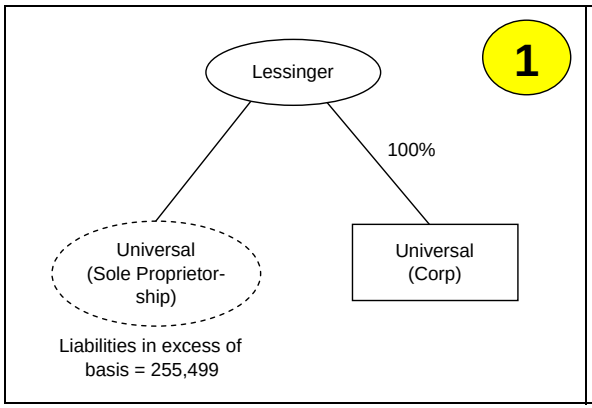
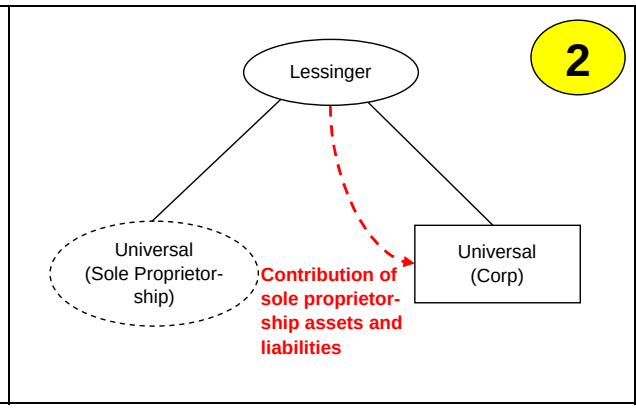
Lessinger v. Commissioner
872 F.2d 519 (2d Cir. 1989)

357(c) & Basis in Taxpayer's Own Note

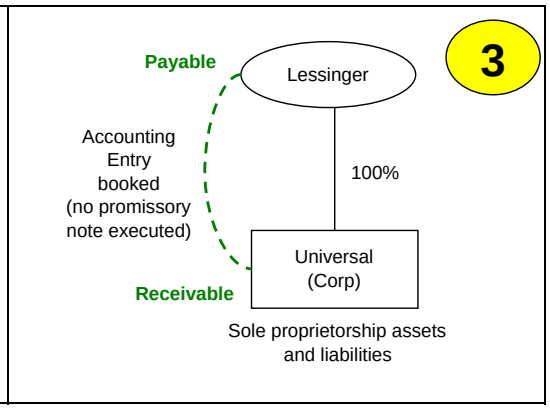
Initial Structure



Contributions



Ending Point



Excerpt from the case:

[Lessinger] transferred the assets and liabilities of a proprietorship he operated to a corporation he owned for reasons entirely unrelated to tax planning. It is clear that he was oblivious to the ramifications of his actions in terms of his tax liability. Prior to the consolidation, the proprietorship had a negative net worth. . . .

[Lessinger] operated a proprietorship under the name "Universal Screw and Bolt Co." for over twenty-five years prior to 1977. Since 1962 he was also the sole shareholder and chief executive officer of Universal Screw & Bolt Co., Inc. . . . In 1976, the [lender] that had provided working capital to the proprietorship refused to continue lending funds to it as a noncorporate entity . . . . [Lessinger] instructed the individual who was his attorney and accountant to do whatever was necessary to make the proprietorship a corporation. The Universal proprietorship was then consolidated into the Universal corporation in 1977. The Tax Court found that [Lessinger] was not informed of the details of the transaction.

The consolidation of the proprietorship into the corporation was conducted in a most casual manner . . . . [Lessinger's] principal argument, broadly stated, is that section 357 is inapplicable to him because in neither an accounting nor an economic sense did he realize a gain. He "merely exchanged creditors" from trade creditors to Universal, and his gain, therefore, was a "phantom" which Congress did not intend to tax.

The Tax Court opinion concludes that "[e]ven if [Lessinger] had executed a note, it would have a zero basis in the hands of the corporation." . . . . In Alderman, the Tax Court disregarded the taxpayers' personal promissory note to their corporation because: "[t]he Aldermans incurred no cost in making the note, so its basis to them was zero. The basis to the corporation was the same as in the hands of the transferor, i.e., zero. Consequently, the application of section 357(c) is undisturbed by the creation and transfer of the personal note to the corporation."

"Basis," as used in tax law, refers to assets, not liabilities. . . . Liabilities by definition have no "basis" in tax law generally or in section 1012 terms specifically. The concept of "basis" prevents double taxation of income by identifying amounts that have already been taxed or are exempt from tax. . . . The taxpayer could, of course, have no "basis" in his own promise to pay the corporation $255,000, because that item is a liability for him. . . . Consideration of "adjusted basis" in section 357(c) therefore normally does not require determining whether the section refers to the "adjusted basis" in the hands of the transferor-shareholder or the transferee-corporation, because the basis does not change. But here, the "basis" in the hands of the corporation should be the face amount of the taxpayer's obligation. We now hold that in the situation presented here, where the transferor undertakes genuine personal liability to the transferee, "adjusted basis" in section 357(c) refers to the transferee's basis in the obligation, which is its face amount.

. . . Lessinger could have achieved incorporation without taxation under the Commissioner's theory by borrowing $260,000 cash, transferring the cash to the corporation (or paying some of the trade accounts payable personally), and later causing the corporation to buy his promissory note from the lender (or pay it off in consideration of his new promise to pay the corporation). If taxpayers who transfer liabilities exceeding assets to controlled corporations are willing to undertake genuine personal liability for the excess, we see no reason to require recognition of a gain, and we do not believe that Congress intended for any gain to be recognized.