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TAXATION OF BOOT NOTES IN A 351/453 TRANSACTION

PATRICIA A. CAIN*

I. INTRODUCTION

If a shareholder (or group of shareholders) transfers appreciated property to a controlled corporation, section 351 will apply to the transaction. To the extent the shareholder receives stock or securities, no gain will be recognized and the corporation will take the shareholder's basis in the property. If a shareholder sells appreciated property to a controlled corporation, subject to minor exceptions,1 section 453 will allow the shareholder to defer recognition of gain. Under the Crane rule,2 the corporation will receive an immediate step-up in basis. However, if a shareholder transfers appreciated property for both stock and an installment note, so that both sections 351 and 453 appear to be triggered, the tax consequences are less clear.

Consider the following example: Taxpayer A transfers Blackacre (basis: 10, fair market value: 50) to Newco, Inc. in exchange for stock worth 25 and an installment note for 25. The note is due in full one year from the transfer.

A's gain realized is 40, but how should this gain be reported? There are at least five different ways to approach the answer:

1. Literal 453 Approach. Under this approach, section 453 is applied literally so that each receipt of property, other than receipt of the note, is treated as a "payment."3 Income recognized in any given year is

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1. Sections 453(g) and 453(i) create exceptions for certain sales of depreciable property. See text accompanying infra notes 183-85. [All references are to the Internal Revenue Code of 1954, as amended, and the Treasury regulations issued thereunder.]

2. Crane v. Commissioner, 331 U.S. 1 (1947), stands for the proposition that a taxpayer is entitled to an immediate cost basis in property that is purchased on credit. This cost basis will include the full amount of any future payments to be made for the property, whether those payments are evidenced by a promissory note with full recourse or are reflected in a non-recourse mortgage liability.

3. I.R.C. § 453(f)(3). The "payments" would thus consist of the stock (25) and the cash payment on the note (25).
determined by multiplying the gross profit ratio times each payment.\footnote{4} The gross profit ratio is 40:50 or 4/5ths.\footnote{5} Thus income recognized in the year of transfer must be determined by multiplying 4/5ths times 25 (the stock). The policy of section 351, however, is to prevent gain recognition upon the receipt of stock. In order to implement this policy, no gain should be recognized in the year of transfer since only stock is received as a “payment” in that year. In year two, payment of the note will trigger a gain of 20.\footnote{6} Basis in the stock should be 5, reflecting the fact that 20 of the realized gain of 40 will not be recognized until the stock is sold.\footnote{7}

(2) \textit{Bifurcation Approach.} Under this approach, the transaction is viewed as though half of Blackacre (basis of 5) were transferred for the stock (25) and the other half (basis of 5) were transferred for the note (25). In this case the stock portion should qualify under section 351, triggering no gain in the year of transfer. Basis in the stock is 5.\footnote{8} Similarly, the sales portion should qualify under section 453. The gross profit ratio is 20:25 or 4/5ths.\footnote{9} In year two, when the note is paid, gain of 20 will be recognized. (Note that the mechanical results regarding how much gain is recognized and when it is recognized are the same here as they are in the literal 453 approach. The theory, however, is somewhat different.)\footnote{10}

(3) \textit{Section 453(f)(6) Approach.} Under section 453(f)(6), the stock is not treated as a “payment,” the “gross profit” includes only recognized gain, and “total contract price” is reduced by the value of the stock. Under section 351(b), gain is recognized only to the extent of the boot note (25). Gross profit ratio is thus 25:25 or 100%. No gain is recognized upon receipt of the stock in the year of transfer, but gain of 25 will be recognized when the boot note is paid. Basis in the stock is 10. The remaining gain of 15 will be recognized when the stock is sold.

(4) \textit{Revenue Ruling 65-155 Approach.} Revenue Ruling 65-155\footnote{11} treats the nonrecognition property (the stock) as a payment, but in com-

