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The Deemed Transfer of Recourse Liabilities Leads to *Owen* Taxes: What Is Wrong With Form Over Substance?

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COMMENT

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I. INTRODUCTION

The sale or exchange of encumbered property is a garden-variety transaction in any financed venture.¹ Although this standard transaction

1. Transfers of encumbered property arise in everyday transactions such as a contribution of

is unremarkable from a business perspective, the tax rules associated with such transfers are replete with inconsistencies, irrationalities and inefficiencies. In short, the tax side of this garden-variety transaction is a complex labyrinth through which taxpayers must maneuver, avoiding wrong turns along the way.

The easiest way to make a wrong turn in this garden-variety transaction is to transfer property with an encumbrance exceeding the property's adjusted tax basis.² When property is transferred with a corresponding liability, a realization event occurs; the assumed or transferred liability becomes part of the transferor's amount realized.³ The transferor may be required to recognize gain on the transfer if the underlying debt exceeds his or her basis in the transferred property. For example, section 357(c) imposes a tax on the transferor of over-encumbered property transferred to a newly-organized, controlled corporation, to the extent that the assumed liability exceeds the transferor's tax basis in the property. As a general rule, however, "there is no income unless and until there has been a release of liability."⁴

Application of the general rule to nonrecourse liabilities is elementary. The transfer of property subject to a nonrecourse liability triggers gain. In short, the liability follows the property. The general rule becomes convoluted when the property transferred is subject to a recourse liability. Should a taxpayer who transfers over-encumbered property but remains primarily liable for the debt recognize gain on the disposition of property which is only secondarily liable? Under the aforementioned general rule, one would think not, because the liability has not been transferred and there has not been a "release of liability."

The Internal Revenue Service ("Service") recognizes an exception to the general rule, requiring a transferor to recognize gain on the transfer of over-encumbered property to a related transferee, even though the transferor remains primarily liable. When encumbered property is transferred and the transferor remains primarily liable, the deemed transfer of

encumbered property to a business, nonrecourse financing for a highly leveraged financed acquisition, and negotiated contingent liabilities such as environmental hazards clean-up costs. See generally Elliott Manning & Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part One)*, 11 TAX MGMT. REAL EST. J. 19 (1995).

2. Section 1012 states that "[t]he basis of property shall be the cost of such property, except as otherwise provided" I.R.C. § 1012 (1997). Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1997, as amended, and the regulations thereunder. The regulations define "cost" as "the amount paid for such property in cash or other property." Treas. Reg. § 1.1012-1(a) (as amended in 1994).

3. See Treas. Reg. § 1.1001-2(a) (1980).

4. *Maher v. Commissioner*, 469 F.2d 225, 229 (8th Cir. 1972) (citing MERTENS LAW OF FEDERAL INCOME TAXATION § 11.19).

liability makes little sense and yields inconsistent results. The exception to the general rule that there is no income unless there has been a release of liability leads to inconsistent positions, not only within the Service and the Tax Court, but also among the circuits. For example, the Service applies the general rule where encumbered property is transferred to an unrelated party in exchange for a wraparound liability and where the transferor remains primarily liable.⁵ However, the Service advocates a contrary result when the transfer of over-encumbered property is between related parties, taxing the transferor without regard to whether he or she remains primarily liable.⁶

In 1996, the Service released a Technical Advice Memorandum⁷ that calls into question the core of the Service's longstanding policy toward transfers of over-encumbered property when a recourse liability exceeds the property's tax basis.⁸ In its latest decision, the Service took the position that although the transferor remains primarily liable for a recourse liability, he must recognize gain on the transfer of collateral because the encumbrance exceeds the transferor's basis in the collateral. Although courts, commentators, and the Service accept the practice of taxing transfers involving recourse liabilities without regard to whether the transferor remains primarily liable, this recent decision underscores the absurdity inherent in this overbroad proposition.

This Comment argues that the inconsistent results involving the transfer of property subject to recourse liabilities where the transferor remains primarily liable are attributable to the Service's paranoia regarding transfers of over-encumbered property between related parties. As a general rule, the Code should not tax a transfer of property that is over-encumbered by a *recourse* liability if the transferor remains primarily liable. This over-expansive application, as the recent Technical Advice Memorandum demonstrates, yields inconsistent and absurd results, supported only by elevating form over substance.

Parts II and III analyze the recent Technical Advice Memorandum,

5. In 1987, the Service took the position that a transfer of property subject to a recourse liability was a taxable event, where the transferor remained primarily liable and the transferee executed a wraparound mortgage in favor of the transferor. See *Professional Equities, Inc. v. Commissioner*, 89 T.C. 165 (1987). The Service lost. *Id.* at 181. In a Cumulative Bulletin, the Service announced its acquiescence, admitting that its position in *Professional Equities* was in error. See 1988-2 C.B. 1.

6. See *Owen v. Commissioner*, 881 F.2d 832 (9th Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990). But see *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989).

7. Tech. Adv. Mem. 96-40-001 (Nov. 29, 1994).

8. For over forty years, the Service has maintained an overbroad policy toward taxing transfers of a liability regardless of whether the transferor remains primarily liable. See, e.g., *Stoncrest Corp. v. Commissioner*, 24 T.C. 659 (1955). But see *supra* note 5 (discussing the Service's acquiescence in *Professional Equities*).

explaining how absurd results follow from expansive use of section 357(c) in the context of recourse liabilities. Part IV examines the inconsistent treatment of property transfers where an encumbrance exceeds basis, beginning with two Supreme Court decisions that raise the issue in the context of nonrecourse lending,⁹ and ending with a split regarding whether the same treatment should be accorded to the transfer of property subject to a recourse liability where the transferor remains primarily liable. Part V argues that the Service's rationale for expanding section 357(c), insofar as it taxes all recourse debt unassumed by a related transferee, is inconsistent with congressional intent. Further, any attempt to expand section 357(c) to include unassumed recourse liabilities is an attempt to elevate form over substance without legislative authority. Part VI re-analyzes the nature and purpose of taxing recourse liabilities, and attempts to provide an economic framework to determine when the transfer of property that is over-encumbered by recourse liabilities should, and should not, trigger gain to the transferor.

II. THE TECHNICAL ADVICE MEMORANDUM

The issue of gain recognized on the disposition of property where an encumbrance exceeds basis arises in a variety of contexts.¹⁰ In the Technical Advice Memorandum, the issue arose in the context of a contribution of property to a controlled corporation under section 351.¹¹ What follows is an analysis of the framework of section 351, section 357(c)—the exception to the general nonrecognition rule of section 351—and the reasons why the Service argues that the transfer section 357(c) in the Technical Advice Memorandum should fall within the exception, requiring the transferor to recognize gain on the transfer.

