Court as to pre-1954 law. It suggested that the stock could be given a negative basis so as to preserve the gain in the form of the stock,[19] noting that prior cases in which the concept of negative basis was rejected concerned depreciation deductions from basis rather than basis in stock.[20] It cited the concurring opinion of Judge Magruder in *Parker v. Delaney*[21] in support of the concept of negative basis.

In *Bryan v. Comm'r*,[22] the facts were similar, except, unlike *Easson*,

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[15] I.R.C. § 351 (transfer to corporation controlled by transferor).

[16] I.R.C. § 357(c)(1)(A).

[17] I.R.C. § 357(c)(1)(B).

[18] 33 T.C. 963 (1960).

[19] 294 F.2d 653 (9th Cir. 1961), *rev'g* 33 T.C. 963 (1960).

[20] Crane v. Comm'r, note 11 *supra*, at 9-10; Parker v. Delaney, 186 F.2d 455, 459 (1st Cir. 1951), *cert. denied*.

[21] Note 20 *supra*.

[22] 281 F.2d 238 (4th Cir. 1960), *cert. denied*. For a comprehensive discussion of Section 357(b), see Greiner, Behling & Moffett, "Assumption of Liabilities

the court found that the purpose was tax avoidance. Consequently, the assumption of liabilities constituted money received by the taxpayer, under former Section 112(d), now Section 357(b). Tax avoidance was also present in *W.H. Weaver*.[23]

Reorganizations

With these cases in mind, different types of reorganizations will be examined. It will be assumed that the transferor corporation owns a building with an adjusted basis of 20, a fair market value of 100, and subject to a liability of 50, which is exchanged for stock of the transferee corporation worth 50 plus the assumption. We will assume that the shareholders of the transferor corporation have a zero basis in their stock in the transferor corporation.

Type "A" Reorganization

In an "A" reorganization (a statutory merger or consolidation[24]), a new corporation would succeed to the assets and liabilities of the transferor and another corporation (consolidation), or one corporation would absorb the assets and liabilities of another (merger).

In a consolidation, shareholders of our hypothetical transferor would receive shares in the new corporation. Here, the new corporation takes a carryover basis of 20 in the building, under Section 362. Neither the transferor corporation nor the shareholders recognize their realized gain under Section 354. The shareholders take a substituted basis of zero in the new corporation's stock under Section 358. This preserves all of the gain, for if the new corporation were to sell the building for 100, it would recognize a gain of 80, and if the shareholders were to sell their stock for 50, they would recognize a gain of 50. There is no question that this postponement of taxation is in accord with the intent of Congress in the reorganization provisions.

Upon a statutory merger rather than a consolidation, the result may depend upon the identity of the surviving corporation. If the corporation owning the encumbered asset should be the surviving corporation, the asset and liability are not transferred, and the result is the same as in the case of a consolidation. However, where the transferee corporation survives and is controlled by the shareholders of the transferor corporation, the merger will also qualify as a "D" reorganization, thus requiring the transferor-corporation to recognize 30 of gain under Section 357(c)

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and the Improper Purpose—A Re-Examination of Section 357(b)," 32 Tax Law. 111 (1978).

[23] 32 T.C. 411 (1959).

[24] I.R.C. § 368(a)(1)(A).

(1)(B).[25] If the requisite control is lacking, the transaction will fail to qualify as a "D" reorganization, and, as an "A" reorganization, gain will not be recognized.