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\footnote{4}{\footnote{I.R.C. § 453(c).}} \footnote{5}{\footnote{Gross profit ratio is the ratio of “gross profit (realized or to be realized when payment is completed)” to “total contract price.” See I.R.C. § 453(c). The profit realized, although not recognized if § 351 prevails, is 40. The total contract price is total consideration of 50. The ratio is thus 40:50 or 4/5ths.}} \footnote{6}{\footnote{The gain is computed by multiplying 4/5ths times 25 cash.}} \footnote{7}{\footnote{But see infra notes 75-77 and accompanying text (boot recognition rule of § 351(b) undercuts validity of the literal § 453 approach).}} \footnote{8}{\footnote{I.R.C. § 358 (substituted basis of half of Blackacre is 5).}} \footnote{9}{\footnote{See supra note 5. Selling price of 25 less basis of 5 equals gross profit of 20.}} \footnote{10}{\footnote{See supra note 7. The results under this approach also mirror the results that would occur if the note were treated as a security.}} \footnote{11}{\footnote{1965-1 C.B. 356. The facts in this ruling involve a combined 1031/453 transaction, but the ruling can be applied by analogy to a 351/453 transaction.}}
puting gross profit ratio, treats only the recognized gain (the boot note of 25 under section 351(b)) as gross profit. The ratio thus becomes 25/50ths. In the year of transfer, this produces a recognized gain of 12.5. An additional gain of 12.5 will be recognized when the boot note is paid. Under this approach, the entire basis of 10 is assigned to the stock. The remaining gain of 15 will be recognized when the stock is sold.12

(5) No 453 Deferral Approach. Under this approach, gain is recognized according to the rules under section 351 alone. These rules allow the shareholder to defer gain only when qualifying nonrecognition property is received. The only type of debt that qualifies for nonrecognition is a security. Short-term notes constitute boot and should be immediately taxable. The fact that these boot notes are similar to the installment obligations that a seller receives in an installment sale should be irrelevant. The installment method of reporting should be available only for sales transactions, not for section 351 transactions. Accordingly, gain to the extent of the boot (25) is recognized in year one.

Although all of the above approaches are logical possibilities, only the third and fifth options have any direct statutory authority.13 Section 453(f)(6), the statutory support for option number three, however, does not explicitly apply to 351/453 transactions.14 Instead, this provision refers only to installment obligations received in a section 1031 like-kind exchange or in certain corporate reorganizations to which section 356 applies.15 Thus, its application to the above hypothetical can be questioned. If section 453 does not apply, then option number five appears to be the most supportable alternative.

The Treasury Department has taken the position in its temporary section 453 rules that section 453(f)(6) should be extended to cover section 351 transactions. More recently, it has issued proposed regulations that demonstrate the way in which section 453(f)(6) should be applied to determine gain and basis questions in a 351/453 transaction. Applying

12. The enactment of § 453(f)(6) in 1980 was intended to reverse this ruling, at least with respect to § 1031 and § 356 transfers, both of which are specifically covered by § 453(f)(6). The ruling’s approach makes no sense under either § 351 or § 453, since it triggers gain prior to the receipt of cash contrary to the policy behind each of these provisions.

13. Option number three is supported by § 453(f)(6) and option number five is supported by a literal application of § 351, as well as by the statutory reference in § 453 to installment sales.

14. The term 351/453 transaction will be used throughout the article to refer to a § 351 transaction accompanied by boot notes that can also be viewed as purchaser evidences of indebtedness under § 453. The term also applies to an incorporation followed by a shareholder installment sale if the two steps are sufficiently interrelated to be collapsed into a single transaction.

15. Section 453(f)(6) will only apply if the boot notes received are not dividends.
these regulations to the above hypothetical will produce the results described in option number three.

The regulations, however, include one further provision. The corporation's basis in Blackacre, determined under section 362, will be A's carryover basis of 10. That basis will be increased by A's recognized gain of 25, but not until year two when the gain is in fact recognized for tax purposes.

The purpose of this article is to evaluate the proposed regulations under section 453(f)(6) as they apply to 351/453 transaction. The evaluation will focus on two questions: (1) the gain question: should section 453(f)(6) apply to defer gain in a 351/453 transaction; and (2) the basis question: if so, is the Treasury Department justified in proposing a deferred “step-up in basis” rule in the regulations promulgated thereunder?

In theory, there is a myriad of possible 351/453 transactions to which the proposed rules could be applied. For example, some transactions may involve single shareholders, while others may involve multiple shareholders. Some may involve transfers of a single asset, while others may involve multi-asset transfers. Most important perhaps are the varying reasons that can exist for structuring the transfer so that it includes boot notes. Some transactions may be solely tax-motivated, while others may be primarily business-motivated. Furthermore, the specific tax motive may vary from case to case.