A. *Section 351: Nonrecognition on the Transfer of Property to a Controlled Corporation*

Section 351 provides for the tax-free transfer of property to a corporation in exchange for stock, provided that certain conditions are satisfied.¹² It also provides that in the case of an exchange where one

9. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1 (1947).

10. For example, the issue may arise in a sale of property where the liability exceeds both the fair market value and the basis of property. The regulations provide that the amount of discharged indebtedness is included in the amount realized. See *Treas. Reg.* § 1.1001-2 (1980). In addition, the issue may arise when a taxpayer walks away from a nonrecourse liability after all depreciation deductions have been taken and the property's fair market value is less than the principal on the debt. See, e.g., *Commissioner v. Tufts*, 461 U.S. 300 (1983). Gain is triggered when the taxpayer is released from his or her obligation to repay the loan. See *Treas. Reg.* § 1.1001-2 (1980).

11. See *Tech. Adv. Mem.* 96-40-001 (Nov. 29, 1994).

12. Section 351(a) provides for nonrecognition of gain or loss on the transfer of assets in kind to a corporation which the transferor(s) "control." See *I.R.C.* § 351(a) (1997). "Control" is in

transferor assumes or acquires property subject to a liability, the assumption or acquisition does not prevent the exchange from falling within section 351, and the liabilities assumed in the exchange are not classified as boot.¹³

B. *Section 357(c): A Trap for the Unwary*

Section 357(c) sets forth the exception to the general nonrecognition rule of section 351 where property transferred is subject to a liability that exceeds basis.¹⁴ It provides that, in the case of an exchange to which section 351 applies:

[I]f the sum of the amount of 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.¹⁵

Thus, if a taxpayer transfers property with a basis of \$10,000, subject to liabilities of \$30,000, the taxpayer must recognize gain of \$20,000—the amount by which the liability assumed exceeds the taxpayer's basis.¹⁶ What if the transferee does not take the property subject to the liability and the transferor remains primarily liable? The regulations state that the “same result will follow whether or not the liability is assumed by the transferee.”¹⁷

C. *The Technical Advice Memorandum: A Factual Analysis*

The Technical Advice Memorandum presents a fairly common scenario. A corporation and shareholder attempt to secure a series of loans. Individually, neither qualify for the requested financing. To obtain bank financing, both the shareholder and the corporation enter into a cross-collateralization and a cross-default agreement. The agreements provide that all real property of both the shareholder and the corporation secures

turn defined as meaning ownership of at least eighty percent of the voting power and eighty percent of all outstanding classes of stock. *See id.* (cross-referencing § 368(c)).

13. *See id.* § 351(b). Section 351 provides for the general nonrecognition rules applicable to a transfer of property to a controlled corporation in exchange for stock. *See id.* § 351(a). Subsection (b) states that any “other” property (excluding the stock) distributed to the corporation still qualifies as a 351 transaction, but the taxpayer must recognize gain on the boot. *See id.* § 351(b). Subsection (d) has been interpreted to exclude assumed or acquired liabilities from the boot recognition rule in subsection (c). *See id.* § 351(d).

14. *See id.* § 357(c).

15. *Id.* § 357(c)(1).

16. *See* Treas. Reg. § 1.357-2(a) (as amended in 1980).

17. *Id.*

each debtor's respective liabilities to the bank.¹⁸ Thus, this transaction involves a recourse liability where the shareholder and the corporation bear primary liability for their respective debts, and the collateral includes multiple properties which are secondarily liable in the event that either debtor defaults.

The cross-collateralized transaction goes awry, however, when the shareholder transfers a single asset in exchange for stock in the corporation. Although this transaction meets the requirements for nonrecognition treatment under section 351,¹⁹ the total liabilities attributable to the shareholder exceed the shareholder's basis in this single asset.²⁰ The Service maintains that this constitutes a release of liability regardless of whether the shareholder/transferor remains primarily liable for the debt. The Service takes the position that in transferring the asset, the transaction falls within the exception to section 351.²¹ Because the taxpayer's total liability exceeds his basis in the single asset, the taxpayer must recognize gain to the extent of such excess because section 357(c) applies "to all liabilities . . . regardless of whether the transferor retains personal liability."²²

The Memorandum also addresses the issue of the shareholder's basis in the corporate stock received in the section 351 exchange.²³ Section 358 of the Code prescribes the applicable rules for adjusting basis in this transaction.²⁴ Under subsection (a), the shareholder takes the basis in the property transferred,²⁵ reduced by the liabilities assumed (even though no liabilities were actually assumed),²⁶ and increased by the amount of gain recognized²⁷ (the excess of liabilities over basis). Since

18. See Tech. Adv. Mem. 96-40-001 (Nov. 29, 1994).

19. This closely held corporation was owned by two shareholders. Prior to the transfer of the single asset, the shareholder owned a two percent interest. *Id.* Presumably, the transfer of the asset gave the shareholder an eighty percent interest in the corporation.

20. Query why the Service aggregated the sum total of the shareholder's liabilities to this single asset instead of pro-rating the liabilities proportionately among all of the assets securing the loan. Does this mean that if the shareholder later transfers another asset he will be taxed on the amount that his *total* liabilities exceed the value of each asset transferred? See discussion *infra* Part III.A.

21. See Tech. Adv. Mem. 96-40-001 (Nov. 29, 1994).

22. *Id.* See also *supra* note 17 and accompanying text (discussing the approach taken under the regulations).

23. See Tech. Adv. Mem. 96-40-001 (Nov. 29, 1994).

24. See I.R.C. § 358(a) (1997).

25. See *id.* § 358(a)(1).

26. See *id.* § 358(a)(1)(A). Section 358(d)(1) provides that "assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange." Thus, under § 358(a)(1), the property exchanged is decreased by "the fair market value of any other property . . . received by the taxpayer"—i.e., the amount of the liability assumed. See *id.* § 358(a)(1)(A)(i).

27. See *id.* § 358(a)(1)(B)(ii).

the asset was subject to liabilities in excess of the shareholder's basis in the asset, the shareholder's basis in the stock received is decreased below zero by the amount of liabilities to which the asset was secondarily liable, and was increased to zero by the amount of gain recognized under section 357(c). As a result, the shareholder has a zero basis in the stock received. On a subsequent disposition of the stock, the shareholder will recognize the full value received because he has no basis to offset the amount realized.²⁸

III. ABSURD RESULTS TO FOLLOW

Although the regulations and corresponding body of case law²⁹ implicitly make section 357(c) applicable to recourse loans, absurd results follow from such application. To illustrate the absurdity, consider some potential future transactions involving the corporation and the shareholder in the Technical Advice Memorandum. If the shareholder later transfers other assets that also served as collateral for the loan, consider how this decision would shift basis to the corporation, thereby permitting it to obtain full taxable benefits from the transferred asset while the shareholder shoulders all corresponding tax burdens. The central issue that leads to certain absurdity in this transaction is the fact that there has been no transfer of liability.

