Toward a Theory of the Corporate Tax Base: The Effect of a Corporate Distribution of Encumbered Property to Shareholders

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I. INTRODUCTION

Since the beginning of the modern federal income tax, corporations have been treated as separate taxable entities and their income as the proper subject of tax.¹ Values transferred to shareholders by corporations are also taxed as income to shareholders.² Until the enactment of the Tax Reform Act of 1986, however, the impact of this “double tax” treatment has been significantly lessened by limitations on the recognition of corporate income. In many circumstances, asset appreciation was never taxed at the corporate level. In general, gain could be avoided with respect to values not derived in the day-to-day business of the corporation which were withdrawn by the shareholders in an extraordinary transaction.³ This treatment reflected what was known as the General

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¹ Pub. L. No. 63-16, § 2, 38 Stat. 114 (1913). Both bases had also been subject to the income tax to fund the Civil War enacted in 1864, c. 172, 13 Stat. 218, and both bases were taxed in the 1894 Income Tax Act, 28 Stat. 509, held unconstitutional in Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895).

² IRC §§ 301, 331, and 356.

³ Prior to the 1986 Act, Pub. L. No. 99-514, § 311, 100 Stat. 2085 (1986) (applicable to transfers out of going corporations), and §§ 336, 337, and 338 (applicable to transfers out of liquidating or deemed to be liquidating corporations) provided for nonrecognition of appreciation on corporate assets. Although no statute explicitly so provided, it appears that generally a transfer of corporate assets to appropriate parties in a corporate reorganization described in § 368 also would not have resulted in corporate gain: Technical Corrections Act of 1985: Hearing on S. 814 before the Senate Committee on Finance, 99th Cong., 1st Sess. 37, 50 (1985) (statement of Martin D. Ginsburg). Cf. Reg. § 1.311-2(a)(2).

Certain provisions of subchapter C suggested that the appropriate tax base was only the operating income of the corporate entity, and that appreciation in capital values should be excluded. Prior § 337, for instance, excluded from recognition on a sale prior to liquidation all but those values related to the sale of inventory in the ordinary course and certain values related to the sale or exchange of installment obligations. Other provisions suggested that the appropriate tax base should be defined in terms of the nature of the transactions undertaken,
Utilities doctrine, so named because of the association of the idea of unrecognized corporate gain on the distribution of appreciated assets with a Supreme Court case of that name.4

The Tax Reform Act of 1986 answered frequent calls5 for "repeal" of the General Utilities doctrine by eliminating most provisions under which

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4 General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). The opinion itself decided far less than the ideas associated with it, since it limited its discussion to whether a dividend declared in a cash amount, but also declared at the outset to be payable in the stock of another company at a stated price per share, should be deemed, once satisfied, to be a distribution in kind made to satisfy a dividend declared in cash. The distribution was held not to be a distribution in kind made to discharge indebtedness and, consequently, was not treated as a sale of assets, which would have triggered taxable gain.

The broader theory of nonrecognition which has come to be associated with General Utilities was in fact an early part of the tax law. See Reg. 45, art. 547, T.D. 2831, 21 Treas. Dec. Int. Rev. 291 (1919) ("no gain or loss is realized by a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition"); Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., The Reform and Simplification of the Taxation of Corporations 32 (Comm. Print 1983); Lewis, A Proposed New Treatment for Corporate Distributions and Sales in Liquidation, in 3 Staff of House Comm. on Ways and Means, 86th Cong., 1st Sess., Tax Revision Compendium of Papers on Broadening the Tax Base (1959); Blum, Taxing Transfers of Incorporated Businesses: A Proposal for Improvement, 52 Taxes 516, 519-20 (1974); Wolfman, Corporate Distributions of Appreciated Property: The Case for Repeal of the General Utilities Doctrine, 22 San Diego L. Rev. 81 (1985); but see Beck, Distributions in Kind in Corporate Liquidations: A Defense of General Utilities, 38 Tax Law. 663 (1985).

Several earlier legislative initiatives had produced considerable erosion in the doctrine. For instance, the 1969 and 1984 amendments to § 311 broadened the circumstances in which a corporation recognized gain on the current distribution of appreciated assets. For a history of certain of these provisions, see generally Porter, Redemptions of Stock with Appreciated Property: Section 311(d), 24 Tax Law. 63 (1970); Steines, Taxation of Corporate Distributions—Before and After TEFRA, 68 Iowa L. Rev. 937 (1983); Watts, Recognition of Gain or Loss to a Corporation on a Distribution of Property in Exchange for its own Stock, 22 Tax Law. 161 (1968).
corporations previously escaped taxation. The rules generally ensure that values accumulating within a corporation are included in the tax base by requiring a corporation to recognize gain on any distribution of assets to shareholders. These provisions reflect a renewed commitment to the double tax scheme in which income generated within a corporation is taxed when earned by the corporation, and is taxed again when received by the shareholders.

Although the concept is straightforward, implementation is not. First, in a liquidation, the value of a corporation's assets (and thus the measure of its tax base) must be determined without a transaction in which consideration is paid. Although the income tax law in several situations imposes a tax without the benefit of a market transaction to establish value, it does not do so on a systematic basis. Second, because a liquidation is a transaction between a corporation and its shareholders, it is not entirely comparable to a transaction between an unrelated buyer and seller.

This article focuses on § 336(b), which deals with a situation in which these two characteristics of corporate liquidations create particular problems: a liquidation in which the corporation is relieved of a debt, and the burden of that debt is borne by the shareholder or the assets received by the shareholder. The section presumes that property distributed is worth at least as much as the debt assumed by shareholders in connection with its distribution, and requires a corporation to recognize gain to the extent the actual fair market value of its property is exceeded by related debt.

As will be discussed in greater detail, the premise of the statute is that liabilities assumed by shareholders in a corporate liquidation should be treated in the same way as liabilities assumed by unrelated third parties in ordinary sale transactions. This article asserts that this premise is unfounded and that the assumption of liabilities should be analogized to a

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6 Section 631(a) of the 1986 Act amended IRC § 336(a) to require that gain and loss be recognized on complete liquidations; § 631(g) of the Act amended IRC § 311 to require gain (but not loss) on current distributions of appreciated property; § 1804(g)(1) of the Act amended IRC § 361 to require gain (but not loss) on certain distributions of appreciated property made in connection with reorganizations. The relevant provisions of IRC § 361 were further amended by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1009.

7 E.g., IRC § § 751 and 1092.

8 For example, if a corporation has an asset with a basis of $50, which was worth $30 and was encumbered by a liability of $100, distributes the asset to a shareholder who assumed the debt, the corporation would have $100 of gain. A similar result will obtain in current distributions under § 311(b)(2), and also in boot distributions in a corporate reorganization under § 361(c)(2)(C). The analysis of the corporate consequences of distributions involving excess liabilities should be the same for current and boot distributions as that outlined in the text for liquidation distributions, at least in those cases in which it is clear that the shareholder will be called on to pay the debt. See notes 42 and 67 for discussion of possible differences in shareholder treatment.
capital contribution. The statutory treatment implies an unnecessarily strong notion of the values to be included in the corporate tax base and thus subject to double taxation. A strong argument can be made that such assumptions, like more straightforward capital contributions from shareholders, should be excluded. This follows from the premise, set forth elsewhere and adopted here, that the corporate tax base should include only those values that are new to both the corporation and its shareholders.

To provide a better understanding of the genesis of this flaw, and to demonstrate the conceptual myopia underlying it, the first part of this article outlines the basic approach to corporate liquidations and the traditional treatment of liabilities in simple cases. It then examines the effect of liabilities in excess of the fair market value of encumbered property, first by considering the way in which such liabilities are accounted for in sales between unrelated parties and then by considering whether this approach is sensible in transactions between corporations and their shareholders given the treatment of capital contributions. The second part of this article considers whether capital contribution treatment should be denied to assumptions of excess liabilities. The third part then considers the ramifications of this approach on the tax treatment of shareholders. The fourth part attempts to answer some practical questions about the application of § 336(b) should the approach advocated herein be rejected. The fifth part asserts that this study of § 336(b) demonstrates the need for a coherent theory of the proper corporate tax base in the wake of the repeal of General Utilities.

II. THE BASIC APPROACH TO GAIN ON CORPORATE LIQUIDATION

A. Unencumbered Assets

Imagine a liquidating corporation whose only asset is a plot of land, held with a basis of $30,000. It has no outstanding liabilities.

Under prior law, any disparity between the fair market value of the land and the corporation’s basis on a liquidation was ignored and no gain was recognized. Despite the inconsistency of this rule with the double

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9 The shareholder can in fact avoid the impact of § 336 by incurring the debt and contributing the proceeds to the corporation. If the shareholder in note 8 had the borrowing power and enough time, the shareholder could have borrowed $100 and contributed it to the corporation. Unless the transaction were rearranged, the corporation would have only $30 in gain. This anomaly is discussed more thoroughly in the text below at note 41.


11 That is, it has no outstanding liabilities beyond the federal income tax liability that may result from the liquidation.

12 IRC § 336 (before amendment in 1986). In the appropriate case involving other kinds of property, a limited amount of gain might have been recognized by a liquidating corporation as
tax scheme, the failure to tax the gain was not totally without a conceptual foundation. The tax-free withdrawal of assets from the corporation stemmed from an old, now generally abandoned, notion that there could be no income for income tax purposes unless the corporation received something in exchange.\textsuperscript{13} As the corporation receives nothing in exchange on a liquidation, nothing has been "realized" in this traditional sense.\textsuperscript{14}

After the 1986 revisions, however, gain on the distribution of appreciated assets in liquidation is taxed even in the absence of a receipt by the corporation. If these values are to be taxed at all, they must be taxed on distribution, the last time they can be included in the corporate tax base.

\textsuperscript{13} But see Block, Liquidations Before and After Repeal of General Utilities, 21 Harv. J. Legis. 307, 313-14 (1984) (arguing that failure to tax corporate distributions was a policy decision without any conceptual foundation); Blum, note 5, at 521 (arguing to same effect). Cf. North, Corporate Distributions of Appreciated Property—A Comment on Policy, 36 Neb. L. Rev. 528, 535 n.40 (1957) (assuming the question is bundled up in the "severance" idea and arguing that if there is gain when a corporation satisfies obligation to distribute cash with appreciated property, a straight distribution of appreciated property should also produce gain).