Type "B" Reorganization

In a "B" reorganization, the acquiring corporation acquires voting stock of the transferor corporation in exchange for its own voting stock.[26] Thus, the transferor corporation becomes a subsidiary of the acquiring corporation. It may or may not be liquidated. Of course, the stock-for-stock exchange does not directly result in the transfer of the liability,[27] and, indeed it could not, for the acquisition must be solely for voting stock in order to qualify as a "B" reorganization. Shareholders of the transferor corporation receive shares in the acquiring corporation at a substituted basis of zero under Section 358, preserving their gain of 50 in the new stock. The acquiring corporation takes a carryover basis of zero under Section 362 in the stock it acquires. Upon liquidation of the acquired subsidiary, no gain is recognized to the acquiring corporation by virtue of Section 336, nor to the transferor corporation by virtue of Section 332. However, the acquiring corporation will take a carryover basis of 20 in the building under Section 334, thus preserving the entire gain of 80 which was not taxed to the transferor. This is consistent with the purpose of the reorganization provisions, under which the acquiring corporation is treated as the successor to the transferor corporation.[28]

Type "C" Reorganization

In a "C" reorganization, the acquiring corporation exchanges its voting stock for substantially all of the properties of the transferor corporation,[29] in this case, the building. This type of reorganization is termed a practical merger. Presumably, the transferor corporation will liquidate, distributing the stock it receives in the acquiring corporation in exchange for its own outstanding stock; however, it may retain the stock and continue. Under the original 1954 House of Representatives bill, the transferor corporation was required to liquidate; this requirement however was eliminated by the Senate.

Using our same example of the building in a "C" reorganization, the acquiring corporation would exchange its own stock worth 50 for

[25] Rev. Rul. 75-161, 1975-1 C.B. 114. The effects of a "D" reorganization are discussed in greater detail *infra.*

[26] I.R.C. § 368(a)(1)(B).

[27] Kahn, "*Weaver* case points up hazards in assuming debt in corporate reorganizations," 11 J. Taxation 275 (1959).

[28] See I.R.C. § 381 (carryovers in certain corporate acquisitions).

[29] I.R.C. § 368(a)(1)(C).

the building, subject to the liability. The transferor corporation realizes a gain of 80. Under *Method* (2), it would not recognize any of this gain,[30] and the gain would be preserved by reducing the transferor corporation's basis in the stock of the acquiring corporation to minus 30.[31] The acquiring corporation takes a carryover basis of 20 in the building.[32]

If the transferor corporation liquidates as part of the "C" reorganization, distributing the shares of the acquiring corporation in exchange for its own outstanding shares, its shareholders will take a substituted basis of zero in the new shares,[33] thus preserving their 50 of gain in the stock. The transferor corporation does not recognize gain[34]; however, the gain is preserved in the acquiring corporation, which took a carryover basis of 20 in the building. This is entirely consistent with the concept of a reorganization, whereby the acquiring corporation is treated as the continuation of and successor to the transferor corporation, and the interest of the stockholders in the transferor corporation substantially continues in the form of their stock in the acquiring corporation.[35] Sometimes, of course, the transferor corporation is far smaller than the acquiring corporation, and so the shareholders of the transferor corporation take only a small minority interest in the acquiring corporation, so in an economic sense there is little continuity as to them; however, what is meant by "continuity" is that they take stock in the acquiring corporation in exchange for their stock in the transferor corporation, and the acquiring corporation is, in part, the continuation of the transferor corporation.

Where the liquidation of the transferor corporation is independent of the plan of reorganization, the transferor corporation nevertheless does not recognize gain under Section 336. Its shareholders have a gain of 50[36] which must be recognized notwithstanding a Section 333 election where stock is received,[37] and they take a basis of 50 in their new stock. The acquiring corporation will take a basis of 20 in the building, preserving, as before, the gain which the transferor corporation did not recognize. It should be noted that this pattern is unlikely to occur frequently.

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[30] I.R.C. § 354(a)(1).

[31] I.R.C. § 358(a)(1)(A).

[32] I.R.C. § 362(b).

[33] I.R.C. § 358(a)(1).

[34] I.R.C. § 336.

[35] See, e.g., Le Tulle v. Scofield, 308 U.S. 415 (1940); Minnesota Tea Co. v. Helvering, 296 U.S. 378 (1935); Pinellas Ice Cold Storage Co. v. Comm'r, 287 U.S. 462 (1933); Cortland Specialty Co. v. Comm'r, 60 F.2d 937 (2d Cir. 1932).