A. *Shareholder Transfers of Multiple Assets in Separate § 351 Transactions*

The Service's position, taken literally, would assess taxable gain each time the shareholder transferred an asset where its basis was less than the liabilities. Assume that the facts in the Technical Advice Memorandum are as follows: The shareholder secures a \$100,000 note with ten assets having a total basis of \$100,000 (\$10,000 each). In 1996, the shareholder transfers one asset to a corporation in exchange for an eighty percent interest.³⁰ Under section 357(c) and the logic of the Technical Advice Memorandum, the shareholder would be required to recognize gain of \$90,000—the amount of the liability (\$100,000) decreased by the basis in the asset transferred (\$10,000). The shareholder would continue paying the loan—because it is a recourse debt—and takes a zero basis in his shares in the corporation.³¹

28. See *id.* § 1001(a) (providing that the gain realized shall be the excess of the amount realized over the adjusted basis in the property transferred).

29. See discussion *infra* Section IV.

30. Presumably, the transaction meets all § 351 requirements for nonrecognition treatment.

31. The basis computation for the shareholder's interest in his shares follows: The shareholder's basis in the asset transferred (\$10,000), reduced by the amount of liabilities assumed (\$100,000), increased by the amount of gain recognized (\$90,000), yielding a zero basis.

Assume that the next year the shareholder decided to contribute asset number two to a different corporation in exchange for a controlling interest meeting the requirements for nonrecognition under section 351. Again, the same results. Assuming no principal payments were made, the shareholder would be taxed on the difference between the liability (\$100,000) and the basis in the asset transferred (\$10,000). If this spiral continued, the shareholder's gain recognized could reach \$900,000 on the release of a \$100,000 liability that the shareholder would ultimately repay.

Of course, this result is absurd. The Service not only ignores the absurdity of such an outcome, but a recent Private Letter Ruling even sanctions such treatment.³² In this ruling, the Service revoked a prior letter ruling³³ that allocated a liability between two assets when the two assets securing a single liability were transferred between two unrelated corporations.³⁴ Therefore, even assuming that the two transfers described above were consummated simultaneously, there would be no way to split the liability.

B. *Basis in Multiple § 357(c) Transactions*

There is one truism in American tax law, the premise of which is quite simple: The U.S. tax system affords various tax benefits, but those benefits are subject to the caveat that sooner or later, the taxpayer must bear a corresponding tax or economic burden.³⁵ The Service's most recent Technical Advice Memorandum, however, appears contrary to this general rule.

In the Technical Advice Memorandum, the shareholder has a zero basis in his shares.³⁶ Under section 362(a), the corporation takes the shareholder's basis in the asset transferred, increased by the amount of gain recognized by the shareholder.³⁷ If the corporation actually assumed the shareholder's liability, then its basis in the transferred asset would increase to reflect the economic cost of issuing its shares. For example, assume that the shareholder's asset had a basis of \$50, subject to a \$40 liability. Because the liabilities do not exceed the shareholder's basis in the asset transferred, section 357(c) would not apply and section 351 nonrecognition rules would apply. The shareholder would take a

32. See Priv. Ltr. Rul. 90-32-006 (Apr. 26, 1990).

33. See Priv. Ltr. Rul. 87-30-063 (Apr. 29, 1987).

34. See Priv. Ltr. Rul. 90-32-006 (Apr. 26, 1990).

35. See, e.g., *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943); *Harrison Property Management Co. v. United States*, 475 F.2d 623 (Ct. Cl. 1973).

36. See discussion *supra* Part II.C. (concerning the treatment of basis in the Technical Advice Memorandum).

37. See I.R.C. § 362(a) (1997).

\$10 basis (\$50 minus \$40) in the shares issued.³⁸ The corporation would take a \$50 basis in the asset transferred.³⁹

If the numbers were transposed and the shareholder's basis in the asset transferred were \$40, subject to a \$50 nonrecourse note, the shareholder would recognize a gain of \$10 under section 357(c). His basis in the distributed shares would be zero.⁴⁰ The corporation would take the shareholder's basis in the property (\$40), increased by the amount of gain recognized (\$10), yielding a \$50 basis in the asset transferred. Arguably, the corporation would receive a step-up in basis to reflect the cost incurred in securing the property. That cost must include the amount of the liabilities that the corporation acquired or assumed when the transferred property was "subject to a liability." Applying the basis rules to recourse liabilities generally, and the Technical Advice Memorandum specifically, yields outlandish results.

Assume, for example, that the shareholder had a \$10,000 basis in the asset transferred and a \$100,000 loan secured by multiple assets. The gain recognized would be \$90,000.⁴¹ The shareholder would take a zero basis in his stock,⁴² and the corporation would take a \$100,000 basis in the asset transferred.⁴³ This does not make sense from an economic perspective and is contrary to current case law. To begin with, the corporation obtains a step-up in basis, but the increase does not accurately reflect the cost of the asset because the corporation has no obligation to repay the debt.⁴⁴ If the asset transferred is used in the corporation's trade or business, then the corporation has increased the amount of depreciation that it may deduct.⁴⁵ Moreover, the question of

38. See *id.* § 358(a).

39. See *id.* § 362(a).

40. Under § 358(a), the basis in the asset transferred (\$40) would be decreased by the liability assumed (\$50) and increased by the gain recognized by the shareholder (\$10), resulting in a basis of zero.

41. See I.R.C. § 357(c) (1997) (taxing the excess liabilities over basis); see also *supra* Section II.A. (discussing the application of § 357(c) to the transfer of a single asset that is one of many securing a single liability).

42. The difference between the adjusted basis in the property transferred (\$10,000) and liabilities (\$100,000), increased by the amount of gain recognized (\$90,000), yields a zero basis. See I.R.C. § 358(a)(1) (1997).

43. The corporation would take the shareholder's basis in the asset transferred (\$10,000), increased by the amount of gain recognized by the shareholder (\$90,000), resulting in a \$100,000 basis in the property transferred. See I.R.C. § 362(a) (1997).

44. The concept that stock or a note has a "zero basis" has been largely condemned by academics and practitioners. See Babette B. Barton, *Economic Fables/Tax-Related Foibles: On the "Cost" of Promissory Notes, Guarantees, Contingent Liabilities, and Nonrecourse Loans*, 45 TAX L. REV. 471, 478-79 (1990); Elliott Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 TAX L. REV. 159 (1984); Stephen G. Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 TAX LAW. 693 (1990).