In practice, the potential 351/453 combinations tend to be limited to transactions such as the following:

(1) A sole proprietor incorporates a going business, transferring assets in exchange for stock and boot notes. The corporation is a subchapter C corporation and the primary motivation for using boot notes is to take advantage of the interest deduction for corporate debt and to withdraw corporate earnings as payments of principal. Any benefits from a basis step-up are viewed as minimal by the shareholder.

(2) A group of transferors transfer their going business, formerly

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17. Possible tax motives include gaining a step-up in basis at the corporate level, obtaining an interest deduction for interest payments on the debt, and withdrawing corporate profits as payment of principal rather than as dividends.
18. This type of situation is rare compared with transactions in which the basis step-up is the taxpayer's central concern. Deductibility of interest and withdrawal of earnings as principal payments are benefits that can be obtained through the issuance of debt securities instead of boot notes. Thus, if basis step-up is not a concern, the distinction between boot notes and debt securities is of minimal importance. If § 453 applies to the boot notes, gain will be deferred in any event. This, however, was not always the case. See, e.g., United States v. Mills, 399 F.2d 944 (5th Cir. 1968) (taxpayer argued notes were securities, the Service argued boot
operated as a partnership, to a newly-formed corporation. They transfer a portion of the assets for stock and a portion for corporate notes in a separate "sale" transaction. The sale portion of the transaction may be either business-motivated or tax-motivated.

(3) An individual owner of appreciated property creates a new corporation and then "sells" the property to the corporation for short-term notes for the sole purpose of acquiring a step-up in basis at the corporate level. The plan is entirely tax-motivated. The step-up is desired either to reduce subsequent corporate ordinary income on the property's resale, or to give the corporation higher depreciation deductions on the property. The corporation may be either a subchapter C or a subchapter S corporation.

A section 351 incorporation with boot is a rare occurrence. Thus, a true 351/453 transaction such as that described in example one is also rare. Indeed, in the two cases cited as examples, the taxpayer argued that the "boot note" was not boot at all, but was instead a security. In each case, the taxpayer's main goal was to defer recognition of gain by avoiding the taxation of boot rule contained in section 351(b). To the extent section 453 can now be used to defer gain on boot notes, cases that fall in the example one category will rarely be litigated.

Examples two and three raise the additional issue of whether basis can be increased at the corporate level. Example two differs from example three primarily in that the transfer is of a going business and thus involves multiple assets and multiple transferors. In both two and three, the taxpayers typically structure the boot note portion of the transaction

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notes; court held: securities); Turner v. Commissioner, 303 F.2d 94 (4th Cir. 1962) (taxpayer argued notes were securities, the Service argued boot notes; court held: boot notes).
21. Most such cases involve the sale of raw land to be subdivided by the corporation. See, e.g., Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982) (sale valid, step-up allowed); Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968) (sale valid, step-up allowed); Burr Oaks Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966) (sale not valid, no step-up); Aqualane Shores, Inc. v. Commissioner, 269 F.2d 116 (5th Cir. 1959) (sale not valid, no step-up).
22. See, e.g., Sun Properties, Inc. v. United States, 220 F.2d 171 (5th Cir. 1955) (sale valid, step-up allowed).
23. See infra note 179 and accompanying text.
24. See supra note 18.
25. Such cases do, however, present other issues for litigation. The amount of gain to be reported upon payment will differ depending on whether the note is classified as a boot note or as a security. See infra section IV. B. Evaluating the Gain Question.
as a separate sale. If the two steps, incorporation followed by a sale, are integral parts of a single plan, then the step-transaction doctrine ought to collapse the steps into a single 351/453 transaction. None of the cited cases considered the step transaction doctrine relevant so long as the boot notes retained their classification as boot notes rather than securities. The main issue in these cases was whether the corporation was entitled to a step-up in basis. The court’s focus was on whether the notes were valid as boot notes. If they were valid, the sale would be honored and the corporation would be entitled to a basis step-up. If not valid, the transaction would be recharacterized as a section 351 transfer solely for stock or securities. Viewing the notes as boot in an otherwise tax-free exchange was simply never considered. Nor would boot characterization have made any difference in the issue before the court: step-up in corporation’s basis. Under the proposed regulations, however, the major consequence from collapsing the two transactions is the triggering of the proposed deferred basis rule.