[36] I.R.C. § 331(a)(1).

[37] I.R.C. § 333(e)(2) for noncorporate shareholders and I.R.C. § 333(f)(1) for corporate shareholders.

The decision of the Tax Court in *Easson*[38] suggests that the transferor corporation should not take a negative basis in the stock where it does not liquidate. The Tax Court interpreted Section 357(c)(1)(A) (recognition of liabilities in excess of basis in Section 351 incorporations) as merely a clarification of pre-1954 law. However, even if the Tax Court were correct and the Ninth Circuit incorrect with regard to pre-1954 law, there can be no doubt as to the meaning of the present statute where it applies specifically. Section 357(c)(1)(B) requires recognition of liabilities in excess of basis in "D" reorganizations, which indicates nonrecognition in other types of reorganizations.[39]

It has been suggested that recognition was not required in the "C" reorganization by inadvertence. One commentator notes that in the original House bill, the transferor was required to liquidate, thus avoiding the situation, but the Senate eliminated this requirement in the "C" reorganization, although not in the "D" reorganization.[40] However, another commentator points out that if liquidation were required, then reorganization would effectively become elective.[41]

A distinction has been drawn, however, between a negative basis through depreciation deductions and by nonrecognition in a reorganization. In *Crane* and *Woodsam*, it was decided that the amount of the liability would go into the original basis for purposes of depreciation. This would be recaptured by including the liability in the amount realized upon subsequent disposition of the property. This concept has been accepted,[42] despite the concurring opinion of Judge Magruder in *Parker v. Delaney*, which would result in a negative basis. One author has suggested that opposition to negative basis is to negative basis through depreciation deductions, not to negative basis in this situation.[43] But another author notes correctly that there is no avoidance, only deferral, in this "C" reorganization as originally contemplated, since the transferee corporation takes a carryover basis in the building and the shareholders take a substituted basis in their new stock[44]; or, if the transferor corpo-

[38] Notes 18 and 19 *supra*.

[39] Section 357(b) requires recognition of the gain to the extent of the liability, without regard to basis, in any reorganization where the principal purpose is either tax avoidance or other than a bona fide business purpose. Moreover, Section 357(c)(1)(B) applies in the case of a reorganization coming within a type other than "D" where it is also within type "D."

[40] Cooper, "Negative Basis," 75 Harv. L. Rev. 1352, 1359 (1962).

[41] Goldman, "The C Reorganization," 19 Tax L. Rev. 31, 34 (1963).

[42] See Del Cotto, "Basis and Amount Realized Under *Crane*: A Current View of Some Tax Effects in Mortgage Financing," 118 U. Pa. L. Rev. 69 (1969).

[43] Schlesinger, "Negative basis, recognized in *Easson* as possible, will arise only rarely," 16 J. Taxation 212 (1962).

[44] Berl, "Disposition of Property Mortgaged In Excess of Basis," 19 N.Y.U. Inst. on Fed. Tax. 1033 (1961).

ration should sell the new stock rather than distribute it to its shareholders, it would realize 80 of gain due to the negative basis.

The situation, perhaps not originally contemplated, wherein the transferor corporation in a "C" reorganization remains viable will be considered following consideration of the "D" reorganization.

Type "D" Reorganization

In a "D" reorganization, the transferor corporation transfers all or part of its assets to the acquiring corporation and the transferor or its shareholders control the acquiring corporation after the reorganization.[45] It resembles a Section 351 incorporation, except that the transferor must be a corporation, and in the "D" reorganization Section 357(c)(1)(B) requires the recognition of gain to the extent of liabilities in excess of basis.