45. See I.R.C. § 167 (1997).

whether a corporation may include liability which grossly exceeds the property's fair market value in the transferred asset's basis has been answered with an anti-taxpayer result.⁴⁶ Therefore, application of section 357(c) to true recourse liabilities yields absurd results with respect to basis—shifting minimal tax benefits to the corporation, while imposing all tax burdens on the shareholder who is paying for the corporation's tax benefits.

C. *The Fabled Transfer of Recourse Liability*

The precise language of section 357(c) speaks to two types of liabilities: those assumed and those to which the property is subject. The corporation in the Technical Advice Memorandum did not assume the shareholder's liabilities. Therefore, the Service was proceeding on a theory that the property transferred was "subject to a liability." Deceptively simple, the "subject to" language in section 357(c) is the catalyst causing confusion about *when* a recourse liability is transferred for tax purposes. At issue is whether a liability that is primarily secured by a transferor who is obligated to repay, and secondarily secured by property if he or she does not meet the obligation, is necessarily transferred with the collateral.

The "subject to" language presents an interesting issue. Nonrecourse liability or nonrecourse debt is defined as "[d]ebt secured by the property that it is used to purchase."⁴⁷ Without question, the "subject to" language applies to nonrecourse liabilities because the asset is primarily liable in the event of default. In the case of a true recourse liability, the property owner is primarily liable and the property is secondarily liable in the event of default.⁴⁸ A transfer of property encumbered by recourse liabilities may, but does not necessarily, result in a release from the transferor's obligation to repay the debt.

46. In *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3d Cir. 1988), and *Estate of Isaacson v. Commissioner*, 860 F.2d 55 (2d Cir. 1988) (per curiam), the Third and Second Circuits addressed the issue of whether cost basis includes a nonrecourse mortgage exceeding the property's fair market value at the time of disposition. The Second Circuit found that the cost "unreasonably exceeded" the property value and the nonrecourse debt "substantially exceeded" the property value such that there was neither an investment in the property nor a genuine indebtedness that would support depreciation and interest deductions. See *Estate of Isaacson*, 860 F.2d at 56. In light of this precedent, it is unlikely that our fictitious corporation would obtain full taxable benefits from the gain recognized by the transferor via depreciation deductions based on inflated basis.

47. BLACK'S LAW DICTIONARY 1057 (6th ed. 1990).

48. "Recourse" refers to "[t]he right of a holder of a negotiable instrument to recover against a party secondarily liable." BLACK'S LAW DICTIONARY 1275 (6th ed. 1990).

1. AVOID ABSURD RESULTS: USE COMMON SENSE

Although this transaction clearly leads to absurd results,⁴⁹ the Service maintains that it is following the plain meaning of section 357(c).⁵⁰ However, as the Supreme Court noted:

When [plain] meaning has led to absurd or futile results, . . . this Court has looked beyond the words to the purpose of the act. Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one "plainly at variance with the policy of the legislation as a whole" this Court has followed that purpose, rather than the literal words.⁵¹

2. AMBIGUOUS DISTINCTIONS BETWEEN RECOURSE AND NONRECOURSE LIABILITIES TANGLE THE ISSUES

Section 7701(g) further obscures section 357(c) by limiting its application to transfers involving nonrecourse liabilities. That subsection provides that, "in determining the amount of gain or loss . . . with respect to any property, the fair market value of such property shall be treated as being not less than the amount of *any nonrecourse indebtedness to which such property is subject*."⁵² By explicitly including nonrecourse indebtedness for purposes of determining gain or loss, this subsection implicitly excludes recourse liabilities. As a result, there are no meaningful guidelines to determine when a recourse liability is transferred.

3. LEGISLATIVE HISTORY OF § 357(c)

The legislative history of section 357(c) is scant.⁵³ At least one commentator has theorized that section 357(c) was enacted in response to congressional dissatisfaction with the operation of section 112(k),⁵⁴

49. See discussion *supra* Part III.

50. See *Owen v. Commissioner*, 881 F.2d 832, 835 (9th Cir. 1989).

51. *United States v. American Trucking Ass'ns*, 310 U.S. 534, 543 (1940) (footnotes omitted).

52. I.R.C. § 7701(g) (1997) (emphasis added).

53. See S. REP. NO. 83-1622, at 270 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4908; H.R. REP. NO. 83-1337, at 40 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4066.

54. Section 112(k) of the 1939 Internal Revenue Code provided in pertinent part:

[I]f, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this section, be considered as money received by the taxpayer upon the exchange.

Revenue Act of 1939, ch. 247, § 213(a), 53 Stat. 862, 870 (1939) (current version at I.R.C. § 357(b)(1) (1997)).

the predecessor to section 357(b).⁵⁵ Section 112(k) provided for a subjective motivation test,⁵⁶ or alternatively a business purpose test,⁵⁷ to determine whether the taxpayer realizes gain on the transfer of encumbered property.⁵⁸ If successful in rebutting the Service's challenge to his or her subjective motivation or business purpose, the taxpayer could obtain a tax-free gain by mortgaging property for an amount exceeding his or her basis and transferring the property, subject to the mortgage, to a controlled corporation. The taxpayer would have the excess and the corporation would have to either repay the debt (if it was a transferred recourse debt) or abandon the property if, after exhausting depreciation deductions, the fair market value of the property exceeded its adjusted tax basis.⁵⁹ Therefore, Congress enacted section 357(c) to provide an objective test to prevent further tax avoidance under the former subjective motivation and business purpose tests where a transferee assumed a recourse liability or took the property subject to a nonrecourse liability.⁶⁰

The Tax Court and Second Circuit further explained the reasons for enacting section 357(c). In *Rosen v. Commissioner*, the Tax Court pronounced that "Congress intended to deal with the case where the transferor takes the deduction for depreciation on account of *assets purchased with borrowed funds and the transferee repays the loan*."⁶¹ Similarly, the Second Circuit stated that "apparently the purpose of . . . section [357(c)] was to prevent a taxpayer's acquiring a permanently tax-free gain by mortgaging certain . . . property for an amount in excess of basis and then transferring property and mortgage under Section 351."⁶² From these cases, it is clear that Congress intended to use section 357(c) to capture those who transfer liabilities and avoid taxes. Therefore, Congress' intended purpose limits the scope of section 357(c)

55. See Colleen M. Martin, Note, *Lessinger and Section 357(c): Why a Personal Guarantee Should Result in Owen Taxes*, 10 VA. TAX REV. 215, 218 (1990). An alternative theory was proposed by George Cooper, who postulates that Congress enacted § 357(c) to resolve judicial difficulty with negative basis. He argues that, unless gain is recognized when the over-encumbered asset is transferred, the transferor will have stock with a basis less than zero. See George Cooper, Comment, *Negative Basis*, 75 HARV. L. REV. 1352, 1355-56 (1962).