\textsuperscript{14} In many of the situations considered here, the distributing corporation may receive its own stock, and might be seen as receiving something in exchange for the property distributed. Nevertheless, there seems to have been no effort made to view such transactions as involving "receipts" on the part of a liquidating corporation. See Farmers Union Corp. v. Commissioner, 19 T.C.M. (CCH) 941 (1960), aff'd, 300 F.2d 197 (9th Cir. 1962) (under the 1939 Code, the taxpayer corporation sought characterization of the transfer of its business as a sale in order to recognize its losses, but the court held instead that the transaction was a partial liquidation). But cf. Tennessee Carolina Transp., Inc. v. Commissioner, 65 T.C. 440 (1975), aff'd, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979).

Some authorities had indicated that the stock received by a corporation in a redemption could be an amount realized, but this approach seems only rarely to have been the rationale used by the court. See Manning, The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries, 39 Tax L. Rev. 159, 178-80 (1984). See generally Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 149 (Comm. Print 1984) ("The theory of section 311 [which previously had triggered gain only in selective circumstances and as changed would trigger gain in most others] is that the distribution of appreciated property to a shareholder is a realization event and, therefore, an appropriate time to impose tax liability. There is no reason why this rule should not apply to nonliquidating transactions between related corporations.").

Furthermore, the approach taken by § 336 suggests that the corporation is still viewed as not having received anything. The section focuses on the fair market value of the assets given up, rather than on the fair market value of the stock received.
The conceptual gap that led to the tradition of nonrecognition is closed by the fiction of a sale. The statute requires the corporation to compute the gain “as if such property were sold to the distributee at its fair market value.”\textsuperscript{15} Despite the apparent familiarity of the device,\textsuperscript{16} little attention has been given to implementing the fiction of a sale. At a minimum, however, a reference to a sale must mean that no less gain (and, one would hope, no more gain) will be recognized than would have been if the corporation had received bargained-for consideration in a transaction with an unrelated party.\textsuperscript{17}

If there had been a purchase for consideration, we would have compared the amount paid with the corporation’s basis to determine the gain recognized by the corporation. In a liquidation, the computation of gain with respect to the unencumbered land requires a determination of its fair market value. Although this determination may be mechanically difficult because there is no buyer actually paying consideration, it is conceptually straightforward. In the above example, if this value is $50,000, and the corporation’s basis is $30,000, the corporation has $20,000 of gain.

\textbf{B. Assets Encumbered by Liabilities Less Than Fair Market Value}

Now suppose the parcel had been pledged by the corporation to secure a $40,000 loan and this debt, bearing market interest,\textsuperscript{18} remains out-

\textsuperscript{15} IRC § 336(a).

\textsuperscript{16} The fiction of a sale is a common device used by the tax law to trigger income in the absence of a traditional realization event. It had subchapter C counterparts under prior law in §§ 311(c) and (d), which taxed a corporation on the value of assets distributed by it in various circumstances. Neither of these provisions, however, provided for recognition of losses, and thus, did not ascertain the taxpayer’s overall economic position.

\textsuperscript{17} Others have assumed that the comparison with a sale transaction alone provides enough guidance in defining the corporate tax base on liquidation. E.g., B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 11.06 (5th ed. 1987). As this article will show, it is questionable whether this result can be achieved under the statute as enacted.

\textsuperscript{18} If the debt does not bear market interest as determined at the time of the liquidation, the corporation will experience an element of economic gain or loss distinct from the gain or loss on its assets. If the rate is below that at which the corporation could borrow at the time of the liquidation, it will have an economic gain because the corporation’s creditor would be willing to take an amount less than the face value of the debt in satisfaction of the debt, so that he will be able to reloan the funds at the higher interest rate. Similarly, if the debt were assumable, the buyer would be willing to pay more for the assets than he otherwise would because his financing costs will be lower than if he had to incur new debt at the higher market rates. Because a buyer of the corporation’s assets would increase the consideration he pays to take this discount into account, an argument can be made that this element of gain should be taken into income by the corporation at the time of the liquidation. A discussion of whether, either under § 1274 or under the terms of § 336 itself, this amount will be included in corporate income is beyond the scope of this article. Cf. R.M. Smith, Inc. v. Commissioner, 591 F.2d 248 (3d Cir. 1979), aff’d 69 T.C. 317 (1977) (note given as consideration in prior law § 334(b)(2) purchase of stock valued at face, not fair market, for basis computation purposes).
standing at the time of the liquidation. Assume, further, that the corporation's creditor (who probably has a right to object to any transfer of the property) has agreed that the debt will remain outstanding according to its original terms after the distribution to shareholders, with a substitution of recourse against shareholders for recourse against the corporation.

Had there been an actual sale, we would have compared the amount received with the corporation's basis in the parcel to determine corporate gain. Because a buyer would take into account the burden of the liability in determining the amount to pay for the asset, he would pay only $10,000 in cash. We would nevertheless (for reasons explored more completely below) treat the seller as having received not only the $10,000 of cash, but also $40,000 as a result of his having been relieved of the liability. In a liquidation, our intuition will ordinarily produce the same result even in the absence of a buyer.

It is not entirely clear how to reconcile our intuition with the statute. The statute directs that gain be determined "as if such property were sold to the distributee at its fair market value." What is the "fair market value" of property subject to a liability? Ordinarily, within subchapter C and under the tax law generally, the fair market value of an asset is determined without regard to liabilities. Thus, the corporation is deemed to have received the full value of the property, $50,000, unreduced by liabilities.

But if this had been a sale, we would have included a liability assumed as if it were consideration actually received by the seller. Is a liability assumed by a shareholder an additional amount deemed received by the corporation? Obviously not, for the corporation never enjoyed any value above and beyond the actual value of the asset or, at most, the amount of the liability. Any confusion results from the fact that in a distribution, the amount realized is determined using the fair market value of the property without reference to any amount actually paid by a purchaser. There would be no similar possibility of double counting in an actual

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19 IRC § 336(a).
20 E.g., Crane v. Commissioner, 331 U.S. 1, 7 (1947). The most obvious statutory example is § 301(b)(1), which provides that the amount of the distribution is the fair market value of the property, and § 301(b)(2) which directs that this amount should be reduced by the amount of any liability assumed or taken subject to.
21 Crane v. Commissioner, 331 U.S. 1 (1947). Indeed, in some cases, the assumption will transform the transaction into a sale. See, e.g., Diedrich v. Commissioner, 457 U.S. 191, 201 (1982) (holding that a donor must treat an agreement to pay the gift tax liability arising from the transaction as a partial payment for the property and recognize gain as a result thereof); Yarbro v. Commissioner, 737 F.2d 479 (5th Cir. 1984), cert. denied, 469 U.S. 1189 (1985) (sale rather than abandonment where property encumbered); Colonnade Condominium v. Commissioner, 91 T.C. 793 (1988) (sale to shareholders of a partnership interest rather than formation of a new partnership); LaRue v. Commissioner, 90 T.C. 465 (1988) (sale rather than abandonment of partnership interest).
sale, since the purchaser will have reduced the amount of other consideration he is willing to pay by the amount of the liabilities he assumes.

The assumption of the liability from the corporation must be treated as having been taken into account on the deemed sale "at fair market value." In other words, in applying § 336, where there is a liability not exceeding the fair market value of the property, the statute must be read either as if liabilities are to be totally ignored, or as if the fair market value of the property distributed is reduced by the amount of the liability. Given the statute's technique for dealing with excess liabilities and the use of "fair market value" elsewhere in subchapter C, the former analysis, ignoring liabilities, seems more appropriate.

C. Assets Subject to Recourse Liabilities in Excess of Fair Market Value

What if the liability were $65,000, exceeding the fair market value of the plot it encumbered? The preexisting relationship between the shareholder and the corporation can lead to circumstances in which a shareholder might agree to pay a liquidating corporation's liabilities without receiving assets adequate to cover those liabilities. In these circum-

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22 Ignoring the liabilities in determining the measure of corporate gain is the same as treating them as capital contributions. Corporations receive contributions to capital without taking these amounts into income. See note 63 and accompanying text.

23 Some specific support for this reading of the statute can be found in the last sentence of § 311(d)(1) of the prior law. Section 311(d) generally required that corporate gain be recognized when certain corporate distributions were made. Sections 311(c) and 311(b) required that corporate gain be recognized when liabilities in connection with distributed assets exceeded the basis of those assets, and when inventory accounted for under a LIFO method was distributed. The last sentence of § 311(d), as first included in § 905(a) of Pub. L. No. 91-172, 83 Stat. 487, 713, provided: "Subsections (b) and (c) shall not apply to any distribution to which this subsection applies." As amended by § 54(a)(1) of The Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 1175, this last sentence reads: "This subsection shall be applied after the application of subsections (b) and (c)." Presumably, this sentence was aimed at avoiding duplicate gain; as first written, it did so, but might have allowed insufficient gain in some cases. As amended, it would not have avoided this duplicate gain unless some adjustment was made to the corporation's basis of distributed property as a result of gain recognized under subsection (b) or (c) before the application of subsection (d). The Joint Committee Staff appears to have thought such an adjustment intended. Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 150-52 (Comm. Print 1984).

This reading is also suggested in the technique adopted in the statute for handling excess liabilities, to the extent that the statute directs that fair market value of the property be deemed to be the face amount of the liability, rather than directing that the face amount be deemed the amount realized by the corporation.

24 One can imagine a number of situations where the shareholder would agree to assume such debt. A corporation could distribute property subject to liabilities for which the shareholder is already secondarily liable as a guarantor or otherwise. Or shareholders could accept property subject to liabilities, like those for certain torts, that cannot be avoided by corporations or their shareholders, despite the presence of limited liability. A corporation might also distribute property with excess liabilities to a shareholder when the exposure of the share-
stances, the fiction of a sale to a third party is inapt, since the transaction is not likely to occur if parties have had no other dealings with each other. 25

Section 336(b) provides: "If any property distributed in the liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution . . . the fair market value of such property shall be treated as not less than the amount of such liability." 26 The corporation will recognize the difference between the face amount of the debt and its basis in the property as gain on the fictional sale. Here, that gain will be $65,000 less $30,000, or $35,000.

Should the corporation recognize the portion of gain attributable to the excess debt when the land is worth less than the debt encumbering it? Ordinarily, the receipt of loan proceeds is taken into account as income only on a later assumption of a debt or a transfer of property subject to a debt. Although the debtor was not taxed on receipt of the loan proceeds, he is credited as if he had been. 27 Usually, this credit is finally "paid for" when the debtor repays the loan with previously taxed dollars for which

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25 Such a transaction might occur if the transferee has a contrary view about the fair market value of the property, but, in that case, the tax law might well accept his value as the fair market value. In a transfer to a third party, a presumption that the fair market value is no less than the amount of the liability, like that imposed by §§ 7701(g) and 336(b), is a reasonable administrative approach to the problem of proving actual value.