Although the main purpose of this article is to evaluate the proposed 351/453 regulations, the article at times raises general policy questions regarding the application of section 351 to controlled corporations, as well as questions regarding the underlying policy of deferred taxation under section 453. In raising these broader issues, the article suggests certain positions that may be viewed as controversial. Some defense of these positions is provided. However, since these broader issues are not intended as the main focus of this article, the defenses are intentionally brief.

26. See, e.g., D’Angelo Assoc., Inc. v. Commissioner, 70 T.C. 121 (1978), acq. (incorporation followed by a sale, steps collapsed, but boot note reclassified as security so no gain under § 351(a)).

27. See cases cited supra notes 20-22.

28. In this article, I use the term “securities” to mean any debt instrument issued by a corporation other than boot notes. This means that the term “debt” includes both securities and boot notes. Furthermore, the term “notes” can mean either a security or a boot note. Under § 351, a security represents an equity investment in the form of debt. A boot note is a nonequity debt.

29. Characterized as boot, the notes would have triggered gain to the shareholder under § 351(b) and the corporation would have been entitled to a step-up in basis under § 362. To the extent the transfer is of a single asset, the entire step-up will be attributed to that asset. For the result in the event of a multi-asset transfer, see infra note 87. Section 453 treatment was not available in any of these cases because the stock received by the shareholder would have violated the 30% rule. See infra note 40.

30. This will be a major consequence in a very limited number of transactions, however. See infra notes 178-90 and accompanying text.

31. For example, the conclusion that all debt instruments issued by a closely-held corporation are more appropriately viewed as securities than as some other form of debt. See infra notes 164-67 and accompanying text.
Before focusing on the regulations, one should be familiar with the statutory provisions on which they are based. Therefore, section II gives an overview of section 453 and its legislative history, focusing on the 1980 revisions. Section III provides an overview of the proposed 351/453 regulations. An evaluation will follow these two overview sections.

II. THE INSTALLMENT SALES REVISION ACT OF 1980

In 1980, Congress enacted the Installment Sales Revision Act of 1980 (ISRA). The main purpose of this act was to simplify and clarify existing law regarding the availability of installment sales reporting. The emphasis on simplification in the legislative history to ISRA is crucial to an understanding of the act’s intent.

The emphasis can be traced back to a 1972 report by the Committee on Tax Policy of the Section of Taxation of the New York State Bar Association. Although this report did not focus on any particular substantive area for proposed reform, it helped to focus attention on simplification as a primary concern in tax reform. With specific reference to this report, Professor Martin Ginsburg, in 1975, began making the case for the reform of section 453, identifying that reform as a simplification measure. His case for reform is reflected in a number of specific recommendations adopted by the Tax Section of the American Bar Association (ABA). The ABA Tax Section was joined by the American Institute of...
Certified Public Accountants (AICPA), as well as the Treasury Department, in its support for simplification of installment sales reporting.\[37\]

### A. The First Installment Sales Bill

The first installment sales bill, H.R. 3899,\[38\] was introduced in the spring of 1979. It proposed five changes to installment sale reporting: (1) elimination of the two-payment rule,\[39\] (2) elimination of the 30% limitation,\[40\] (3) an increase from $1,000 to $3,000 as the floor amount for a qualifying installment sale of personal property,\[41\] (4) an absolute prohibition of installment method reporting on sales between related persons, and (5) rules which would eliminate a taxpayer's ability to avoid installment gain on obligations bequeathed to the obligor/purchaser.\[42\]

The ABA Tax Section, the AICPA, and the Treasury Department joined forces in urging legislators to carry these proposed revisions even further. Thus, for example, Harry L. Gutman, Deputy Tax Legislative Counsel, Department of the Treasury, testified with respect to H.R. 3899:

> The Treasury Department believes that H.R. 3899 reduces complexity in the installment sale area. However, Treasury recommends that Congress take this opportunity to provide consistency

(recommending elimination of the 30% limitation and reversal of the installment sale election, so that all deferred payment sales would automatically qualify for installment reporting).

\[37\] See 1979 Senate Hearings, supra note 35, at 44 (statement of M. Ginsburg) and at 82 (statement of H. Gutman, Treasury Department).

\[38\] A companion bill, S. 1063, was introduced in the Senate.

\[39\] See Revenue Ruling 69-462, 1969-2 C.B. 107, which required two payments of principal in order for a purchaser to qualify for installment sales treatment of property. This requirement was upheld in 10-42 Corp. v. Commissioner, 55 T.C. 593 (1971), and in Baltimore Baseball Club, Inc. v. United States, 481 F.2d 1283 (Ct. Cl. 1973). This rule served as a trap for the unwary in cases involving deferred payment sales for a balloon note with interest only payable in the interim.