56. See *supra* note 54. Specifically, § 112 looked to the taxpayer's primary motivation for transferring liabilities. See *id.* As with most subjective motivation tests, it is usually easier to read the taxpayer's mind than to determine his or her "primary motivation" for engaging in a transaction.

57. See *id.* A business purpose test has an extremely low threshold. Most transactions have some business purpose even if tax avoidance is the motivating factor.

58. See *id.*

59. See, e.g., *Jackson v. Commissioner*, 708 F.2d 1402, 1405 (9th Cir. 1983). But see *Commissioner v. Tufts*, 461 U.S. 300 (1983).

60. See Frank M. Burke, Jr. & Sam W. Chisholm, *Section 357: A Hidden Trap in Tax-Free Incorporations*, 25 TAX L. REV. 211, 214-15 (1970).

61. 62 T.C. 11, 19 n.3 (1974) (emphasis added), *aff'd*, 515 F.2d 507 (3d Cir. 1975).

62. *Bongiovanni v. Commissioner*, 470 F.2d 921, 924 (2d Cir. 1972).

to transfers of recourse liabilities where such liabilities are likely to be paid by the transferee (i.e., the transferee assumes the debt), and to transfers of property subject to nonrecourse liabilities. In both situations, the transferor would no longer be primarily liable for the debt.

IV. ARBITRARY EXPANSION OF § 357(C)

In 1947, the Supreme Court provided taxpayers a tremendous tax benefit.⁶³ The Court held that a taxpayer must increase his or her tax basis in encumbered property to include nonrecourse liabilities.⁶⁴ In effect, this decision permits a taxpayer to take deductions beyond his or her economic investment.⁶⁵ Best of all, this unfunded investment has no strings attached.⁶⁶ On disposition of the encumbered property, the taxpayer recognizes gain to the extent the fair market value exceeds his or her basis. It is unclear from *Crane*, however, whether the taxpayer receives a tax-free release of indebtedness if the amount of the underlying debt exceeds the property's fair market value.⁶⁷

Thirty-six years later, the Court reaffirmed *Crane*, resolving the release-of-indebtedness issue left unresolved in *Crane*.⁶⁸ In *Commissioner v. Tufts*, the Court held that, if a taxpayer is permitted to increase basis by the amount of nonrecourse debt, the taxpayer must also include the release of indebtedness in calculating the amount realized on disposition of the property, even if the amount of the debt is greater than the property's fair market value.⁶⁹

Crane and *Tufts* make clear that nonrecourse liabilities are included

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

64. See *id.* This is quite a remarkable proposition. The Code provides that "[t]he basis of property shall be the cost of such property . . ." I.R.C. § 1012 (1997). Based on the language of the statute and the decision in *Crane*, the cost of property (basis) includes nonrecourse debt which the owner is not personally liable to repay.

65. A taxpayer can take depreciation deductions for the exhaustion, wear and tear of property used in a trade or business. See I.R.C. § 167(a) (1997). These deductions are limited to the taxpayer's basis in the property. See *id.* § 167(c). The greater the basis, the more depreciation deductions a taxpayer may take to offset taxable income. Thus, an increase in basis for nonrecourse liabilities generates tax write-offs without an actual economic outlay.

66. Liability for a nonrecourse debt follows the property, not the owner. The owner of encumbered property can walk away from the property at any time without any adverse consequences. This decision, of course, became the spine of the typical 1980's tax shelter where a taxpayer would purchase property with nonrecourse debt, exhaust all possible depreciation deductions and, once the fair market value of the property fell below the principal, abandon the property without any adverse tax or economic consequences.

67. For example, assume the fair market value of property is \$10,000, the taxpayer's basis is \$5,000, and the underlying debt is \$15,000. Under *Crane*, it was unclear whether the taxpayer realized \$5,000 (fair market value minus basis) or \$10,000 (transferred indebtedness minus basis). See *Crane*, 331 U.S. at 15 n.42.

68. See *Commissioner v. Tufts*, 461 U.S. 300 (1983).

69. See *id.* at 317.

in the basis of property at acquisition and included in amount realized on disposition. What remains uncertain, however, is everything in between. For example, the Court has not visited the issue of whether recourse liabilities secondarily secured by collateral can trigger section 357(c) gain when the collateral is transferred and the transferor remains primarily liable.

The courts and the Service are split on the issue of when a transfer of property is "subject to" a recourse liability. On the one hand, both have taken the position that a transfer of encumbered property between related parties involves a transfer of liabilities, regardless of whether the transferor actually repays the debt.⁷⁰ On the other hand, both have also taken the position that a transfer of encumbered property between unrelated parties is not tantamount to a transfer of liabilities if the transferor remains personally liable.⁷¹

A. *The Service's Position in the Technical Advice Memorandum Is Inconsistent With Its Position in Professional Equities and Consistent With Owen—Can This Inconsistency Be Reconciled?*

The result in the Technical Advice Memorandum is consistent with *Owen* yet entirely inconsistent with *Professional Equities*.

1. *OWEN*: TRANSFER OF LIABILITIES BETWEEN RELATED PARTIES

In 1977, Owen and McEachron formed a general partnership.⁷² Three years later, they borrowed money to buy equipment, secured the loan with the equipment, gave the lender personal guarantees, and placed title to the equipment in the partnership. The partnership then leased the equipment to a related corporation.⁷³

One year later, the partnership transferred all of its assets to the related corporation. At that time, the loans exceeded the equipment's

70. See discussion *infra* Part IV.A. (regarding the Service and the Ninth Circuit's position on transfers of liabilities between related parties). But see *Lessinger v. Commissioner*, 872 F.2d 519 (2nd Cir. 1989) (holding that a proprietorship's transfer of property with liabilities in excess of basis did not trigger § 357(c) gain because the transferor offset the liabilities with his personal note); *Maher v. Commissioner*, 469 F.2d 225 (8th Cir. 1972) (holding that a shareholder did not have taxable income on the transfer of encumbered stock to a controlled corporation even though the corporation assumed the liability); *Aizawa v. Commissioner*, 99 T.C. 197 (1992) (holding that only the portion of the liability that satisfied the foreclosure is subject to taxation because the transferor remained primarily liable for the remainder), *aff'd*, 29 F.3d 630 (9th Cir. 1994).