Using the example of the building with a basis 20, a fair market value 100, and subject to a liability of 50, owned by the transferor corporation, suppose it is transferred to the acquiring corporation in exchange for stock worth 50 plus the assumption, in a "D" reorganization. (It should be noted that one of the requirements for qualification as a "D" reorganization is that the acquiring corporation be controlled by the transferor corporation or its shareholders.) Absent Section 357(c)(1)(B), the treatment would be like that in the "C" reorganization. However, Section 357(c)(1)(B) requires the transferor corporation to recognize the 30 of liabilities in excess of basis, and to take a zero basis (rather than minus 30) in the new stock,[46] which it will then distribute. The shareholders of the transferor will take a substituted basis of zero in the transferee's stock distributed to them. The acquiring corporation's carryover basis of 20 in the building will be increased by the 30 of gain recognized to the transferor corporation, giving it a basis of 50 in the building.[47]

Where, as here, the only asset of the transferor corporation is the building, the effect is like that of the "C" reorganization, except for the treatment of the liability in excess of basis. (It should be noted in this connection that where a reorganization qualifies as both a "C" reorganization and as a "D" reorganization, it is treated as a "D" reorganization.)[48] The acquiring corporation is essentially the continuation of the transferor corporation. Indeed, the continuity is greater here because the transferor corporation or its shareholders control the acquiring cor-

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[45] I.R.C. § 368(a)(1)(D).
[46] I.R.C. § 358(a)(1).
[47] I.R.C. § 362.
[48] I.R.C. § 368(a)(2)(A).

poration, while in the "C" reorganization they may have but a small interest in the acquiring corporation.

This, however, was not the species of "D" reorganization which Section 357(c)(1)(B) was designed to reach. The situation described here lends itself to recharacterization as an "E" reorganization—a recapitalization,[49] or an "F" reorganization—a mere change in identity, form, or place of organization,[50] to neither of which Section 357(c)(1)(B) refers.

The "D" reorganization to which Section 357(c)(1)(B) was addressed is the "D" that is part of a divisive reorganization. Suppose our corporation had a second building, and it could transfer the first building to a new corporation without recognition of gain. The new corporation would take a carryover basis of 20 in the building, preserving the 80 of gain, even though it could only receive 50 in cash by selling the building and paying off the liability. The old corporation would take a minus 30 basis in the stock of the new corporation, although it could distribute the stock to its shareholders[51] without recognizing gain.[52] The effect is that the old corporation has received the benefits of borrowing in excess of basis, tax-free, while the new corporation takes a reduced basis in the building.

This would be easier to see in a more extreme example. Suppose the basis of the building were still 20 but its fair market value were to rise from 100 to 200. The old corporation then borrows an additional 140, increasing the liability to 190. It transfers the building to a new corporation, which takes the building at a carryover basis of 20, subject to 190 of liabilities. The old corporation would, absent the recognition of 170 by which the liabilities exceed its basis, take a basis of minus 170 in the stock of the new corporation. The old corporation has the best of three worlds: It has the cash as if it had sold the building, it is rid of the liability, and the cash is tax-free.[53] One commentator emphasizes that it must distribute the stock in the "D" reorganization,[54] thus elim-

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[49] I.R.C. § 368(a)(1)(E).

[50] I.R.C. § 368(a)(1)(F).

[51] Section 355 deals with spin-off. However, that section is generally beyond the scope of this article. It should be noted, however, that a single business can be divided pursuant to Section 355. See, e.g., United States v. Marett, 325 F.2d 28 (5th Cir. 1963); Edmund P. Coady, 33 T.C. 771 (1960), *aff'd* 289 F.2d 490 (6th Cir. 1961).

[52] In a dividend distribution of the building itself, the corporation would recognize 30 of gain under Section 311(c).

[53] This resembles the bail-out situation, though at the corporate level. Cf. I.R.C. § 306.

[54] I.R.C. § 354(b)(1).

inating the negative basis.[55] This, however, does not call for nonrecognition, because the new corporation is not the continuation of the old corporation and it does not take the benefits of the borrowing, which remain with the old corporation. The old corporation must now recognize the benefits as taxable income. Thus, this situation is like the Section 351 incorporation, except that the transferor is necessarily a corporation rather than an individual, and so it is logical that the treatment of liabilities in excess of basis be consistent.

