

1-1-1965

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Recommended Citation

Herbert Cropper, Comment, *Tax Problems of Accounts Payable and Receivable Upon Incorporating a Cash Basis Taxpayer*, 6 SANTA CLARA LAWYER 216 (1965).

Available at: <http://digitalcommons.law.scu.edu/lawreview/vol6/iss1/19>

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TAX PROBLEMS OF ACCOUNTS PAYABLE
AND RECEIVABLE UPON
INCORPORATING A
CASH BASIS
TAXPAYER

The business advantages of operating in the corporate form, such as unlimited life of the corporation, limited liability of stockholders, ready transferability of interests, plus individual advantages of spreading income and fringe benefits may prompt many sole proprietors and partnerships to incorporate. In order to retain the maximum benefit of such change in business form, the tax consequences must be carefully investigated and adequate tax planning undertaken. This note will discuss two tax aspects of changeover to the corporate form and some of the unsolved problems related thereto.

The first aspect discussed deals with recognition of gain or loss on the transfer of the assets and liabilities to the corporation. All such transfers of a business to a new corporation fall into two categories: (a) those governed by section 351,¹ and (b) those to which the section does not apply. The other aspect of the change of a going business to corporate form that demands particular attention is the effect of the change on items of income and deduction. In particular, serious problems arise under the current code and case authority when a *cash basis* taxpayer transfers accounts receivable and accounts payable to an *accrual basis* corporation. Who reports the income on the accounts receivable, the transferor or the transferee? When is it reportable? Who is entitled to a deduction for the accounts payable; the transferor, the transferee, *or no one?*

In order to examine the problem in a controlled factual situation, assume a *cash basis* taxpayer transfers the following assets and liabilities to his wholly owned corporation in exchange for stock:

ASSETS	FAIR MARKET VALUE
Cash	\$ 1,000
Trade accounts receivable	75,000
Total Assets	<u>\$76,000</u>
LIABILITIES	
Accounts payable	\$50,000

In exchange for the above transfer, the taxpayer received \$26,000 in capital stock.

¹ INT. REV. CODE of 1954, § 351.

Inasmuch as the taxpayer was on the cash basis, he had reported no income from the trade accounts receivable nor had he been able to claim a deduction for the accounts payable which were assumed by the corporation.

TAX CONSEQUENCES TO THE TRANSFEROR

Under the general principles of taxation, if a person acquires stock or securities of a corporation for property other than cash he will realize a gain or loss on the transaction measured by the difference between the adjusted basis of the property transferred and the fair market value of the stock or securities received. By virtue of section 1002² the entire amount of this gain or loss would be recognized unless otherwise provided elsewhere in the Code.

One of the exceptions to the general rule of section 1002 is set out in section 351. Specifically, it provides that no gain or loss shall be recognized to a taxpayer who transfers property to a corporation solely in exchange for its stock or securities if he alone or together with other transferors controls³ the corporation immediately after the exchange.

The objective of section 351 is to postpone rather than eliminate the recognition of taxable gain or loss on the appreciation or depreciation in value of property transferred to the corporation. This postponement is accomplished through special rules relating to "basis" which apply both to the stock or securities received by the transferor and to the property acquired by the corporation on the transfer. If a transaction satisfies the requirements of section 351 except that the transferor receives money or property *other* than stock or securities, then any gain realized by him on the transaction would be recognized to the extent of the money and the fair market value of the other property received.⁴ Note, however, in computing the gain

² Unless otherwise indicated all references are to the Internal Revenue Code of 1954 and the regulations promulgated thereunder.

³ INT. REV. CODE OF 1954, § 368(c). ". . . [T]he term 'control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

⁴ INT. REV. CODE OF 1954, § 351(b) provides in part: "(b) RECEIPT OF PROPERTY.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

- (1) gain (if any) to such recipient shall be recognized, but not in excess of—
 - (A) the amount of money received, plus
 - (B) the fair market value of such other property received"

recognized, section 357(c)⁵ comes into consideration anytime the liabilities transferred exceed the basis of all the assets transferred.

Computation of Gain Recognized

The above illustrated transfer to the corporation is not entirely tax free under section 351 since the liabilities assumed by the transferee exceed the transferor's basis.

- (1) The total gain realized is computed as follows:

Accounts payable assumed	\$50,000	
Capital Stock received	26,000	
Total amount realized		\$76,000
Less: Basis (cash transferred)		(1,000)
TOTAL GAIN REALIZED		\$75,000

- (2) Under section 357(c) the realized gain should be recognized to the extent of \$49,000, computed as follows:

Accounts payable assumed	\$50,000	
Less: Basis (cash transferred)	(1,000)	
TOTAL GAIN REALIZED		\$49,000

Accounts Receivable

The main thrust of section 351 is to permit the taxpayer to transfer property to a newly formed corporation without the imposition of a tax at the time of incorporation. Nevertheless, the Commissioner in early cases applied the "assignment of income" principle enunciated in *Lucas v. Earl*⁶ to the transfer of receivables to a controlled corporation.