71. See discussion *infra* Part IV.B.2. (regarding the Service's acquiescence in *Professional Equities*).

72. See *Owen v. Commissioner*, 881 F.2d 832, 833 (9th Cir. 1989).

73. See *id.* In fact, the lessee corporation was owned by Owen and McEachron. See *id.*

basis.⁷⁴ The Service assessed a capital gain tax on the excess of the liabilities over basis without regard to Owen's and McEachron's assumption of the partnership debt.⁷⁵

The Commissioner prevailed at the tax court level.⁷⁶ On appeal, Owen advanced a multi-pronged argument concerning section 357(c),⁷⁷ distinguishing between assumed liabilities and liabilities to which the transferred property is subject.⁷⁸ The latter category, he argued, applies only to nonrecourse, unassumed liabilities.⁷⁹ Citing *Smith v. Commissioner*,⁸⁰ *Rosen v. Commissioner*,⁸¹ and *Beaver v. Commissioner*,⁸² the Ninth Circuit held that liabilities secured by collateral are excluded from calculating gain "even if the transferor remains subject to the liabilities following the transfer."⁸³

The Ninth Circuit's rationale is incomplete. The court chose to ignore the legislative history of section 357(c) and the absurdities that result in applying that section to recourse liabilities. Instead of addressing these issues, the court's rationale rests on overexpansive judicial doctrine. The issue of whether a recourse liability can be transferred was considered, with different results, in *Professional Equities, Inc. v. Commissioner*.⁸⁴

2. *PROFESSIONAL EQUITIES*: TRANSFER OF ENCUMBERED PROPERTY BETWEEN UNRELATED PARTIES

Professional Equities, Inc. purchased land by either assuming existing mortgages thereon or by executing deeds of trust and purchase money notes.⁸⁵ The taxpayer later resold the property using conditional sales contracts whereby the buyers executed "wraparound mortgages"⁸⁶

74. *See id.*

75. *See id.* at 832-33.

76. *See Owen v. Commissioner*, 53 T.C.M. (CCH) 1480 (1987).

77. Owen argued that § 357(c) should only apply when a transferor realizes an economic benefit. *See Owen*, 881 F.2d at 835. In addition, he argued that § 357(c) does not apply to liabilities that the transferor guarantees. *See id.* For arguments on the issue of economic benefit, see *supra* Part III.B. and *infra* Part VI.

78. *See Owen*, 881 F.2d at 836.

79. *See id.*

80. 84 T.C. 889, 909 (1985).

81. 62 T.C. 11, 19 (1974), *aff'd*, 515 F.2d 507 (3d Cir. 1975).

82. 41 T.C.M. (CCH) 52, 54 (1980).

83. *See Owen*, 881 F.2d at 836.

84. 89 T.C. 165 (1987).

85. *See id.* at 167.

86. "Debt is 'wrapped' when property sold is subject to debt which the parties chose not to pay off and not to assign." Report of Professor George Mundstock, in *Lowell v. Commissioner*, Docket No. 15586-88, 28 (on file with the author). For example, assume a home is subject to a favorable mortgage which is not assignable. To continue this favorable debt in the sale of the home, the seller takes back a new note from the buyer, secured by a second mortgage. The seller

in favor of Professional Equities.⁸⁷ The issue in *Professional Equities*, as in *Owen* and in the Technical Advice Memorandum, was whether the transferee took recourse collateral subject to the liabilities regardless of whether the transferor remained primarily liable. The Tax Court held that the regulations at issue in *Professional Equities*, like those in *Owen* and in the Technical Advice Memorandum, apply only if the transferee assumes or takes the property subject to the liability.⁸⁸

The Tax Court held that a new mortgage is executed by the transferee which includes the transferor's unpaid balance of the underlying debt. "The [transferee] does not assume or *take the property subject to the underlying indebtedness*."⁸⁹ The transferee is liable for and makes payments to the transferor while the transferor remains liable for and makes payments on the underlying indebtedness. Therefore, the transfer of recourse collateral is not tantamount to a transfer of property subject to the underlying indebtedness unless the transferee assumes the transferor's obligation to repay.

B. *Reconcilable Differences: Is the Service Paranoid About Transfers Between Related Parties?*

Why is the transfer of collateral secondarily secured by a recourse liability transferred "subject to" the underlying liability in *Owen* but is not transferred in *Professional Equities*? The answer could explain why the Service cites to *Owen* principles in lieu of those espoused in *Professional Equities* in the Technical Advice Memorandum.⁹⁰

Professional Equities can be distinguished from the garden-variety transactions at issue in *Owen* and in the Technical Advice Memorandum. In essence, *Professional Equities* involved a transfer of recourse collateral to an unrelated third party. The transaction fell within section 453(c) of the Code, which contains a built-in safeguard against transfer abuses between related parties. The transactions involved in *Owen* and in the Technical Advice Memorandum concerned section 351 transactions that by definition must occur between related parties.⁹¹ The only built-in safeguard to prevent transfer abuses between related parties is found in section 357(c). By expanding the purpose of section 357(c) to include transfers of recourse collateral, the Service and the courts have

remains primarily liable on the favorable debt, making all payments using payments from the new debt. The new debt "wraps around" the favorable debt.

87. See *Professional Equities*, 89 T.C. at 167.

88. See *id.* at 171.

89. *Id.* (emphasis added).

90. Tech. Adv. Mem. 96-40-001 (Nov. 29, 1994).

91. See *supra* Part II.A. and accompanying notes for discussion of the rules relating to a tax-free exchange under § 351.

cast a wider net to capture all potential abuses, such as transfers of collateral securing recourse liabilities where the transferors are insolvent. This net, however, is overbroad and undermines congressional intent.

Congress' proclivity for scrutinizing dealings between related parties finds expression in many deliberately prophylactic statutory provisions.⁹² Nothing in the Code seems to warrant treating promises to pay by related parties any differently than promises to pay between unrelated parties.⁹³

In substance, the transfers of recourse collateral described in the Technical Advice Memorandum and in *Owen* closely parallel the transfer of recourse collateral described in *Professional Equities*. Conversely, the form of the transactions parallels the transfer in *Owen*. The only way to reconcile the Service's position in the Technical Advice Memorandum is to analyze the inconsistency that distinguishes *Professional Equities* from *Owen*. The only barrier separating these divergent positions is the Service's preoccupation with the degree of certainty as to "whether the [taxpayer] will in fact make the payments on the indebtedness as promised."⁹⁴ In order to alleviate its paranoia, the Service elevates form (*Owen*) over economic substance (*Professional Equities*) whenever recourse collateral is transferred between related parties, irrespective of the transferor's commitment to repay the debt. This position is neither supported by a logical reading of the Code nor by a meaningful interpretation of its legislative history.

V. WHAT IS WRONG WITH FORM OVER SUBSTANCE?

The Service is elevating the form of the transaction—whether it is between related or unrelated parties—over the substance of the transaction—whether there has been a transfer of property subject to a liability in an economic sense. What is wrong with form over substance? To begin with, the courts and the Service are espousing a dogmatic approach to deem transfers of liabilities between related parties. Such dogma is unnecessary, causes absurd tax consequences, and the rationale for elevating form over substance is more fabled than real. Additionally, a taxpayer can avoid the tax consequences of section 357(c) by restructuring the transaction, but such restructuring will cause unnecessary economic costs.