26 A corporation transferring a similarly encumbered asset in a current distribution or as boot in a reorganization will recognize similar gain. See § 311(b)(2) which provides: "Rules similar to the rules of section 336(b) shall apply," and § 361(c)(2)(C) which contains essentially the same language as § 336(b). These provisions seem to be somewhat redundant given the interpretation of § 7701(g) offered in the General Explanation of the 1984 Act. Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 239-40 (Comm. Print 1984). See note 46. However, the provisions of the new statute are broader in scope: while § 7701(g), by its terms, only applies to nonrecourse debt, new §§ 336, 311, and 361 invoke the presumption regarding fair market value whenever the debt, recourse or nonrecourse, is secured by distributed property or assumed by distributee shareholders.

27 If loan proceeds are used to purchase an asset, the amount spent is reflected in the debtor's basis just as if he had used his own after-tax funds. If they are used to pay ordinary business expenses, deductions are available. The text ignores the possibility that the loan pro-
no deduction is allowed at the time of payment. If the debtor subsequently does not have to repay the debt, these proceeds must be taken into account.28

1. Accounting for Liabilities in Transactions With Third Parties

The method most often used for taking the prior proceeds into account is the inclusion of the amount of debt relief in the amount realized in exchange for the encumbered asset.29 At the time of the assumption, a significant event has occurred in connection with the debt (and, although in some cases almost coincidentally, in connection with the property). Because the transferring debtor will no longer pay off the debt or at least is less likely to repay the debt, it is a convenient time to charge the debtor with this deferred income. The assumption is not the primary event resulting in the tax, but merely the time at which the consequences of the earlier event are imposed.

There are other possibilities. The taxable event could instead be the time of the extension of the loan. This has never seemed appropriate, if only because of the debtor's inability to pay. A more logical time is the time at which the debt is actually paid by the transferee (or forgiven by the creditor), but this occurrence may be beyond the debtor's knowledge. Thus, as a practical matter, the transfer of the property and the accompanying assumption is the best alternative. Although the time of the assumption is the time income will be recognized, facts pertaining to an earlier event may also be relevant in determining the effect of the assumption.30

29 The confusion created by this oversimplified view is most obvious in the strained efforts in the case law and commentary to find an "economic benefit" to the debtor-transferor at the time of the transfer. See, e.g., Crane v. Commissioner, 331 U.S. 1 (1947); Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981), rev'd 461 U.S. 300 (1983); Teitelbaum v. Commissioner, 346 F.2d 266 (7th Cir. 1965); Commissioner v. Fortee Properties, Inc., 211 F.2d 915 (2d Cir. 1954), cert. denied, 348 U.S. 826 (1954); Dillingham v. United States, 81-2 USTC ¶ 9601 (W.D. Okla., 1981); Dalebout, Stewart & Streulig, The Relief of Liabilities under Section 752(b) When a Distributee Partner Receives Payments under Sec. 736, 17 Tax Adviser 166, 170 (1986) (lamenting the rule that requires a retiring partner to treat his liability with respect to partnership debts as if totally relieved despite state law likelihood of continued liability).
30 The actual benefit to the taxpayer at the time of the assumption is largely irrelevant. Taxpayers in the past have unsuccessfully asserted that they should not be charged with this fictional amount realized because the assumption was not worth the nominal amount of the debt where, for example, the assumption was made without a release of the transferring debtor's liability on the debt. E.g., Evangelista v. Commissioner, 629 F.2d 1218 (7th Cir. 1980); Malone v. United States, 326 F. Supp. 106 (N.D. Miss. 1971), aff'd per curiam, 455 F.2d 502 (5th Cir. 1972); Rosen v. Commissioner, 62 T.C. 11 (1974), aff'd without opinion, 515 F.2d 507 (3d Cir. 1975) (requiring a transferor to recognize § 357(c) gain even though he remained personally liable on the debt assumed by his wholly owned corporation). The law
Because the transfer of the property is only a convenient time for the taxation of the debt proceeds, the consequences of the assumption could be determined under several alternative approaches. Under one alternative, the entire assumption could be treated as an amount received in exchange for the property and thus could give rise to capital gain. This is the result favored by the Supreme Court with respect to nonrecourse debt,\textsuperscript{31} and has ordinarily been the result with respect to recourse debt as well.\textsuperscript{32} This approach presumes that the property is worth as much as the debt whenever the debt exceeds the fair market value of the property.\textsuperscript{33} The opposite presumption that the property is in fact worthless could be made which would result in the realization of something in the nature of discharge of indebtedness for the entire amount. This treatment is rarely advocated, but, as a purely technical matter, is as plausible as the first alternative.\textsuperscript{34} Under a third alternative, only that portion of the assumption supported by the fair market value of the property would be treated as received in exchange for the property, and the rest treated as something in the nature of discharge of indebtedness.\textsuperscript{35}

2. Accounting for Liabilities in the Context of Corporate Distributions

Outside the corporate context, this last alternative is technically the appropriate result when recourse debt is involved.\textsuperscript{36} But, in the corpo-

\textsuperscript{33} Actually, this approach need only involve assumptions that the property was once worth more than its current value, that a creditor had extended a loan on the basis of that value, and that the transferor should be taxed as if a completed sale had occurred at that time. Note, Mortgagee's Gain on Mortgaging Property for More Than Cost Without Personal Liability, 6 Tax L. Rev. 319 (1951).
\textsuperscript{34} It is only as plausible in those cases in which the fair market value of the asset is unequivocally below the value of the note. The first rule probably makes more sense as an administrative matter, for it avoids difficult questions about the actual fair market value of the asset.
\textsuperscript{35} This was the alternative urged in the Brief Amicus Curiae of Wayne Barnett in Commissioner v. Tufts, 461 U.S. 300 (1989).
\textsuperscript{36} See Reg. § 1.1001-2(a)(2); see also Cunningham, note 32, at 603-05, 614. With respect to nonrecourse debt that was supported by property values at the time the debt was extended, the
rate context, the choice among these alternatives is finessed by the statutory language imposing the fiction of a sale and directing that the first alternative be followed.\textsuperscript{37} Even with respect to recourse debt assumed by a shareholder in excess of the fair market value of the property received, the corporation relieved of excess liabilities will have only capital gain and no discharge of indebtedness income.

But should the corporation have income when a shareholder takes property and assumes a recourse debt? The statutory reference to the consequences of a sale fails to acknowledge that transactions between the corporation and its shareholders may have consequences different from a transaction between an unrelated buyer and seller.

The traditional treatment of liability assumptions in connection with sales treats the assumption as if it were a form of consideration actually paid by the buyer. This view hypothesizes values running in two directions: both from the transferor and to the transferor. The transferor gives up the physical property and he is deemed benefited to the extent that the original loan proceeds remain outstanding because the transferee has promised to pay this amount to his creditor on his behalf. In the simple case outside the corporate context, when a debtor transfers property to an unrelated person subject to a purchase money mortgage, it is relatively easy to view the transferee only in his role as purchaser. It follows that the amount of the assumption can be treated as the equivalent of consideration paid by the purchaser.\textsuperscript{38}

\textit{Tulis} approach is not entirely illogical. The debt can be seen as a put granted by the lender on the property. See Lurie, New Ghosts for Old—Crane Footnote 37 Is Dead (Or Is it?), 2 Am. J. Tax Policy 89 (1983).

\textsuperscript{37} Ironically, failing to bifurcate the gain makes even less sense on a corporate liquidation. Outside this context, the rule treating property as worth no less than liabilities associated with it avoids difficult valuation problems. On a liquidation, the fair market value of virtually all property must be ascertained without reference to a market transaction.

\textsuperscript{38} The possibility that the transferor has engaged in a nontaxable transaction is ignored. If the parties were related, the transferee could be treated as making a gift to the transferor when he makes his promise to pay the transferor’s creditor. However, the possibility of this characterization of such a transaction seems to have been rejected in the Supreme Court’s decision in Diedrich v. Commissioner, 457 U.S. 191 (1982). In the \textit{Diedrich} case, the donors had made the payment of the tax by the donees a condition of the gift, and the donees had in fact paid the gift tax in accordance with this condition. The Court rejected the taxpayer’s contention that the donors had simply made a “net gift” of the difference between the fair market value of the transferred property and the gift taxes paid by the donees.

There are surprisingly few cases decided on other fact patterns, and a number of these involve rather blatant attempts to secure value for the donor by incurring liabilities shortly before a transfer. E.g., Estate of Levine v. Commissioner, 634 F.2d 12 (2d Cir. 1980); Johnson v. Commissioner, 59 T.C. 791 (1973), aff’d, 495 F.2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974); First Nat’l Indus., Inc. v. Commissioner, 404 F.2d 1182 (6th Cir. 1968), cert. denied, 394 U.S. 1014; Magnolia Dev. Corp. v. Commissioner, 19 T.C.M. (CCH) 934 (1960).

At least one decision, however, paid little attention either to the timing of the encumbrance or the presence of an actual cash benefit to the transferor. Ebben v. Commissioner, 783 F.2d 906, 911, 913 (9th Cir. 1986)(taxpayers contributed appreciated unimproved real property sub-
The provisions of § 336(b) seem to assume that this same analysis should apply with respect to transfers by liquidating corporations. But it is also possible to view the assumption as a capital contribution. Shareholder contributions to capital are not considered income to the corporation, and the corporation takes the property with a basis equal to the shareholder’s basis in the property. To the extent that the shareholder does so, the corporation will never be required to take the values into income.

The distribution of property subject to a liability, or any other assumption by a shareholder in connection with the receipt of property, involves nothing more than a shareholder making a promise to pay a third party on the corporation’s behalf. The same economic result could have been obtained if the shareholder had instead borrowed the funds and contributed them to the corporation, either at the time of the initial loan or at the time of the liquidation. There is a disparity, however, in the tax

to purchase money mortgage to charity). In several other decisions the importance of such facts is harder to establish. See, e.g., Evangelista v. Commissioner, 629 F.2d 1218 (7th Cir. 1980); Malone v. United States, 326 F. Supp. 106 (N.D. Miss. 1971), aff’d per curiam, 455 F.2d 502 (5th Cir. 1972); Oates v. United States, 69-2 USTC 9658 (N.D. Tex. 1969); Guest v. Commissioner, 77 T.C. 9 (1981), acq.

The extension of Diedrich to property encumbered with long-standing debt which did not give rise to untaxed consumption by the donor creates some tension with the general treatment of gifts of depreciated property. A donor is able to transfer to another the value that arose in his hands, to be taxed only to the donee, if ever. If the property has a basis that has been reduced below fair market value by depreciation deductions, the donor will have enjoyed an unwarranted tax benefit. The transfer of property subject to an unpaid debt involves a similar use of basis by the transferor. Is there any difference between the two cases? There may be. In the gift of property for which excess depreciation was enjoyed, the transferor is not keeping any of the value for which the transferee will pay the tax. The excess of fair market value over adjusted basis is no longer available to the donor. In the case involving an assumption, the donor may keep this value in the form of loan proceeds and the unpaid basis associated with the loan to enjoy in the future. Or he may have already spent the proceeds and used the unpaid basis to offset income.