Stated broadly, this principle effectively prevents the shifting of income from one taxpayer to another through the transfer of a right to receive the income. The assignment principle was applied to charge the transferor with income where the principle asset transferred to the controlled corporation was the right to income from services already performed by the transferor.⁷ The application of the "assignment of income" principle is not inconsistent with the language of section 351. The Commissioner in applying this principle does not tax the transfer of the receivables to the corporation but

⁵ INT. REV. CODE OF 1954, § 357(c) provides in part: "(1) IN GENERAL.—In the case of an exchange—

(A) to which section 351 applies . . . if the sum of the amount of the liabilities assumed . . . exceeds the total adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be."

⁶ 281 U.S. 111 (1930).

⁷ See also *Brown v. Commissioner*, 115 F.2d 337 (2d Cir. 1940); *Clinton Davidson*, 43 B.T.A. 576 (1941).

rather taxes them as income to the transferor when they are later collected by the corporation. The theory is that the anticipatory assignment is not effective for tax purposes.

In more recent cases the Commissioner has not pressed for the application of the assignment of income principle to the transfer of accounts receivable.

Where accounts receivable of a cash basis transferor were transferred to a controlled corporation in a section 351 exchange, *Birren & Son v. Commissioner*⁸ held that the transferee corporation takes the receivables with a zero basis and is taxed on the subsequent collection. The Tax Court, in *Thomas W. Briggs*,⁹ rejected the Commissioner's attempt to charge the transferor with income on the receivables either at the time of the transfer or at the time of collection by the corporation.

There is no attempt in *Briggs* to distinguish the earlier "assignment of income" cases, but perhaps the distinction lies in the fact that in *Briggs* the receivables were not for services rendered personally by the transferor and also that they were transferred as part of a going business which involved substantial other assets.

However, in *Ezo Products Co.*,¹⁰ it was the Commissioner's and not the taxpayer's position that the corporation should report income from accounts receivable transferred from a cash basis transferor. So, apparently, as the latest cases indicate, it is the Commissioner's position that the transferee corporation should be taxed on the receivables received from a cash basis transferor.

Accounts Payable

The tax result of our hypothetical problem appears to be grossly inequitable since the taxpayer has never had the benefit of a deduction for the accounts payable. As will be seen infra, neither the corporation nor the taxpayer gets the benefit of a deduction for the accounts payable.

In *Arthur L. Kniffen*¹¹ gain was recognized to a cash basis taxpayer upon the assumption of liabilities in excess of basis by his newly formed corporation. Included in the total liabilities assumed were accounts payable representing expenses which had not been previously deducted. The court held that a gain was taxable to the taxpayer under section 357(c). In another contested issue of the

⁸ 116 F.2d 718 (7th Cir. 1940).

⁹ 15 CCH Tax Ct. Memo. 440 (1956).

¹⁰ 37 Tax Ct. 385 (1961).

¹¹ 39 Tax Ct. 553 (1962).

case, the court held that the individual taxpayer could not deduct the liabilities when they were assumed by the corporation.¹²

Further, the taxpayer's basis of the stock received cannot be increased upon the payment of the payables by the corporation. The transferor's basis is computed under section 358¹³ as follows:

Basis of property exchanged	\$ 1,000
Decreased by the fair market value of other property received, i.e., liabilities assumed ¹⁴	(50,000)
Increased by the recognized gain	49,000
BASIS	<u>—0—</u>

TAX CONSEQUENCES TO TRANSFEREE

Accounts Receivable

In accordance with *Birren & Son, Briggs and Ezo Products Co.*, *supra*, the corporation takes the receivables with a zero basis. However, this basis is to be adjusted in accordance with section 362(a), *i.e.*, the corporation's basis shall be the same as it would be in the hands of the transferor, increased by the recognized gain (accounts receivable with a zero basis plus the \$49,000 recognized gain).

Inasmuch as the corporation is on the accrual basis, the transferred accounts receivable are considered to be income to the corporation in the year of the transfer, not in the year collected.¹⁵

Accounts Payable

The question whether the corporation will be allowed a deduction for the accounts payable assumed by it presents a different problem. This issue was considered in a different factual context in *Holdcraft Transportation Co. v. Commissioner*.¹⁶ The taxpayer was

¹² 39 Tax Ct. at 567.

¹³ INT. REV. CODE of 1954, § 358(a) provides in part, "(a) GENERAL RULE.—In the case of an exchange to which section 351 . . . applies—

(1) Nonrecognition Property.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer . . . and

(B) increased by . . .

(ii) the amount of gain to the taxpayer which was recognized on such exchange"

¹⁴ In computing basis to the transferor, liabilities assumed are treated as money received. See Treas. Reg. § 1.358-3.

¹⁵ *Ezo Products Co.*, 37 Tax Ct. 385 (1961).