92. See, e.g., I.R.C. §§ 267, 453(e), 453(g), 707(b), 1031(f) (1997).

93. But see Prop. Treas. Reg. §1.1012-2(a), 51 Fed. Reg. 12022, 12046 (1986). This proposed regulation notes that dealings between related parties are not necessarily arm's-length transactions. However, this proposition is far from a presumption that all transactions between related parties are not arm's-length transactions. See, e.g., I.R.C. § 707(a) (1997) (addressing transactions in which a partner is not considered to be acting in the capacity of partner).

94. *Maier v. Commissioner*, 469 F.2d 225, 229 n.6 (quoting Brief for Commissioner).

A. A Dogma

Many commentators argue that the Service's genuine concern is "whether the [taxpayer] will in fact make the payments on the indebtedness as promised."⁹⁵ Congress enacted section 357(c) to prevent a taxpayer who has reaped the benefits of borrowing, such as increased depreciation deductions or pocketing loan proceeds tax-free, from escaping the obligation to repay by contributing property to a corporation and later abandoning the corporation or allowing the corporation to abandon the property, thereby permitting creditors to foreclose.⁹⁶ This is a concern with nonrecourse liabilities, which concern is specifically addressed in the literal language of sections 357(c) and 7701(g). This concern is not always shared in the context of recourse liabilities.

In the context of recourse lending, a transferor cannot escape his or her obligation to repay a debt unless the transferee agrees to repay the debt and the third-party creditor agrees to release the transferor from his or her primary obligation to repay the debt. A legitimate concern is whether a related transferee will repay the loan to protect its interest in the transferred collateral in the event the transferor defaults. Another concern is that the transferor may avoid paying any tax if section 357(c) does not apply to recourse liabilities.

These concerns do not justify over-expansive use of section 357(c). First, such a transaction would not make any sense from a tax perspective. Second, the Service already has a mechanism, other than section 357(c), for capturing those who transfer encumbered property subject to recourse liabilities simply to avoid taxation.

Any payments made on behalf of the transferor (shareholder) by the transferee (corporation) will be recharacterized once payment is made. The Service can recharacterize the loan payment as a dividend distribution.⁹⁷ To the extent that the payment amount equals the corporation's current and accumulated earnings and profits, the shareholder recognizes ordinary income.⁹⁸ Any excess is tax-free to the extent of basis,⁹⁹ and

95. *Id.*

96. See discussion *supra* Part II.C.2. (regarding the legislative history of § 357(c)). The shareholder is shielded from corporate liability. If the corporation becomes insolvent, and thus, unable to repay the transferred obligation, the shareholder's economic loss is limited to his or her basis in the shares.

97. See, e.g., *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712, 723-24 (5th Cir. 1972) (recharacterizing payments on a debt owed by the corporation but guaranteed by the shareholder as constructive dividends to the shareholder). "A constructive dividend is paid when a corporation diverts property . . . to the use of a shareholder without expectation of repayment, even though no formal dividend has been declared." Rev. Rul. 78-83, 1978-1 C.B. 79.

98. See I.R.C. § 301(c)(1) (1997).

99. See *id.* § 301(c)(2).

any amounts remaining are accorded sale or exchange treatment.¹⁰⁰ If the transferor were truly scheming to escape from section 357(c), he or she would not likely trade capital gain tax resulting from the transfer for ordinary income tax resulting from a constructive dividend.

The Service already has a mechanism for catching those who transfer collateral securing a recourse liability for the sole purpose of avoiding tax. The Service is apprehensive about limiting the scope of section 357(c) because if that section does not apply to transfers of encumbered collateral (recourse or nonrecourse), an insolvent taxpayer may transfer property that the transferee can use to offset income through depreciation, while the transferor defaults on the loan.¹⁰¹ The Service can reach these transferors through section 357(b), which provides:

If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition [of the liability]—

(A) was a purpose to avoid Federal income tax on the exchange,

. . . .

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351, . . . be considered as money received by the taxpayer on the exchange.¹⁰²

This section is the safety net that the Service and most courts have ignored. The Sixth Circuit correctly applied section 357(b) to a transfer of collateral secured by recourse liabilities in a section 351 transaction.¹⁰³ There, the Service taxed the transferor under section 357(b) because the transferor's principal purpose for transferring the property was to avoid the payment of income tax. The Service already has used section 357(b) as a vehicle to capture those who transfer collateral subject to recourse liabilities for the sole purpose of avoiding tax.

B. *Costly Alternatives*

A taxpayer may alter the transaction to avoid the application of section 357(c). For example, a transferor may borrow funds to repay a recourse obligation securing the transferred collateral. This arrangement "creates incentives for alternative financing arrangements with third-party creditors that yield the desired, yet expensive-to-arrange, tax out-

100. See *id.* § 301(c)(3).

101. The transferor would not have income from discharge of indebtedness at the time of default because insolvency excepts a taxpayer from realizing discharge-of-indebtedness income. See *id.* § 108(a)(1)(B).

102. *Id.* § 357(b).

103. See *Drybrough v. Commissioner*, 376 F.2d 350 (6th Cir. 1967).

comes. These outside credit arrangements also could exacerbate downturns in the economy by creditors less willing patiently to wait out a debtor's default than might a related party creditor."¹⁰⁴

VI. CONCLUSION: A FRAMEWORK FOR CLASSIFYING LIABILITIES

The issue of gain recognized on the disposition of property where the liability exceeds basis can arise in a variety of contexts.¹⁰⁵ This Comment demonstrates how section 357(c) taxes the excess of liabilities over basis when a liability is assumed by a transferee or when a related transferee takes transferred property "subject to" the liability. A transfer of a liability where the transferee assumes a liability is uncontroversial. Generally, the transferee takes affirmative steps to effect the assumption. Unlike assumption of a liability, determining when a transferee takes property "subject to" a liability is much more difficult in the context of recourse liabilities.¹⁰⁶ This difficulty may be attributed to the undefined terms "subject to" and "liability," as well as the Code's lack of guidance on the precise meaning of the terms. Absent meaningful guidance regarding the purpose, nature, and extent of these terms, application to various Code provisions leads to inconsistent,¹⁰⁷ irrational,¹⁰⁸ and inefficient¹⁰⁹ results.