A rule triggering gain by imposing exchange treatment prevents values enjoyed by one taxpayer from being taxed in the future to another. The Diedrich line of cases, if extended, seems best viewed as a limitation on the extent that gift treatment will be available. See text accompanying notes 49-63 for a discussion of such a limitation on the treatment of contributions to capital.

IRC § 118.
IRC § 362(a).

Basis is provided under § 362(a) in the case in which a controlling group of shareholders transfers property and receives stock in exchange. Section 362(a) also controls the basis of property received as a contribution to capital under § 118 from a shareholder without the receipt of stock. See Reg. §§ 1.118-1 and 1.362-1(a).

Basis in other transactions involving the issuance of stock is controlled by Reg. § 1.1032-1(d), which directs that the corporation’s basis should be equal to the cost under § 1012. Generally, this cost will be the fair market value, which will equal the shareholder’s basis plus gain recognized by the shareholder. See, e.g., MacCallum Gauge Co. v. Commissioner, 32 B.T.A. 544 (1935). See Kohl, The Identification Theory of Basis, 40 Tax L. Rev. 623, 642-50 (1985), for a discussion of cases in which the fair market value of property received does not equal the fair market value of the stock.
treatment of a borrowing followed by a contribution and its economic equivalent, an assumption of a liability on a distribution. Suppose a shareholder borrows $100, and contributes the funds to a corporation: The corporation has no income, but, after the corporation buys an asset with the $100, it will be able to deduct that amount as depreciation. If the corporation sells the asset for $30 after having fully depreciated it, it will have gain of $30. Similarly, if it distributes the asset to the shareholder, it will report a $30 gain.

Suppose, instead, that the corporation borrowed the $100 and acquired the asset. It distributes the asset to the shareholder, who assumes the liability. (The option of a sale to a third party is not available, since the asset is worth less than the liability.) Under current law, the corporation will have $100 of gain, rather than $30. Although the corporation and the shareholder are in the exact same economic position in both situations—the corporation has no asset traceable to the contribution, the shareholder has the asset and is liable for the $100 debt—the tax consequences are different.42

In mandating sale treatment, the drafters of the statute appear to have believed that it is inappropriate to view the assumption of an excess liability by a shareholder as a capital contribution. The drafters obviously thought the corporation should not be able to avoid tax on the proceeds of a loan it would never repay. Section 336(b) may have seemed merely the extension of the settled treatment of assumed liabilities to corporate liquidations.43 Although under prior law, liability relief enjoyed by a

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42 The shareholder will be in the same tax position if the distribution is a liquidating distribution, presumably, since the basis in stock awarded the shareholder for his contribution of borrowed funds in the first example will be the equivalent of the reduction in the amount realized by the liability assumed in the second. If the distribution is current, the same result is also possible, although not inevitable. Any disparity in the treatment of the shareholder would result from the fact that the amount of the assumption could be treated as additional basis in his stock rather than a reduction in the amount he realized in the distribution. See generally note 65.

43 Under former § 311(c), the assumption of an excess liability on a distribution of appreciated property triggered a limited amount of gain. Although the rules for computing this gain fell short of taxing the corporation as if it had received the full amount of the assumed debt in a sale of the distributed property, they were inconsistent with the view of the debt assumption as a contribution of capital.

The sparse legislative history of the prior law offers slight insight into the justification for rejection of that position. It indicates that § 308(c) (ultimately enacted as prior § 311(c)) was "concerned with another situation which has produced tax avoidance consequences under current law." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A91 (1954).

At the time the provision was included in the drafting of the 1954 Code, Congress was clearly concerned with the transfer of property subject to liabilities to corporations. Such transactions seemed too much like sales to the corporation, financed by a third party. If the corporation instead of the shareholder could repay the lender the amounts received by the shareholder, the shareholder could support personal consumption out of corporate funds without incurring a shareholder level tax. Apparently, the drafters believed that a similar evil existed with respect to transfers from a corporation. The concern must have been that by
corporation on a complete liquidation was not treated as consideration,\(^{44}\) this extension undoubtedly seemed to the drafters of the 1986 Code to be the logical consequence of the repeal of General Utilities. And although prior distribution rules had limited the gain to be recognized to the fair market value of the property distributed,\(^{45}\) case law has probably made receiving a loan equivalent to the full value of the asset immediately before a distribution to a shareholder, the corporation would escape the burden of repaying the loan with corporate after-tax values. See IRC § 357(c).

House Report No. 1337 indicates that the prototype of the provision was “expected [to operate so that the] appropriate tax will be imposed upon the distribution through correlation of section 308(c) [ultimately enacted as prior section 311(c)] and 301(a)[dealing generally as enacted, with the effects of distributions on shareholders].”

The report is ambiguous as to what the “appropriate” amount of tax is, and about which aspect of the House draft version of § 301(a) produces the “correlation.” The correlation intended may be that between the amount the shareholder takes as his basis and the amount of total gain recognized by the corporation or by the shareholder. To the extent that the shareholder receives unencumbered property, the full value of that property has at least been taken into income by the shareholder, if not by the corporation. But if the shareholder receives encumbered property, he will have basis in the property equal to the fair market value of the property unreduced by liabilities, and will only have taken the net value of the property into income. The corporation, presumably, will have long ago taken the amount equal to its basis in the property into income. Only with respect to the amount by which the corporation’s liabilities exceed its basis will there have been neither a shareholder level tax nor a corporate level tax to support the shareholder’s basis. Thus, this amount should be taxed to the corporation. This explanation, although plausible, assumes that on a distribution of corporate property, the full value of the distribution should be taxed once, and only once, and assumes an indifference to whether this tax is imposed at the corporate or shareholder level. These assumptions seem out of place given the rest of the dual tax structure, particularly the fact that in corporate distributions not involving liabilities, corporate basis (and thus previously recognized corporate gain with respect to distributed property) plays no part in determining the proper amount of shareholder gain on distributions.

\(^{44}\) Despite the fact that a liquidation in which shareholders assumed liabilities could have been taxed as a sale to the extent of the assumed liabilities (whether using the § 311(c) approach or some other approach, and whether applicable to all or only excess liabilities), it seems that no serious effort ever has been made to do so. (Note that § 357 does not address corporate liquidations.) The leading treatise merely notes that assumption of liabilities in liquidations is customary and that it is, therefore, sensible to view this aspect of a liquidation as being within the original intent of § 336. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 11.09 (5th ed. 1987). An earlier version of this treatise observed that to regard the assumption of liabilities generally as consideration would be inconsistent with the limitations imposed on such treatment under § 311(c) for liabilities in excess of basis. Id. at ¶ 11.69 and n. 253 (4th ed.).

The prior disparate treatment of liabilities in excess of basis in §§ 311 and 336 appears not to have been an oversight, but to have been a conscious decision on the part of the legislative drafters. In H.R. 8300, the effect on corporations of both current and liquidating distributions was dealt with in a single section, § 308. Subsection (a) included language essentially the same as that enacted in § 311; subsections (b) and (c) provided exceptions for LIFO inventory and for liabilities in excess of basis; subsection (d) provided that subsection (a), but not subsections (b) or (c), should apply in partial or complete liquidations. Subsection (d) eventually became § 336 of the 1954 Act. H.R. 8300, 83d Cong., 2d Sess. 72 (1954).

\(^{45}\) Prior § 311(c) apparently addressed the concerns raised by the dicta in footnote 37 of the Crane case. 331 U.S. at 14. If the property distributed was “subject to a liability” and the liability was “not assumed by the shareholder,” the prior version of § 311(c) provided that the gain to be recognized was limited to the excess of the fair market value of the property distrib-
such a limit unnecessary.46

46 Commissioner v. Tufts, 461 U.S. 300 (1983). Even before Tufts, the effect of the statutory limit was called into question by the addition of § 7701(g) in 1984, which provides that "in determining the amount of gain or loss (or deemed 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." The intended scope of § 7701(g) is unclear. Because the section had its origins in a technical amendment aimed at a particular abusive transaction, it was given little attention in the pre-enactment legislative history. Taken literally, it could render meaningless the limitation in old § 311(g) in the case of nonrecourse debt not assumed by the shareholder. (Note that it apparently would have no effect in the case in which a recourse debt of the corporation to which distributed property was subject was not assumed by the shareholder.) An argument could be made that no such repeal should be assumed without some express statement of intent to that effect.

In the explanation prepared by the Staff of the Joint Committee on Taxation subsequent to enactment of § 7701(g), such an intent is assumed and indeed is offered as the sole intended effect of the provision:

The Act includes a general rule clarifying that, for purposes of the income tax provisions of the Internal Revenue Code (Subchapter A), in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property is to be treated as being not less than the amount of any nonrecourse indebtedness to which the property is subject. This provision is to be limited in application to those Code provisions which expressly refer to the fair market value of property in determining the amount of gain or loss with respect to certain transfers of property, e.g., determinations under section 311 (relating to corporate distributions), section 338 (relating to stock purchases treat as asset acquisitions), section 751(c) (relating to transfers of partnership interests), and sections 617, 1245, 1250, 1252, 1254 and 1255 (relating to the treatment of gain from the disposition of property). The provision is not intended to affect the tax treatment of dispositions (e.g., actual sales of property) in which the amount of gain or loss is computed by reference to the amount realized from the disposition (under section 1001) (rather than based on a determination of fair market value pursuant to a specific Code provision), whether or not the amount realized is determined in whole or in part by reference to liabilities to which a property is subject (see Commissioner v. Tufts, 461 U.S. 300 (1982)). Nor would the provision have any application to transactions covered by section 752(c). The provision also is not intended to affect the determination of the basis of the property in the hands of the transferee. (See Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976)).
D. Assets Encumbered by Nonrecourse Indebtedness in Excess of Fair Market Value

There is one situation in which § 336(b) provides an appropriate result: That is, where the corporate debt associated with the property transferred is nonrecourse after the transfer. The shareholder takes the property subject to the debt, but he will never be called upon to pay on the debt from his personal resources.

As long as the fair market value of the property exceeds the amount of the debt, the fact that the creditor has recourse only against the encumbered property does not make a difference. Although one might be inclined to view this transaction as more like a distribution of net value than a distribution of the full value accompanied by a capital contribution, the corporation will report an identical amount of gain under either alternative.