It has been said that the purpose of Section 357(c) "is to tax to the transferor of property the portion of the gain inherent in the property which represents tax-free dollars already received by the transferor prior to the transfer. This portion of the gain does not remain in the stock, nor does it pass into corporate solution as equity value in the property [unlike the other situations where the assets and benefits of the transferor corporation passed to the transferee corporation which was considered to be the continuation of the transferor corporation]. It has been received by the transferor in cash, and there is no longer a reason for deferral of the tax." [56]

An escape from recognition in the "D" reorganization which may sometimes be useful has been pointed out. Since the test is whether the aggregate of the liabilities assumed exceeds the sum of the bases in the assets transferred, the transferor could transfer some unmortgaged assets as well.[57] However, this avoids the question more than it circumvents Section 357(c)(1)(B) and, in any event, would not be of any assistance here.

In a "D" reorganization, the stock of the transferee corporation is distributed. This has the secondary effect of avoiding the negative basis question.[58] In addition, the transferor corporation in a "C" reorganization is not required to distribute the stock (in the transferee corporation) and dissolve. In Revenue Ruling 57-518,[59] the Service allowed a "C" reorganization where 70 percent of the assets were transferred. The corporation retained 3 percent of its inventory and cash and accounts receivable to pay its debts before liquidation. The Service held that whether "substantially all" of the properties are transferred will depend

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[55] Cooper, note 40 *supra*. The shareholders take a substituted basis in their new stock rather than a carryover basis, and the basis of the distributed stock in the hands of the distributing corporation is no longer relevant, as discussed *supra*.

[56] Del Cotto, "Section 357(c): Some Observations on Tax Effects to the Cash Basis Transferor," 24 Buffalo L. Rev. 1, 6 (1974). Cf. Donald D. Focht, 68 T.C. 223 (1977).

[57] Kahn, note 27 *supra*; Reg. § 1.357-2(a).

[58] Del Cotto, note 56 *supra*.

[59] Rev. Rul. 57-518, 1957-2 C.B. 253.

upon "the nature of the properties retained by the transferor, the purpose of retention, and the amount thereof" in the particular case.[60] Courts, too, have allowed reorganizations in appropriate situations where less than 100 percent of the assets were transferred.[61] The Service has announced that it will issue a ruling on this point if 90 percent of the net assets and 70 percent of the gross assets are transferred.[62] Apparently, the transfer of operating assets is most essential, for the transfer of non-operating assets could constitute a bailout and a transfer of less than substantially all the operating assets in a purported "C" reorganization is, in essence, a sale of the assets transferred.

The Service has conceded also that the transferor corporation in a "C" reorganization need not dissolve. In Revenue Ruling 68-358,[63] it assumed the continuation of the transferor as a holding company to hold the stock of the acquiring corporation which it received in the reorganization in exchange for its properties. This pattern occurred in *World Service Life Insurance Co. v. United States*,[64] where the net operating loss carryover of the transferor was held to pass to the transferee in the reorganization despite the continuation of the transferor as a holding company. In Revenue Ruling 73-552,[65] the Service held that the transfer of operating assets and liabilities for voting stock qualified as a "C" reorganization, even though the transferor intended to enter into an active trade or business with the liquid assets. The transferor intended to distribute the stock, so the problem of negative basis did not arise.

From this, it is but a short step to a divisive "C" reorganization. The transferor corporation continues with cash and the stock of the acquiring corporation. Then, in some future year, one of a number of things may happen. Its shareholders may wish it to resume business, so it may issue new shares to raise funds and then engage in business once again. Thus, it will have the tax benefits of the earlier borrowing, in exchange for the negative basis in the stock, contrary to the rationale for the deferral.[66] Or it may sell the stock to raise funds and argue

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[60] *Id.* at 254.