It is a virtual maxim of taxation "that taxation of gains and losses is predicated upon the realization of a related economic benefit or loss."¹¹⁰ Therefore, when transferred assets are subject to liabilities exceeding their aggregate basis, the unambiguous language of section 357(c) ensures the statutory result. To prevent the transferor from escaping a tax on the economic benefit (i.e., increased deductions on an unfunded investment), the shareholder is deemed to have realized a gain on the transfer to the extent the liability exceeds the property's tax basis. This proposition presupposes that the transferee will pay the liability in the future, but what if it is unreasonable to assume that the transferee can or

104. Barton, *supra* note 44, at 477.

105. For example, the issue may arise in a sale of property where the liabilities exceed both the fair market value and the basis of property. The regulations provide that the amount of discharged liabilities must be included in the taxpayer's amount realized regardless of whether the transferor remains primarily liable. See Treas. Reg. § 1.1001-2 (1980). Or, the issue may arise when a taxpayer, as in *Tufts*, walks away from a nonrecourse liability after depreciation deductions have been taken and the property's fair market value is less than the principal on the debt. See *Commissioner v. Tufts*, 461 U.S. 300, 302-03 (1983). Gain is triggered when the taxpayer is released from his or her obligation to repay the loan. See *id.* at 312.

106. The transfer of property subject to nonrecourse liabilities releases the transferor from his or her primary obligation to repay the debt because the liability transfers with the property.

107. See discussion *supra* Section IV.

108. See discussion *supra* Section III.

109. See discussion *supra* Part VI.B.

110. Carter G. Bishop, *A Tale of Two Liabilities*, 16 WM. MITCHELL L. REV. 1, 4 (1990).

will pay the liability? As this Comment illustrates, this lingering question consistently leads to inconsistent and absurd results. One way to answer the question is to develop a framework within which to determine when a transfer of property subject to a recourse liability should and should not be subject to tax. This Comment proposes a two-step framework: (1) determine whether the indebtedness is the transferor's liability; and (2) determine whether there has been a transfer of the liability in an economic sense.

A. *Defining Liabilities*

The Code does not currently define "liability." The following is an attempt to provide a working definition of "liability" consistent with the rationale for taxing a transferor on the transfer of encumbered property: to prevent the transferor from obtaining the tax benefits of borrowing without the burden of satisfying his or her obligation to repay.¹¹¹ The first step in the analysis is to determine whether a liability corresponds to economic benefits attributed to the transferred property. A working definition of "liability" that is consistent with the matching of tax benefits to corresponding burdens is as follows:

[A]n obligation is a liability of the obligor . . . to the extent, but only to the extent, that incurring or holding such obligation gives rise to—

- (1) [T]he creation of, or an increase in, the basis of any property owned by the obligor (including cash attributable to borrowing);
- (2) A deduction that is taken into account in computing the taxable income of the obligor; or
- (3) An expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. . . .¹¹²

After determining whether property transferred is subject to a liability, the analysis shifts to the actual transfer.

B. *Timing the Transfer of Liabilities*

If the purpose of taxing a transferor is to prevent the transferor from exploiting tax benefits by shifting the liabilities to a transferee, then a determination of whether to tax a transfer of encumbered property where the transferor remains primarily liable should analyze the economic reality of the transaction. The real issue is, and should be, whether the transferor is going to repay the debt, not whether the transferor and transferee are related parties. Section 357(c) does not set forth an ana-

111. See discussion *supra* Part III.C.3.

112. This definition is derived from Temp. Treas. Reg. § 1.752-1T(g) (1988). This definition does not appear in the final § 752 regulations because it properly belongs in a regulation under the general definition section, § 7701. See Manning & Hesch, *supra* note 1, at 19, n.2.

lytic framework to assess whether the transferor will repay the debt, however, sections 465 and 752 provide plausible alternatives to the Service's current methodology.

1. SECTION 1001

The regulations with respect to section 1001 are instructive on interpreting when a recourse liability should be included in the transferor's amount realized.¹¹³ These regulations provide that "the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is *discharged* as a result of the sale or disposition."¹¹⁴ Further, "[t]he amount realized on a sale or other disposition of property that secures a *recourse* liability does not include amounts that are . . . income from the discharge of indebtedness . . ."¹¹⁵ Assuming that the Service taxes a related transferor on the transfer of property subject to a recourse liability in an attempt to avoid the situation where a related transferee repays the debt and the transferee's payment would be explicitly excluded from the transferor's amount realized. Payments made by a corporation on a debt for which the transferor remains primarily liable would constitute income to the transferor resulting from discharge of indebtedness. Such payments would be classified as either dividends or distributions.¹¹⁶

2. ECONOMIC RISK OF LOSS: §§ 465 AND 752

The "at-risk" rules¹¹⁷ and section 752(c) provide an analytic framework. They are instructive in analyzing the economic realities of repayment of recourse liabilities. Generally, the at-risk rules and section 752(c), like section 357(c), attempt to prevent taxpayers from exploiting tax benefits without bearing economic burdens. Specifically, the at-risk rules prevent taxpayers from taking deductions or losses that are attributed to a liability that they will never have to repay. The focus in this section is whether the taxpayer actually bears the economic risk of loss in the event of default.

Similarly, the regulations corresponding to section 752 illustrate *when* a recourse liability is deemed to transfer with the property. Under these regulations, a person has not taken property "subject to" a liability unless the transferee "is personally obligated to pay the liability"¹¹⁸ and the creditor "knows of the assumption and can directly enforce the

113. See Treas. Reg. § 1.1001-2 (1980).

114. *Id.* § 1.1001-2(a)(1) (emphasis added).

115. *Id.* § 1.1001-2(a)(2) (emphasis added).

116. See *supra* notes 97-100 and accompanying text.

117. See I.R.C. § 465 (1997).

118. Treas. Reg. § 1.752-1(d)(1) (1991).

[transferor's] obligation for the liability."¹¹⁹ The partnership regulations provide an exception where the transferor and transferee are related.¹²⁰

3. RE-ALLOCATE INCOME AND DEDUCTIONS AMONG RELATED
TAXPAYERS: §§ 367(d) AND 482

If the service is legitimately preoccupied with transfers of over-encumbered property between related parties, then perhaps Congress should enact a look-back provision like those found in sections 367(d) and 482 of the Code.¹²¹ These sections respect transfers between related parties unless the Secretary determines that a re-allocation of income and/or deduction is necessary to prevent the evasion of taxes or to clearly reflect the income of both the related transferor and transferee.¹²² This approach seems most equitable. It would embrace the arm's-length approach to the transfer of recourse liabilities espoused in *Professional Equities* and address the related-party concerns raised in *Owen* with the benefit of hindsight in lieu of overbroad presumptions.

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119. *Id.* § 1.752-1(d)(2).

120. If the disposition of encumbered property is between a partner and the partnership, the liability is deemed transferred "to the extent that the amount of the liability does not exceed the fair market value" at the time of disposition. *Id.* § 1.752-1(e). This provision was clearly designed to accord pass-through treatment to partners. Therefore, it would not apply to the situation in the Technical Advice Memorandum because corporate shareholders are not accorded the same treatment in determining the basis for their shares.

121. I.R.C. §§ 367(d), 482 (1997).

122. *Id.*

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