Where the value of the land is less than the amount of the debt, however, the shareholder's promise to pay is not sufficiently likely to warrant treating the transaction as if the shareholder had in fact made a capital contribution. The relief from indebtedness enjoyed by the corporation results just as much from the arrangement with the creditor as from the special nature of its transferee.\textsuperscript{47} The relationship between the corporation and its shareholder no longer suggests that the corporate debt will be paid despite the fact that no third party would assume it. In such a case it is appropriate to include the excess liability in corporate income.\textsuperscript{48}

\textsuperscript{47} If the amount of excess nonrecourse liabilities is included in corporate income, should shareholder payment result in an adjustment to corporate income? The same question arises any time a shareholder makes a payment that might have been made by the corporation had it not been liquidated. Although the propriety of reopening the corporation's tax base to allow such offsets has not been tested frequently, it would seem that no such adjustments should be allowed. The liquidation of a corporation marks the end of its tax base for expense purposes as well as for income purposes.

\textsuperscript{48} Inclusion of this amount in corporate income would not be inconsistent with the general concept of the corporate tax base articulated here. Since the distribution of the loan proceeds would not have been inconsistent with the rights of the nonrecourse creditor, those values would have been available for distribution to shareholders at the time the loan proceeds were received. In contrast, the claims of recourse creditors more likely would have prevented distribution of those loan proceeds.
III. The Treatment of Capital Contributions

A. Possible Limitations on Contribution Treatment

There are a number of possible arguments why contribution treatment might not be extended to an assumption of excess liabilities, but none of them are convincing. The tax-free capital contribution is often justified on the grounds that it avoids unduly burdening the assets transferred.\footnote{H. Abrams & R. Doernberg, Federal Corporate Taxation 19 (1987); Note, § 351 of the Internal Revenue Code and “Mid-Stream” Incorporations, 38 U. Cin. L. Rev. 96 (1969).} If the availability of basis to offset receipts is a significant factor in the taxation of the transferee corporation, and thus affects the general economic viability of the business, a failure to provide basis would produce a strong deterrent to incorporation.

Perhaps the treatment of contributions to corporations is only necessary to avoid deterrence of initial incorporation and other significant capital transactions. If so, there might be little concern about deterring transactions that are part of liquidations. Existing law does not, and probably should not, limit contribution treatment to such significant transactions, if only because drawing such distinctions would be impossible.

Perhaps contribution treatment should only be available if the payment by the shareholders is made directly to the corporation, or when the payment is made before the corporation is dissolved. Existing law, however, makes no distinction between direct contributions of property to corporations, and payment by a shareholder with respect to a corporation’s debts.\footnote{Eskimo Pie Corp. v. Commissioner, 4 T.C. 669, 676 (1945) (payment of interest owed by subsidiary treated as investment in subsidiary and therefore not deductible by parent), aff’d, 153 F.2d 301 (3d Cir. 1946); Rev. Rul. 70-271, 1970-1 C.B. 166, (assumption of liability by shareholder in connection with a transfer of assets under § 368(a)(1)(C) will be treated as contribution to capital of transferring corporation and thus will not result in corporate gain); Rev. Rul. 67-411, 1967-2 C.B. 124 (shareholders who paid expenses of corporation liquidated after the transfer of substantially all of its assets under § 368(a)(1)(C) must treat such payments as capital contributions increasing their basis in their stock holdings, and not as current investment expenses).} Payments to third parties do not generate taxable income to the corporation\footnote{E.g., Rev. Rul. 70-271, 1970-1 C.B. 166. Corporate income will result if the liability is satisfied by an amount less than the face amount of the debt. In the case in which a shareholder pays corporate debt indirectly by purchasing the debt and then contributing it to the capital of the corporation, this inclusion is directed by statute. IRC § 108(e)(6). This is not inconsistent with the general idea that corporations should be allowed basis (without income) when shareholders pay on their debts, since in this case, neither the corporation nor the shareholder will have paid on the debt. Cf. Bryan note 10, at 119.} or affect the corporation’s ability to deduct the amount paid,\footnote{Royal Oak Apartments, Inc. v. Commissioner, 43 T.C. 243 (1964) (corporation allowed a deduction for state excise tax paid by shareholders after liquidation), acq.} and should result in an increase in the shareholder’s basis.
in his stock.\textsuperscript{53} Existing law, furthermore, treats such a payment as a contribution even when made after the shareholder relationship has ended, for instance, as a result of the sale of the stock.\textsuperscript{54}

Further, perhaps contribution treatment should not be available because the assumption of a corporate debt involves only a promise to pay, not a current transfer of tax-paid shareholder dollars. However, there is no such limit on contribution treatment in other contexts. Prior shareholder recognition of gain is not a prerequisite to a tax-free capital contribution and resulting corporate basis.\textsuperscript{55} If the shareholder incurred a liability in order to purchase the property contributed, he will not yet have paid for his basis.

Finally, perhaps contribution treatment should be denied an assumption on liquidation, even when it is available for a shareholder borrowing followed by a contribution because, not only is the shareholder basis not yet tax-paid, but also the corporate basis is likely already to have been used.\textsuperscript{56} The rules for capital contributions generally do not acknowledge this difference either: If the shareholder had assumed the corporate liability apart from the transfer of assets, contribution to capital treatment would likely have been available.\textsuperscript{57}

\textsuperscript{53} Kaufmann v. Commissioner, 10 T.C.M. (CCH) 790 (1951)(amounts paid on indemnification to successor of merged corporations held an addition to shareholder basis). This increase is most likely to be an addition to the basis of the stock received, although it could result in an immediately recognized capital loss in the event the received stock had since been sold in a closed transaction. See, e.g., Rev. Rul. 83-73, 1983-1 C.B. 84 (acquiring corporation allowed deduction, despite the fact that it received reimbursement), clarifying Rev. Rul. 58-374, 1958-2 C.B. 396.

\textsuperscript{54} E.g., Leward Cotton Mills v. Commissioner, 245 F.2d 314 (4th Cir. 1957) (selling shareholders paid income tax liability of corporation; treated as adjustment of purchase price to sellers, but corporation itself entitled to deduction for interest), rev'd 26 T.C. 885 (1956); Madison Fund, Inc. v. Commissioner, 365 F.2d 471 (3d Cir. 1966), cert. denied, 385 U.S. 1008 (1967).

\textsuperscript{55} A shareholder could, for instance, contribute property acquired with borrowed funds. But cf. Prop. Reg. § 1.453-1(f)(3)(ii), purporting to deny corporate basis resulting from an installment sale between a corporation and a shareholder until shareholder gain has been realized. Here, however, the regulation does take into account the special nature of the corporation—shareholder relationship to deny the corporation treatment ordinarily accorded unrelated third parties.

\textsuperscript{56} Liabilities in excess of fair market value will only create problems when liabilities exceed basis as well. For acquisition indebtedness, this will occur only when depreciation deductions have been taken.

\textsuperscript{57} The analysis in the text suggests that any practical problems resulting from § 311(b)(2) or § 336(b) can be avoided through careful planning. The paucity of judicial or administrative consideration of prior § 311(c) similarly suggests that it rarely created problems for taxpayers that could not be solved through careful planning. It seems likely that although § 311(c) was taken into account in planning, many corporations could avoid its impact either by receiving contributions at the time of the contemplated distribution so that the liability would be less than the basis, or by including in the distribution additional property with adequate basis.

Perhaps such efforts did nothing more than hide the problem from the auditor and leave the corporation vulnerable to a recharacterization of the transactions. In any event, questions
B. Underlying Justification for Contribution Treatment

On the other hand, unless the treatment of tax-free capital contributions represents a principled exception to the corporate tax base, its application to assumptions of excess liabilities is inappropriate.\(^58\)

The current tax-free transfer and basis rules allow, in effect, gain reported by the shareholder to pay for both corporate and shareholder basis in a myriad of situations.\(^59\) This replication of basis on contributions from shareholders limits the potential corporate gain to the amount that exceeds the amount treated as if it was already taken into income by shareholders. It does not, however, ensure that only those values arising while the property is in corporate hands will be recognized by the corporation. If the basis of the shareholder is less than the fair market value of the property at the time of its contribution, the corporation will, if it sells the property, recognize appreciation that accrues while the shareholder held the property.\(^60\) Conversely, under current law, the corporation may

about the proper treatment of shareholder assumptions rarely arose. The fact that the problem can be so easily avoided in so many cases merely verifies this article's analysis.

\(^58\) One might argue nevertheless for extension on the grounds of consistency which may be no small consideration in a workable tax statute.

\(^59\) Is this doubling of basis any different from the doubling of basis that occurs when a loan is made? When a loan is extended, under current law, the lender takes a basis in the debt equal to the amount of the loan. (This basis means that that amount can be returned to him without tax, and that he can sell the right to receive payment without tax.) The debtor takes the loan proceeds without including them in income. If he buys an asset, he will have a basis equal to the cost of the asset, even though it has not yet "cost" him anything in terms of tax-paid dollars. In some sense, basis has been doubled here, but not in the same sense as when a corporate contribution is made.

In the debt situation, the debtor will eventually have to earn his basis in tax-paid dollars. He will either have to pay the mortgage in taxed dollars without being allowed a deduction for them, or he will have to take unpaid debt into account when he no longer has to repay it.

The corporation to which capital is contributed will never have to "earn" its basis in this sense. Although one could find a corporate analog to the payment of debt principal in the payment of dividends, for which no deduction is allowed at the corporate level, there are several problems with this analogy. First, no corporation is required (either directly by corporate law or indirectly by the tax law) to pay dividends so long as reinvestments are made in the business rather than in passive assets. Second, the structure of subchapter C more often assumes that the payment of dividends is equivalent to the payment of interest than it is to the return of capital. Finally, and most importantly, the shareholder, unlike the creditor, generally will take such receipts into income.

One could also attempt to find the corporation's "earning" of its basis in the return of capital by the corporation to the shareholder. But, again, there is no obligation that these amounts be repaid. There has been no suggestion that a corporation unable to return capital contributions to shareholders on liquidation must recognize income. In fact, such repayment will occur only in circumstances that are relatively extraordinary in the corporation's life.

\(^60\) Thus, the basis rules in effect only provide an exclusion from corporate income to the extent of the shareholder's after-tax investment. It has been suggested that this is a principled phenomenon, reflecting the fact that corporate gain should be exactly commensurate with the economic gain of shareholders. The extra element of double taxation inherent in these rules is necessary to offset the benefits obtained by contributing shareholders in postponing their previously accrued gains as well as those that accrue within the corporation. See Bryan, note 10 at
also be able to shelter some of its appreciation if the fair market value is lower than the basis at the time of the contribution. The corporation will, in effect, be able to enjoy losses that accrued while the property was in the hands of the shareholder.