¹⁶ 153 F.2d.323 (8th Cir. 1946).

a corporation which was formed to take over the assets of a trucking partnership. The partnership business had certain contingent liabilities arising from accidents which had occurred prior to the incorporation. It was agreed that the new corporation would assume these contingent liabilities as a part of the transfer of the business to it. The contingent liabilities eventually resulted in payments being required, which payments were made by the corporation and deducted as a corporate expense. The court held that the expenditures were not operating expenses or losses of the taxpayer but rather were a part of the cost of the acquisition of the property of the partnership. Also, the fact that the claims against the partnership were contingent and unliquidated at the time of acquisition was not of controlling consequence.

As seen in the *Holdcraft* case, the transferee corporation is denied a deduction for the payables. The transferor cannot claim a deduction because he is on the cash basis and had not paid the liabilities. In the *Kniffen* case, *supra*, the taxpayer was denied a deduction for business expenses which were part of liabilities assumed by a new corporation. The court found that the taxpayer was on the cash basis and in denying the deduction commented as follows:

The argument that the assumption of these liabilities by the transferee corporation constitutes payment to third party creditors is obviously lacking in merit and does not require further discussion.¹⁷

There was no indication in the *Kniffen* case as to whether the expenses disallowed to the taxpayer had been allowed to his new corporation. Apparently no case can be found which has specifically dealt with both sides of this issue.

In *Citizen's National Trust and Savings Bank v. Commissioner*,¹⁸ decided prior to *Holdcraft*, there was dicta to the effect that when the deduction for expenses had been disallowed to the predecessor on the cash basis, allowance had been made to the successor corporation. This was not an affirmative issue in the case but it was apparent that the Commissioner had allowed the deduction to the successor. The court commented that the Commissioner was correct in denying the deduction to the predecessor and conceded that the expenses were deductible by someone in some year.

In *Doggett v. Commissioner*,¹⁹ decided after *Holdcraft*, the court also held that a cash basis taxpayer could not deduct the amount of accounts payable which were transferred to a new corpo-

¹⁷ 39 Tax Ct. at 567.

¹⁸ 119 F.2d 717 (9th Cir. 1941).

¹⁹ 275 F.2d 823 (4th Cir. 1960).

ration in a section 351 transaction. The court commented that since the payables arose out of the business, they should be deductible by someone, but that the taxpayer was met with the objection that he did not pay them. Also the court rejected the theory that the corporation acted as the transferor's agent in paying the payables.

From the dicta in *Citizen's National Trust and Savings Bank and Doggett*, it appears to be the courts' opinion that someone ought to be allowed the deduction for the payables but that it shouldn't be the transferor taxpayer. However, the only taxpayer left is the transferee corporation and the deduction has been denied under the theory of *Holdcraft*.²⁰

A summary of the tax consequences of the transfer in the hypothetical situation will help illustrate the great inequity of the present state of the law.

Upon the transfer to the corporation, taxpayer recognized a \$49,000 gain. Assume the corporation collects the receivables and pays the payables and then liquidates. Taxpayer will receive \$26,000 (\$1,000 original cash plus \$75,000 receivables less \$50,000 payables).²¹ The taxpayer's stock had a zero basis and upon the liquidation he will recognize a gain of \$26,000. The total gain recognized is \$75,000 (\$49,000 plus \$26,000).

It could be said that the taxpayer started out with \$75,000 of unreported accounts receivable and at the end of the transactions has reported a \$75,000 gain, representing these unreported receivables. However, this fails to recognize the fact that taxpayer had incurred \$50,000 in liabilities to produce the \$75,000 accounts receivable and he has been allowed no tax benefit for these payables. (Note the further inequity in that the corporation would be required to pay tax on the receivables in the amount of \$26,000 (\$75,000 receivables less a basis of \$49,000).)

As the law stands neither the transferor nor the transferee is allowed a deduction for the accounts payable. There is no reason why one of the parties shouldn't get the benefit of a deduction and it is apparent from the grossly inequitable tax result shown above that when a court is faced with both sides of the payables problem either the transferor or the transferee will be allowed the deduction. However, until the courts reconcile the problem or statutory relief is provided, the only possible way the transferor can get a deduction for the payables is to retain them and take the deduction when he

²⁰ See also *Athol Manufacturing Co. v. Commissioner*, 54 F.2d 230 (1st Cir. 1931).

²¹ Corporate taxes are ignored for this illustration.

makes payment. Depending upon the transferor's overall tax situation he should also consider retaining the accounts receivable (or a part of them) to offset the deductions for the accounts payable. At the present time there doesn't appear to be any assured way for the transferee corporation to deduct the payables. However, it should be noted that under certain circumstances, the Internal Revenue Service may issue a private ruling by entering into a closing agreement with the taxpayer, which would permit the transferee corporation to deduct the payables as an expense and to report the receivables as income. Otherwise, unless the transferor is willing to forgo the deduction for the accounts payable, he will be unable to completely place all of the former business activity under the corporation.

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