\[40\] Prior to 1980, § 453 installment sales reporting was not available if the purchaser received more than 30% of the selling price in the year of sale. This too served as a trap for the unwary in those cases in which purchasers miscalculated. One of the oft-cited hardships of this rule was the case in which the seller and purchaser might agree to a below market rate of interest on the note. If § 483 was triggered, a portion of the intended principal (selling price) would be converted to interest with the result that the selling price would be reduced. If the reduction caused the down payment to increase above 30% as compared with the reduced selling price, the purchaser lost all benefits of installment reporting.

\[41\] Any deferred payment sale of real estate would have qualified.

\[42\] The potential for abuse was actually broader than that indicated by the proposed rule regarding bequests. A taxpayer, for example, could make a sale of property to a relative or close friend, deferring gain under the installment method. If the taxpayer subsequently cancelled the purchaser's obligation gratuitously, the gain could be avoided in full. See Miller v. Usry, 160 F. Supp. 368 (W.D. La. 1958). Consistent with the original sale characterization, the purchaser could claim a cost basis under § 1012. Under current law, cancellation triggers gain to the seller. See I.R.C. § 453B(f).
of treatment and clarity of rules for all sales for future payment. While this effort might result in a more complex statutory provision—indeed it will require an expansion of section 453 to cover all deferred payment sales—the law will be simplified immeasurably. A set of cogent uniform rules based on sound policy will clear up the morass created by the lack of coordinated taxing structure.\textsuperscript{43}

In keeping with this spirit of reform and simplification and in a rare example of cooperative effort, legislative drafters, Treasury officials, and representatives of various tax professional groups worked out a new installment sales bill.\textsuperscript{44} This bill, with only minor revisions, was finally enacted as the Installment Sales Revision Act of 1980.\textsuperscript{45}

\textbf{B. The Second Installment Sales Bill}

The redrafted bill differed from its predecessor in several important respects. First, it expanded the availability of installment reporting by repealing the floor amount for eligible sales of personal property in its entirety, and by providing that installment sales for a contingent sales price would be covered by the new rules.\textsuperscript{46} In addition, it expanded coverage to shareholders who receive qualifying obligations in a section 337 liquidation.

Expanding the coverage of section 453 was viewed as a simplification because it would eliminate the need to determine which deferred payment sales qualified under section 453 and which did not. Furthermore, if all deferred payment sales were to be reported on the installment method, then there should be no requirement to elect that method as there had been in the past. Thus, in another move toward simplification, the new bill eliminated the "election-in" requirement, replacing it with an "election-out" requirement for those rare cases in which a taxpayer might wish to report gain in full in the year of sale.\textsuperscript{47}

Expanding the coverage of section 453 can also be viewed as an equitable measure. Qualifying for installment reporting often involved

\textsuperscript{43} See 1979 House Hearings, supra note 35, at 35-36.

\textsuperscript{44} This bill was introduced in the House as H.R. 6883, 96th Cong., 2d Sess. (1980). A companion bill, S. 2041, was introduced in the Senate.

\textsuperscript{45} Pub. L. No. 96-471, 94 Stat. 2247.

\textsuperscript{46} The earlier bill had increased the floor amount. See supra note 41 and accompanying text. Contingent sales price transactions had never been covered because computing the gross profit ratio had always depended on a fixed sales price.

\textsuperscript{47} It is, of course, possible to elect out of § 453 and report the gain on the cost recovery method (also referred to as the open transaction method) if the deferred payment obligations qualify under Burnet v. Logan, 283 U.S. 404 (1931). Such qualification, however, is likely to be difficult. Since failure to qualify will result in immediate taxation under the closed transaction method, the election out of § 453 is fraught with risk and is generally inadvisable except in cases in which immediate taxation of the gain is the desired result.
planning around a number of hidden traps,\textsuperscript{48} and thus often depended on the quality of tax advice given to an individual taxpayer. Since installment reporting gives taxpayers the benefit of deferring payment of tax until they have the cash in hand,\textsuperscript{49} the unwary and ill-advised taxpayer was being denied that benefit. The new bill made this benefit available on a more equitable basis by removing the traps.