But these imperfections in the corporate tax base are traceable to the realization rules applicable to the shareholder. The additional value is included only because of imperfection in the means used to establish the shareholder's tax base at the time of the contribution. The corporate tax base will not include amounts already taxed to the shareholder, for it only taxes values exceeding the shareholder's basis.

Thus, the contribution rules reflect the notion that only those values that the corporation could have made available to the shareholders, beyond their initial contributions, should be taxable to the corporation. The inclusion in the corporate tax base of the values used by shareholders to pay excess liabilities assumed by them in corporate liquidations is inconsistent with the general concept of the contribution rules. These values do not represent wealth made available by the corporation to its shareholders above and beyond their contributions to it.

To summarize, the assumption of recourse liabilities by shareholders, whether or not in excess of the value of property distributed to shareholders should be viewed as a nontaxable contribution to the capital of the corporation, and not as consideration received by the corporation. So long as the fair market value of the property distributed exceeds the dollar amount of associated liabilities, there is no difference in the two models. If, however, the fair market value of the property is less than

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119. Certainly, the provision of a stepped-up basis to the corporation would provide a strong motivation to incorporate appreciated assets prior to a contemplated sale. See Lewis, note 5, at 1648.

61 The 1986 legislation includes the first deviations from this general principle. Under § 336(d)(1), a corporation cannot recognize a loss on liquidation with respect to any property contributed to it within the five years before the liquidation; under § 336(d)(2), a corporation may lose the ability to use basis to the extent that it exceeded the fair market value of the property when contributed, if the property was contributed with a purpose of "stuffing" the corporation simply to create corporate level losses. See generally Yin, Taxing Corporate Liquidations (and Related Matters) after the Tax Reform Act of 1986, 42 Tax L. Rev. 573, 619-48 (1987).

Other recent legislative proposals would have eliminated the benefit of this duplication of shareholder losses, without eliminating the mirror image problem of the duplication of shareholder gains. See § 358(a)(2) as revised in the Final Report on Subchapter C prepared by the Staff of the Senate Committee on Finance, 99th Cong., 1st Sess., The Subchapter C Revision Act of 1985, at 103-104 (Comm. Print 1985).

62 These discrepancies could be eliminated by making capital contributions recognition events for shareholders. Such a change could be made without affecting the rules relating to corporate basis, and would further the view of the corporate tax base advocated herein. They would, however, have an adverse effect on incentives to incorporate.

63 See note 22. Although the text at note 22 described this as "ignoring" the assumption, this contribution analysis does account for the assumption and the earlier receipt of proceeds in the same way that the traditional sale analysis does. The corporation received funds at an
the amount of the liability under the current law sale model, the corporation will be taxable on the excess as if it had received the entire amount of the debt. This value, because it will ultimately be available to the corporation only as a result of a payment by a shareholder that is equivalent to a contribution, should not be included in the corporate tax base.

IV. SHAREHOLDER ISSUES UNDER THE CONTRIBUTION MODEL

A. Amount Realized and Shareholder Basis in the Absence of Excess Liabilities

In ordinary circumstances, the shareholder receiving assets in a liquidation treats the amount received as an exchange for his stock, and computes gain or loss accordingly. Although there is no specific statute so providing, it was clear under prior law that a shareholder was allowed to reduce the fair market value of his receipts by the amount of the liability, and the repeal of General Utilities should not change that re-

earlier time which were not income because of the promise to repay; and these receipts, to the extent they remain unpaid, must now be accounted for. Accounting for them as a contribution to capital means that they will have the same net effect to the corporation as if they were ignored. Although capital contributions ordinarily create corporate basis, no such addition need be made at the time of liquidation because corporate basis was already provided to the corporation at the time of the loan proceeds. Indeed, the prior creation of basis is the only reason for trying to account for them at all.

64 Ford v. United States, 311 F.2d 951 (Ct. Cl. 1963) (per curiam); Rev. Rul. 72-137, 1972-1 C.B. 101 (distinguishing noncontingent from contingent liabilities, the former reducing the amount of a distribution in complete liquidation and the latter taken into account as capital losses at the time of discharge); Rev. Rul. 59-228, 1959-2 C.B. 59 (amount realized by shareholders on complete liquidation reduced by present value of assumed pension liabilities); cf. GCM 39266 (Aug. 1, 1984) (allowing recipient shareholders to reduce the value of half-finished contracts by estimated costs of completion), revoked on other grounds by GCM 39758 (Sept. 28, 1988).

Some cases have suggested, citing Arrowsmith v. Commissioner, 344 U.S. 6 (1952), that such amounts should not be allowed as offsets to the amount realized by the shareholder under § 331, but instead should only be allowed as deductions at the time of payment. E.g., Schneider v. Commissioner, 65 T.C. 18, 31 (1975). The invocation of Arrowsmith for this proposition is peculiar, since its principal holding is that payments made by recipient shareholders not taken into account in computing the amount realized should be treated as reduction in the amount realized at the time of payment. To the extent that a value can be placed on the liability, the offset should be allowed immediately. Both the offset and the income item will be discounted since the statute directs the use of fair market value. See also Forrester v. Commissioner, 4 T.C. 907 (1945), acq. (pre-Arrowsmith case, relying on accounting method approach to conclude that the taxpayer should not be entitled to take into account assumed liabilities (even when contributions had been made to liquidating trustee in year of liquidation) prior to the year in which payment is actually made).

Other cases have suggested that there should be no offset to a shareholder if he was already liable in a secondary capacity on the debt. E.g., Abdalla v. Commissioner, 69 T.C. 697 (1978), nonacc., aff'd on other issues, 647 F.2d 487 (5th Cir 1981). So long as the shareholder has not received basis credit for the debt, this result is inappropriate.
sult. The shareholder takes the fair market value of the property as his basis under § 334(a), and it appears to be well settled that fair market value is determined without reduction for assumed liabilities. This result should follow regardless of how the corporation accounts for the assumption of the liability.

More difficult questions arise when the shareholder makes payments on liabilities after the liquidation. In a sale of assets between unrelated parties, if the liabilities have not been taken into account by the seller (either as basis or as an accrued deduction), they are usually ignored in the calculation of the seller's gain and payment after the acquisition can be taken into account under the buyer's method of accounting. If lia-

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65 Where all proceeds are received in one taxable period, an addition to the basis of the shareholder's stock will have the same effect as a reduction in the amount realized. This choice may make a difference where installment reporting is permitted. Suppose a liquidating corporation distributes to its shareholder an installment note and § 453(h)(1)(A) applies. Two annual payments of $100 will be made and the shareholder assumes a $60 liability. The shareholder otherwise has no basis in his stock. If liabilities assumed reduce the amount realized, the reduction in net gain will occur in the first year. In the first year, the shareholder will recognize gain of $40, $100 less the entire $60; in the second year, the shareholder will recognize gain of $100. If, on the other hand, the liabilities assumed result in additions to basis in the stock given up, this basis will be allocated over the payments received on the installment note. Under this approach, the shareholder will recognize gain of $70 in each year ($100 less half of $60). See, e.g., LTR 8617001 (Oct. 20, 1985) (concluding that liabilities assumed by shareholders receiving installment notes must be allocated over payments received on note). The same disparity would arise in circumstances in which the actual distribution of proceeds spans several taxable periods. Here, however, the actual computation is complicated by the possibility that the basis to be used in each period must relate to identified shares under Revenue Ruling 68-348, 1968-2 C.B. 141. In any event, an addition to basis, and the resulting allocation over the period in which the proceeds are received is more consistent with the view of the assumption as a contribution urged here.

66 Ford v. United States, 311 F.2d 951 (Ct. Cl. 1963) (per curiam); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 11.04 n. 34 (5th ed. 1987). The same rule appears to be applicable to current distributions. Id. at 7.23.

67 A shareholder receiving assets in a current distribution takes the fair market value of the asset into income without taking into account his basis in his stock, but, as specifically provided in the statute, this amount is to be reduced (but not below zero) by the amount of the liabilities. IRC § 301(b)(2). This result is more generous to the shareholder than the theory presented herein would suggest. Consistent with that theory, all liabilities should increase the shareholder's basis in the corporate stock with respect to which the distribution proceeds are received, rather than reduce the amount of distribution. Only if the transaction is treated as a sale or exchange would the basis offset income at the time of the distribution.

Under § 356, a shareholder receiving boot in a corporate reorganization includes the value of property he receives in income, but only to the extent of the gain realized on the transaction. No authority has been found regarding the effect of liabilities in boot distributions. Regardless of how the boot is characterized, presumably the amount of the distribution should be reduced by the liability. This is also a more favorable result than under the contribution model which would require an addition to stock basis to the extent of the liability. Under § 358, the property takes a basis equal to its fair market value. For this purpose, "fair market value" means value without reduction by the amount of the liability.

68 See generally Landis, Liabilities and Purchase Price, 27 Tax Law. 67 (1973). This rule of thumb produces appropriate results in most, but not all, cases. The rule works best where the seller has received the benefit of the expenditure. See Crane, The Effect of Assumed Liabilities
ilities produced basis or a deduction for the seller, they increase both the seller’s gain and the buyer’s basis in the assets acquired. Under these general rules, no amount deducted by the seller produces a deduction for the buyer. As a result of these rules, all assets are held with a fair market value basis in the buyer’s hands.

The same general principle, that liabilities properly taken into account by the transferor\(^6\) increase the basis of property acquired, could apply to corporate liquidations. However, since the statute directs the shareholders to use a fair market value basis in all events, liabilities assumed by shareholders generally do not increase basis, but instead lower the amount realized. If a liability has been taken into account by the corporation, it reduces the amount realized, and, if not, payment should be treated as an adjustment to the amount realized, or as a current deduction.\(^7\)

**B. Amount Realized and Shareholder Basis in the Case of Excess Liabilities**

What if the liability is greater than the fair market value of the asset?\(^7\)

Suppose a corporation distributed property worth $50,000 subject to a

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\(^6\) There may be cases in which the corporate transferor is allowed an extraordinary accrual at the time of the liquidation. See Battle, Filler & Schultz, New Section 336: Selected Issues in the Taxation of Complete Liquidations, 65 Taxes 775, 780-84 (1987). If such accruals are allowed, there will be some additional difficulty in distinguishing between those liabilities that should result in a reduction of the shareholder’s amount realized and those that should produce a current deduction when paid. These adjustments will result in additions to shareholder basis in stock in the case of liabilities related to a current distribution or to boot distributions when the shareholder retained stock.

