[Peracchi] needed to contribute additional capital to his closely-held corporation (NAC) to comply with Nevada's minimum premium-to-asset ratio for insurance companies. Peracchi contributed two parcels of real estate. The parcels were encumbered with liabilities which together exceeded Peracchi's total basis in the properties by more than half a million dollars. . . . [U]nder section 357(c), contributing property with liabilities in excess of basis can trigger immediate recognition of gain in the amount of the excess. . . . [I]t seems that section 357(c) was enacted to eliminate the possibility of negative basis. . . . Section 357(c) prevents negative basis by forcing a shareholder to recognize gain to the extent liabilities exceed basis. Thus, if a shareholder contributes a building with a basis of $50 and liabilities of $90, he does not receive stock with a basis of minus $40. Instead, he takes a basis of zero and must recognize a $40 gain.

. . . . Section 1012 provides that "[t]he basis of property shall be the cost of such property. . . ." But "cost" is nowhere defined. What does it cost Peracchi to write the note and contribute it to his corporation? The IRS argues tersely that the "taxpayers in the instant case incurred no cost in issuing their own note to NAC, so their basis in the note was zero." . . . See Alderman v. Commissioner, 55 T.C. 662, 665 (1971); Rev. Rul. 68-629. . . . Peracchi's obligation on the note . . . represents a new and substantial increase in Peracchi's investment in the corporation. The Code seems to recognize that economic exposure of the shareholder is the ultimate measuring rod of a shareholder's investment. . . .

. . . . Peracchi could have borrowed $1 million from a bank and contributed the cash to NAC along with the properties. Because cash has a basis equal to face value, Peracchi would not have faced any section 357(c) gain. NAC could then have purchased the note from the bank for $1 million which, assuming the bank's original assessment of Peracchi's creditworthiness was accurate, would be the fair market value of the note. In the end the corporation would hold a million dollar note from Peracchi--just like it does now--and Peracchi would face no section 357(c) gain. The only economic difference between the transaction just described and the transaction Peracchi actually engaged in is the additional costs that would accompany getting a loan from the bank.

. . . . What would happen if the note had a zero basis? The IRS points out that the basis of the note in the hands of the corporation is the same as it was in the hands of the taxpayer. Accordingly, if the note has a zero basis for Peracchi, so too for NAC. . . . But what happens if NAC--perhaps facing the threat of an involuntary petition for bankruptcy--turns around and sells Peracchi's note to a third party for its fair market value? According to the IRS's theory, NAC would take a carryover basis of zero in the note and would have to recognize $1,060,000 in phantom gain on the subsequent exchange, even though the note did not appreciate in value one bit. That can't be the right result. . . . Accordingly, we hold that Peracchi has a basis of $1,060,000 in the note he wrote to NAC. The aggregate basis exceeds the liabilities of the properties transferred to NAC under section 351, and Peracchi need not recognize any section 357(c) gain.