The second major change in the new bill was the provision covering related-party sales. The original bill had included an absolute ban on installment reporting for such sales. This ban provoked a significant outcry. In keeping with the fact that the primary purpose behind the revisions was simplification, some people argued that the act should not even attempt to deal with taxpayer abuse such as manipulation of installment sales benefits by related parties. Others were more willing to deal with such abuse,\textsuperscript{50} but only if the remedy were more narrowly drawn. The final bill's method of countering this abuse was to limit the related-party provisions to the perceived abuse. Thus, as enacted, section 453(e) provides that a second disposition by the related purchaser will trigger gain to the initial seller,\textsuperscript{51} but otherwise allows installment reporting on the initial sale.\textsuperscript{52}

Finally, there were a number of tack-on provisions, which, although important, did not receive as much attention in the legislative process as

\textsuperscript{48} For example, the 30% limitation might be violated if mortgage exceeded basis by a significant amount or if the notes bore insufficient interest under the § 483 test for imputed interest. \textit{See generally} Solomon & Kirkelie, \textit{The Installment Sale—Qualification}, 26 S. Cal. Tax Inst. 669 (1974).

\textsuperscript{49} This is a benefit that is subject to criticism. \textit{See} Cain, \textit{Installment Sales by Retailers: A Case for Repeal of Section 453(a) of the Internal Revenue Code}, 1978 Wis. L. Rev. 1 (1978) (although focusing on installment sales by dealers, the article's arguments can be used to question the justification of any deferral under § 453) [hereinafter cited as Cain, \textit{Installment Sales}]. Once the benefit is made available, however, horizontal equity would support making it equally available to all sellers who are similarly situated.

\textsuperscript{50} \textit{See}, e.g., 1980 House Hearings, supra note 32, at 36 (statement of Charles Walker, Chairman, Section of Taxation, American Bar Association). The main abuse which Treasury sought to curtail was the purported sale between related parties for installment notes, followed by a cash sale to an outside unrelated party. The abuse was not so much in the sale itself, but in its combination with a second disposition for cash. The combination resulted in cash proceeds being made available to an economic unit such as husband and wife without any immediate tax cost to the unit.

\textsuperscript{51} Dispositions, other than of marketable securities, that occur more than two years after the initial sale are exempted (I.R.C. § 453(e)(2)), as are dispositions resulting from an involuntary conversion and dispositions after death (I.R.C. § 453(e)(6)), as well as dispositions in which tax avoidance is not a principal purpose (I.R.C. § 453(e)(7)). In addition, § 453(g) eliminates installment reporting benefits for certain related party sales of depreciable property. This provision was not an original part of the second bill, but was added later.

\textsuperscript{52} \textit{But see} I.R.C. § 453(g) (providing for immediate recognition of gain if the sale is of depreciable property between § 1239 related parties).
did the major changes discussed above. The provision covering like-kind exchanges, although added to the second bill by the redrafters, is such a provision.

C. Section 453(f)(6): Specific Legislative History

The original installment sales bill contained no provision covering the receipt of installment obligations as boot on an otherwise qualifying nonrecognition transaction. The second bill contained the provision which is now section 453(f)(6):

In the case of any exchange described in section 1031(b)—

(A) the total contract price shall be reduced to take into account the amount of any property permitted to be received in such exchange without recognition of gain,

(B) the gross profit from such exchange shall be reduced to take into account any amount not recognized by reason of section 1031(b), and

(C) the term "payment" . . . shall not include any property permitted to be received in such exchange without recognition of gain.

Similar rules shall apply in the case of an exchange which is described in section 356(a) and is not treated as a dividend.

A close reading of the statutory language discloses that there is no specific language which provides that a like-kind exchange with accompanying boot notes qualifies as an "installment sale." The drafters probably assumed such a transaction would qualify and thus saw no need to address the issue directly. Such an assumption seems correct. First of all, there is no reason to assume that a bargained-for exchange between unrelated parties is not a sale merely because it involves like-kind property. To qualify further as an installment sale, the exchange must involve a disposition of property, and at least one deferred payment. Any section 1031 exchange with boot notes necessarily meets these two latter requirements.

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53. Thus, for example, the Senate amended the House Bill by indicating that the guarantor of a purchaser's installment obligation would not constitute payment. See I.R.C. § 453(f)(3). This amendment is more significant than it may seem from reading the statutory language, since it was specifically intended to ratify the use of bank letters of credit as security for installment notes. See Griffith v. Commissioner, 73 T.C. 933 (1980) (holding, pre-ISRA, that a letter of credit may convert a note into full payment thereby triggering gain in full). Contra Sprague v. United States, 627 F.2d 1044 (10th Cir. 1980).