\(^7\) Many of these problems would be avoided if the application of the statutory presumption equating fair market value with the amount of the liability was not limited to the computation of the corporation’s gain. The language of §§ 336(b) (“for the purposes of subsection (a) [of section 336] and section 337”), 311(b)(2)(“for the purposes of this subsection”) and § 361(c)(2)(C)” for purposes of subparagraph (A) [of this section] seems to preclude such use of the presumption for any other purposes. Similarly, most discussions of § 7701(g) have assumed that it will affect only the transferor’s gain and not the consequences to the transferee. See, e.g., Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 239 (Comm. Print 1984); Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 339 n.77 (Comm. Print 1987).
$65,000 liability. How should the additional amount of liability assumed by the shareholder be treated?\textsuperscript{72} Should it reduce the amount realized below zero, producing an immediate loss of $15,000 or should it increase the shareholder's basis in the assets received? Should an excess liability both reduce the amount realized and provide basis in assets?

In the simple case of a liability not exceeding the fair market value of the property, the liability reduces the amount realized, but nevertheless is included in the basis. If a corporation made a liquidating distribution to a shareholder of land worth $14,000 subject to a liability of $4,000, the shareholder would have a basis of $14,000 ("including" the value of the liability) although he would have taken only $10,000 into income on its receipt ($14,000 reduced by the liability of $4,000). Although this appears to be a double credit for the same liability, it is not, since basis still reflects only tax-paid values. It reflects the amount realized (that has already been taxed) plus the amount of the liability to be paid later without deduction. The liability is not "included" in asset basis in the same sense as it would be in an ordinary exchange because, in a liquidation, the starting point is fair market value, not other consideration actually paid.

Where the excess debt is recourse, the question is how to give the shareholder credit for the possible payment on the excess liability. One possibility is to increase the basis in the stock, as if the assumption were a contribution to capital. In a complete liquidation, this analysis would produce an immediate reduction in gain or an increase in the loss with respect to the stock, and would have the same effect as a reduction in the "amount realized."\textsuperscript{73} This result is consistent with the contribution treatment urged here for determining corporate consequences of distributions with excess liabilities. If, however, the debt is nonrecourse, the liability should not produce additional basis; that is, it should not trigger an immediate additional loss. The likelihood of actual payment on this debt

\textsuperscript{72} The only decided case found considering such a situation, Peterson v. Commissioner, 30 T.C.M. (CCH) 95 (1971), is too cryptic to be of much help in answering this question. In that case, the taxpayer argued for a capital loss on a complete liquidation of his corporation, but the court held that there was no demonstration that the taxpayer had, as a result of the liquidation, assumed a liability greater than the fair market value of the assets received, and that the fact that the taxpayer had a preexisting personal liability as guarantor reduced the likelihood that a loss should be currently recognized. The court noted, in addition, that under state law, the shareholder's liabilities would be limited to the amount received on the liquidation, and that payments on claims beyond that amount would be personal claims against the shareholder, to be taken into account at the time at which they were actually paid.

\textsuperscript{73} With respect to current distributions, the increase in basis granted under this approach would trigger additional loss only if a recognition event had occurred with respect to the shareholder's stock, as it would if a redemption were treated as a sale of stock under § 302. See generally note 65. In any event, the statute expressly forbids the reduction of the amount realized below zero. With respect to boot distributions, it would have no effect unless the shareholder received no stock in the transaction.
is not sufficient to warrant taking payment into account at this time.  

Alternatively, the shareholder could increase his basis in the distributed property. In our hypothetical, this approach would give the shareholder a basis of $14,000 in land worth $10,000. Read literally, the statute precludes such a result even for recourse indebtedness, as the shareholder’s basis in the distributed property is limited to fair market value. Furthermore, this approach would create differences in the treatment of such items in a complete sale of a business and in a liquidation. In sales transactions, assumed liabilities create basis in the assets transferred, but only to the extent of the fair market value of the assets. Amounts paid above and beyond the fair market value of the assets are allocated to intangibles such as goodwill. After corporate liquidation, if goodwill does not exist, liabilities should be allowed as immediate losses.

Another possibility is to wait to account for the liability until payment is made. Deferral is likely to be the most appropriate result in the case of the nonrecourse liability. Presumably, some allowance should be made no later than the time the taxpayer actually incurs the burden of the nonrecourse liability. A choice must still be made as to whether the liability is to be taken into account as an immediate loss related to his former stock holding (as if a belated contribution to capital), as an immediate loss with its character derived from the nature of the underlying payment, or as an addition to basis in property received in the liquidation effective only as of that latter time.

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74 A tenuous argument could be made that the presumption of fair market value at least as great as the amount of the liability dictated by §§ 336(b), 311(b)(2), and 361(c)(2)(C) should carry over to the provisions relating to the treatment of shareholders. There is no reason to do so. See authorities cited in note 71; Andrews, On Beyond Tufts, 61 Taxes 949 (1983).

75 IRC §§ 334(a) and 301(d).

76 If the shareholder’s basis in the received property is not increased to reflect this liability, the liability should not be included as an amount realized on a later disposition. Reg. § 1.1001-2(a)(3).

77 Cf. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).

78 Reg. §§ 1.338(b)-2T(b) and 1.338-4T(h)(3) require the stripping of basis created by excess liabilities away from the particular encumbered assets. These regulations will, under § 1060, apply to all “transfers of assets which constitute a trade or business, and with respect to which the transferee’s basis is determined wholly by reference to the consideration paid for such assets.” It is unclear whether a complete liquidation is a transfer of assets so described. Given that § 1060 is concerned with the allocation of a set purchase price and that the consequences of complete liquidations must be determined without a set purchase price, its application may be limited. Nevertheless, its presumption that a purchaser cannot end up with basis in property greater than its fair market value as a result of excess liabilities has possible application here.

79 The treatment of the nonrecourse liability at the corporate level reflected the fact that it was not likely to be paid at the time of the liquidation, and suggests that it can reasonably be treated as arising after the liquidation. Thus the traditional approach of Arrowsmith v. Commissioner, 344 U.S. 6 (1952), need not be controlling.
V. Problems in Applying Section 336(b) as Written

The discussion so far has outlined a contribution model for shareholder assumptions of recourse liabilities which is inconsistent with the statute as written. If, however, the contribution model is rejected, how should the statute be implemented? Since there is no competing model, except the imprecise notion that corporate gain on liquidation should be equivalent to corporate gain on a sale to a third party, implementation raises some vexing questions.

For instance, should § 336(b) apply to a distribution in the aggregate or to each asset? Consider a corporation which distributes two assets to a shareholder, both worth $75, one with a basis of $5 and one with a basis of $45. The shareholder assumes a liability of $100, which is secured only by the first asset. If § 336 applies in the aggregate, the corporation will have only $70 of gain with respect to the first asset and $30 with respect to the second, since the liability did not exceed the total fair market value. If 336(b) applies asset by asset, the corporation will have $95 of gain with respect to the first asset (computed by treating the first asset as worth $100 according to the terms of the statute), and $30 with respect to the second.

Obviously, the excess liability provisions will have a far greater effect if applied asset by asset, for the circumstances in which the liabilities associated with any single distributed asset will exceed that asset's fair market value are likely to be more frequent than the circumstances in which the liabilities exceed the fair market value of all distributed assets. Even an unrelated party might accept an excess liability with respect to one asset if the value of other assets received were sufficient to meet the obligation.

If all distributions to shareholders are aggregated, § 336(b) may have no meaning at all. If, in the aggregate, liabilities are greater than the fair market value of all assets, the corporation is insolvent and it is unclear that § 336 should apply. It is clear that former

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80 There is at least one other possibility. The operating assumption behind § 336(b) might be that the value of the property must be at least equal to the liability or the shareholder would refuse to accept the distribution. Cf. note 25. Under this theory, aggregation of the assets distributed to each shareholder would be appropriate. The excess liabilities associated with one asset might be offset by the value of other assets received by the shareholder.

81 The text ignores the case in which the corporation may in fact be solvent because the fair market value of the debt is in fact less than the fair market value of its assets. In such a case there may be no excess liability at all. See note 18. Other provisions of the Code define insolvency as occurring when there is an excess of liabilities over the fair market value of assets. See, e.g., IRC § 108(d)(3). Apparently, this provision is referring to the face value and not the fair market value of liabilities, and, given the operation of its provisions, this seems to be the appropriate approach. It is unclear whether those authorities considering the applicability of § 336 would apply the same definition.
§ 332 did not, and presumably new § 337 does not, apply to a liquidation unless the shareholders receive a return on their equity interest. Under this precedent, a transaction may not be a "corporate liquidation" unless there is a return to equity.

If § 336 does apply to an insolvent corporation, it appears to mandate that all liability gains be recognized. Presumably, insolvent taxpayers in other situations may enjoy nonrecognition of cancellation of indebtedness income with respect to any debt forgiven or satisfied by the transfer of property of a value less than the face amount. Does new § 336(b) suggest that liquidating corporations are to be treated less favorably?

Given that if § 336(b) were applied in the aggregate, (1) it would only operate in the case of insolvency, (2) § 336 might not apply at all in the case of corporate insolvency, and (3) if it did apply in insolvency, it would foreclose the operation of § 108 in the case of liquidating corporations, an argument can be made that Congress did not intend that the section be applied in the aggregate.

The history of similar provisions also suggests that an aggregate approach should be rejected. The prior law governing current distributions was interpreted as applying to each asset separately, and the drafters may have intended that this approach continue under the new law. The asset-by-asset approach was the logical consequence of the statutory de-

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82 H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986) (where parent, holding both preferred and common stock of subsidiary, received return only on preferred, § 332 did not apply to prevent parent's loss).

83 Presumably in such cases, any transfers to shareholders that might have occurred would have been treated as transfers to creditors, to the extent that shareholders were also creditors, and to shareholders only as agents (for either creditors or the corporation), to the extent they were not. Any gain or loss recognized by the distributing corporation would have been subject to the rules for recognizing gain and loss outside subchapter C of the ultimate transfer of those assets to creditors.

84 IRC § 108.

85 If a corporation's debts are clearly forgiven in transactions separate from and prior to the liquidation, perhaps the benefits of § 108 will still be available. But if the debts are taken over by the shareholder (whether directly or indirectly), the availability of nonrecognition is far more problematic. In any event, if § 336(b) is intended to apply only in the aggregate, there is an irreconcilable tension between its provisions and the availability of § 108. Since a corporation dissolving under § 336 will lose its tax attributes in any event, perhaps there is good reason for not allowing § 108 to operate. The treatment would be unduly harsh, however, to the extent that § 108 still allows some cancellation of indebtedness income to escape taxation without any offsetting adjustments in tax attributes.