[61] See, e.g., Britt v. Comm'r, 114 F.2d 10 (4th Cir. 1940) (92 percent); Western Indus. Co. v. Helvering, 82 F.2d 461 (D.C. Cir. 1936) (85 percent); Cortland Specialty Corp. v. Comm'r, 60 F.2d 937 (2d Cir. 1932) (91.5 percent) (reorganization treatment denied for other reasons).

[62] Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Proc. 66-34, 1966-2 C.B. 1232; Rev. Proc. 74-26, 1974-2 C.B. 478, 479.

[63] Rev. Rul. 68-358, 1968-2 C.B. 156. The ruling held that the loss carryover would be transferred to the new corporation, assuming the transaction did not fall within the prohibitions of Section 269.

[64] 471 F.2d 247 (8th Cir. 1973).

[65] 1973-2 C.B. 116.

[66] Del Cotto, note 56 *supra*.

against the negative basis. Or, it could distribute the stock in one of several ways. It should be recalled that had it distributed the stock originally and liquidated, continuity would have existed between the two corporations to justify the deferral. Upon a subsequent distribution as a dividend, the rationale of Section 311 should apply to require recognition of the amount by which the basis in the stock is less than zero.[67] Or, it could subsequently liquidate, distributing the stock in liquidation. The transferor corporation would never recognize the gain of 30, it having been preserved by means of a carryover basis in the new corporation.[68] The shareholders would recognize their gain on these shares of the transferor corporation and increase their bases in their new shares accordingly, unless they can and do elect to defer recognition.[69]

Conclusion

There should not be recognition in the case of an "A" merger where the transferee corporation survives and there is sufficient control to bring the transaction within the scope of a "D" reorganization. The same continuity is present as would be if the transferor were the survivor, or if the transaction were instead a consolidation or a "C" reorganization. Indeed, from the viewpoint of the shareholders, continuity is greater where they receive 80 percent control of the surviving corporation (and the transaction is also a "D" reorganization) than it is where they receive less than 80 percent control of the surviving corporation (and the transaction is not also a "D" reorganization). Moreover, a merger cannot possibly be used to effect a divisive reorganization, to which Section 357(c)(1)(B) should be addressed.

Section 357(c) should be expanded to reach the divisive "C"

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[67] Section 311(c) provides:

(c) LIABILITY IN EXCESS OF BASIS. — IF —

(1) a corporation distributes property to a shareholder with respect to its stock,
(2) such property is subject to a liability, or the shareholder assumes a liability of the corporation in connection with the distribution, and
(3) the amount of such liability exceeds the adjusted basis (in the hands of the distributing corporation) of such property,

then gain shall be recognized to the distributing corporation in an amount equal to such excess. . . .

It does not expressly apply because there is no liability; however, the rationale applies because the liability (zero) exceeds the (negative) basis.

[68] Unless Section 311 were read into Section 336.

[69] I.R.C. §§ 333(e)(1), 334(c).

reorganization[70] as well as the divisive "D" reorganization, to recognize the gain to the transferor corporation when it has transferred the liability but continues to exist and retains the benefits which resulted in the liability in excess of basis. However, it should not be expanded to reach the acquisitive "C" reorganization where the acquiring corporation is properly the continuation of the transferor corporation.

One commentator has placed this subject in its proper perspective: "Tax-free reorganizations involving real estate corporations may be one answer—but many principals have found this device, while theoretically appealing, of dubious practicality." [71]

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[70] The divisive "C" reorganization is often treated as a "D" reorganization by virtue of Section 368(a)(2)(A); however, the 80 percent control which is required for "D" reorganization treatment is not always present. Cf. Section 1239, where sale of depreciable property to 80 percent owned corporation produces ordinary income, but sale to less than 80 percent owned corporation may produce capital gain.

[71] Young, "Tax hurdles the real estate investor faces under the 1954 Code," 5 J. Taxation 34, 35 (1956).