86 Rev. Rul. 80-283, 1980-2 C.B. 108. In this ruling, the Service relied heavily on the fact that the language in § 311(c) made no reference to the "sum" of the liabilities in question, or to "total" basis, as did § 357(c). The Service position seems logical, given its earlier established position that gain or loss be calculated on an asset-by-asset basis (in part so that losses in no way offset gains), and that gain recognized be characterized based on the character of the asset distributed. Reg. § 1.311-1(d). It also seems sensible, given the difficulty involved in determining the amount of and character of gain, and of the transferee corporation's basis in situations in which gain is triggered under § 357(c). See generally Rabinovitz, Allocating Boot in Section 351 Exchanges, 24 Tax L. Rev. 333, 356-65 (1969).
nial of losses (or, more specifically, the denial of the use of basis associated with loss property) and the need to preserve the character of any gain on a current distribution.

Neither rationale need control complete liquidations: Most losses can be recognized, and the statute already obscures the underlying characterization problems. But since these considerations may still be important in the treatment of current distributions, consistency may dictate continuing the asset-by-asset approach for liquidating distributions as well.\footnote{It is not clear that current §311(b)(2) need be governed by the same logic that controlled prior §311(c) because the measure for the triggering of liability gain is now fair market value, not basis. If the section is applied in the aggregate and if the liability does not exceed this total fair market value, the basis of the loss asset will not come into play in the actual calculation of gain. Suppose the second asset in the text had a basis of $90, and thus carried with it a $15 loss. If the fair market value of properties can be aggregated before applying §311(b)(2), the corporation will have only $70 gain on the first asset and the loss on the second will not be recognized. Even if the fair market value of all the assets is exceeded by the liability, the basis of the loss property need not be used in any part of the computation. The fair market value can be used to determine the initial applicability of the provision without the use of the related basis to determine the measure of gain. If the liability were $200, the amount of the excess and, thus, the fictional additional value would be $50. Whether this $50 triggered gain would depend upon additional choices in the computation. If any use of the basis of the loss asset is objectionable, then the excess liability value could be allocated only to the gain assets, triggering gain to the extent of the entire $50. Whatever computation rule is chosen, there remains an irreconcilable tension between the excess liability rule and the rule that denies losses on current corporate distributions. The excess liability rule is designed to require the corporation to pay for all the basis made available to it as a result of the receipt of the loan proceeds. This rule seems to assume that the corporation will in fact benefit from all of the basis generated. But the corporation will not be allowed to use its basis in loss assets at the time they are distributed. Query whether the corporation should be required to take into account unpaid for basis, when at the same time it is not allowed to use its basis in loss property.}

But, if §336(b) applies asset by asset, there will be many cases in which corporations will be forced to recognize more gain if assets are distributed in liquidation than they would if those assets were sold to a third party. Suppose a corporation had two assets; each is worth $100 and has a basis of $100. One is subject to no liabilities. The other is subject to a liability of $150. If the corporation sells both assets, and the buyer assumes the liability, the buyer will pay only $50 in cash. The corporation will have no gain, since the deemed consideration ($50 cash plus the $150 assumed liability) equals the total basis of $200. If the corporation distributes the assets in liquidation, however, §336(b) says that gain will be measured only after having assumed that the fair market value of the property is equal to the amount of the liability. The corporation will recognize no gain with respect to one asset, but will recognize $50 with respect to the other asset.\footnote{The asset-by-asset approach makes even less sense when liabilities do not relate to particular assets. Suppose a corporation distributes two assets, each with a basis of $15, but with fair
Whether Congress intended such a result is open to question. In those situations in which a sale to an unrelated party could take place, it does not seem appropriate to create more gain on a liquidation than on such a sale. Such a rule would lead only to complicated attempts to avoid liquidation treatment, and unrewarding efforts to divine the true nature of transactions.

VI. TOWARD A CONSISTENT THEORY OF THE CORPORATE TAX BASE

Ultimately the proper determination of the tax consequences of a liability assumed by a shareholder on a corporate liquidation depends on the definition of the corporate tax base. Prior to 1986, there did not appear to be an accepted and coherent theory of what should be included in the base. As the repeal of General Utilities removes a significant impediment, efforts to develop the concepts are warranted.

The statutory language implies that a third-party sale is an adequate theoretical framework. As the prior discussion has shown, however, a third party sale may not be an adequate analogy, particularly on a corporate liquidation. Moreover, assumption of a corporate liability in excess of the fair market value is only one of several transactions in which a sale model works poorly.

For instance, most corporations have on the books previously unamortized intangibles, reflecting the cost of changes in the corporate structure. Since these costs are not likely to represent transferable assets, reference to a sale provides no guidance as to how to account for such costs on a corporate liquidation. Should they therefore be allowed as a deduction as if for an abandoned capital asset, or as some other offset to corporate income?

market values of $10 and $50. In connection with the distribution, a liability of $48 is assumed by the shareholder.

If the liability is allocated by basis, each asset will be allocated $24, resulting in gain of $9 (the amount by which $24 exceeds $15) on the first asset and $35 on the second. If the liability is allocated by fair market value, $8 of the liability will be allocated to the first asset and $40 to the second asset, resulting in no excess liability gain and $5 of loss on the first asset and $35 of gain on the second.

89 One notable effort to provide such a theory, relied upon heavily herein, is Bryan, note 10. Another is Warren, The Corporate Interest Deduction: A Policy Evaluation, 83 Yale L.J. 1585 (1974), although that analysis dealt only with the question of whose interests ought to be considered the “corporation’s,” and not with the more technical question of when those interests should be measured. An earlier attempt to reconcile at least some aspects of the corporate tax base following the repeal of General Utilities can be found in Blum, note 5, at 519-22.

90 These costs include, for example, the costs of raising equity capital, see, e.g., Surety Fin. Co. v. Commissioner, 77 F.2d 221 (9th Cir. 1935); the costs of paying dividends, see, e.g., General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964), cert. denied, 379 U.S. 832 (1964); and the costs of other corporate restructuring, see, e.g., McCrory Corp. v. United States, 651 F.2d 828 (2d Cir. 1981).
A second, and more pervasive, problem relates to unaccrued claims on corporate assets. Should extraordinary deductions be allowed to the corporation? In a sale to a third party, such claims, to the extent they could be identified, would be taken into account in the determination of the purchase price. They would, therefore, automatically offset corporate gain. In the liquidation context, however, there is no market pressure to establish the extent of the claims on the corporation’s assets, and thus it is difficult to determine an appropriate allowance.

The concept endorsed here, that the corporate tax base include only values that can be made available to shareholders above and beyond their contributions, would suggest that in these two areas, the proposed offsets should be allowed. Other theories are also possible. Alternatively, the corporate tax base could be viewed as including all values ever put at the disposal of the corporation, regardless of their relation to values taxed to shareholder. Under such a concept, offsets would not be available for the above items, since values “destroyed” by the corporation would nevertheless have been at the corporation’s disposal.

While obviously much additional work needs to be done in developing the base, two points are already clear. First, the analogy to a sale is unworkable in a number of situations. Second, piecemeal adoption of corporate provisions without a coherent theory of the tax base produces problematic results.

VII. Conclusion

Assuming the language of § 336 is read in a common sense way, an assumed liability will affect the measure of corporate gain only when that liability exceeds the fair market value of the property distributed. With respect to property for which the associated liabilities do not exceed the

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91 Past consideration of questions regarding the availability of extraordinary accruals for liquidating corporations to take into account claims of third parties on corporate assets certainly would have benefited from such a concept. In Rotolo v. Commissioner, 88 T.C. 1500 (1987), the government and the corporate taxpayer agreed that advance payments on long-term contracts should result in corporate income on complete liquidation. Thus, for a large portion of the taxpayer’s assets, General Utilities was effectively mooted. Viewing the case as involving only technical accounting method questions, however, the government unsuccessfully insisted that the taxpayer be denied the related costs incurred under the contracts. The view of the corporate tax base that led to the government’s position in this case can be seen in GCM 39266 (Aug. 1, 1984), involving similar facts, which concluded that allowing the corporation such a deduction in a case in which the shareholders received the property would improperly allow “double” deductions. Although such an offset would have allowed a double deduction, that double deduction would have been entirely consistent with the double tax scheme. The fact that payment (that is, incurring the cost) was not made until after the liquidation does not mean that the value was available to the shareholder. The same reasoning was invoked to deny corporate level deductions in Schneider v. Commissioner, 65 T.C. 18, 31 (1975). GCM 39266 was revoked by GCM 39758 (Sept. 28, 1988), in response to the Rotolo decision.
fair market value, the common sense interpretation of the statute produces the appropriate result. We can either treat all of the liabilities assumed (regardless of amount) as contributions from shareholders excluded from corporate income, or we can ignore all liabilities, and recognize gain based on the fair market value of the corporation's assets.

The amendments produce inappropriate results where recourse liabilities exceed the fair market value of the property to which they relate. Current § 336(b) ignores the fact that the shareholder could have provided the same benefit to the corporation through a contribution to capital. When a shareholder assumes liabilities exceeding the fair market value of the property, the excess should not produce corporate gain.\textsuperscript{92} This treatment would produce no undue distinctions between corporate distributions and sales of corporate assets to third parties. The amount that the third party would be willing to pay will be no different than the net value the corporation can make available to the shareholders. Total gain, measured either by comparing consideration (including assumed liabilities) with corporate basis or by comparing the actual fair market value of the property with basis, should be the same in both cases. Indeed, existing law, as it is most likely to be interpreted,\textsuperscript{93} seems to force the sale of a group of assets to third parties, rather than to allow distribution in the case in which a related liability exceeds the value of any particular asset. There is no justification for the additional gain in the case of the shareholder assumption, particularly in the face of a statute purporting to treat a liquidating corporation as if it had sold its assets.

Although the problem identified here could be resolved by a few relatively small changes in statutory language, the source of the problem is far from insignificant. The new statute embodies an overly inclusive notion of the corporate income tax base. The enactment of this relatively minor provision, and the unthinking adoption of all aspects of the treatment of sales transactions with third parties, reveals the lack of coherence in the corporate tax base. The starting point for the corporate tax base should be only those values that a corporation can make available to its shareholders above and beyond their contributions.

\textsuperscript{92} This result could be accomplished under the current statutory structure either by explicitly directing that an assumption of a recourse liability be treated as contribution for corporate purposes, or by simply allowing an offset to the gain computed under current §§ 311 and 336 for excess liabilities (and providing some clarification of the fact that liability assumptions are ignored). Neither approach would answer all the questions that might arise regarding collateral issues, such as shareholder basis and deductions related to the liabilities. Under the latter approach, some limitation for those liabilities that might never be paid by shareholders might be more easily included.

\textsuperscript{93} See text accompanying notes 80-88.