55. I.R.C. § 453(b)(1).

56. The assumption that a § 1031 exchange with boot notes qualifies as an installment sale is additionally supported by Revenue Ruling 65-155, 1965-1 C.B. 356. See also Mitchell v. Commissioner, 42 T.C. 953 (1964), acq.
The purpose of section 453(f)(6) was not to expand the availability of installment reporting to section 1031 exchanges. Instead, the purpose was to reverse Revenue Ruling 65-155 insofar as it treated the receipt of like-kind property as a payment in the year of sale. Under the ruling's approach, gain would be triggered in the year of sale despite the absence of any cash payments. Computing gain in this manner makes no sense under either section 1031 or section 453, both of which reflect the principle that, in appropriate circumstances, a taxpayer should be able to defer gain until cash is received.

Prior to the redrafting of the installment sales bill, the problem regarding 1031/453 transactions did not receive much attention. Although Professor Ginsburg had included the problem in his 1975 discussions of reform, his focus at that time was on the problem that arose when receipt of like-kind property violated the 30% down payment limitation. The classification as a payment, however, has consequences beyond qualification under the 30% rule. Gain recognition is accelerated if the property is treated as a payment. Even Treasury viewed this acceleration as unwarranted. Indeed, it appears that Treasury was primarily responsible for drafting the proposed legislative changes that were eventually enacted as section 453(f)(6).

Professor Ginsburg, in various representative capacities, and as one of the key forces behind the redrafting, continued throughout the hearings to identify the 1031/453 transaction as deserving of reform. However, neither Treasury nor Professor Ginsburg, nor any other person involved in the drafting process, ever mentioned the potential extension of section 453(f)(6) to 351/453 transactions.

57. As discussed in the text, § 1031 exchanges were probably always viewed as potential installment sales to the extent that boot notes were received on the exchange. Section 453 treatment had not always been available in such cases, however, due to the 30% down payment rule. ISRA did expand § 453 treatment to all such exchanges by abolishing the 30% rule.

58. 1965-1 C.B. 356.
59. See Ginsburg, Taxing the Sale, supra note 32, at 482.
60. See also 1979 Senate Hearings, supra note 35, at 45-46 (testimony of Professor Ginsburg).
62. See 1980 House Hearings, supra note 32, at 46 (Chairman Rostenkowski to Martin Ginsburg: “We are aware of the amount of time and effort you have devoted to this legislation. We know that you were truly one of the principal architects of this legislation . . . .”).
64. But see Professor Ginsburg's post-enactment explanation of ISRA, where he does mention the possibility of a 351/453 transaction. Ginsburg, Future Payment Sales After the 1980 Revision Act, 39-2 INST. ON FED. TAX'N 43-29 (1981) [hereinafter cited as Ginsburg, Future Payment Sales].
D. Concluding Observations

Although legislative history is always of some relevance in the interpretation of tax statutes, its degree of importance varies from case to case. Arguments based on the concept of legislative intent are often misleading. Too often they are based on the supposition that a legislative body can have a specific intent with respect to the words it chooses to include in its final legislative expression. It is not likely that Congress as a whole ever formed any specific intent with respect to the coverage or non-coverage of transactions under section 453(f)(6). Nor is it appropriate in this case to suggest that specific legislative intent can be gleaned from the specific statutory language. The most that the history behind section 453(f)(6) reveals about legislative intent is that the provision was intended to reverse the gain-reporting rule that had been set forth in Revenue Ruling 65-155. From its language, we can tell that the new rule is intended to apply to section 1031 transactions and certain section 356 transactions.

The legislative history, however, does provide information beyond the narrow question of specific legislative intent. The history puts the statute in context. It tells us that ISRA was adopted in order to simplify existing law. It did so by expanding the benefits of installment reporting, thereby eliminating the numerous distinctions and qualification rules of the old law. In addition, the history shows that the final bill was a cooperative project, resulting from the joint effort of taxpayer representatives in private practice and of government officials. ISRA is essentially pro-taxpayer, with Treasury supporting the pro-taxpayer provisions on condition that certain specific taxpayer abuses be addressed. In keeping with the legislative history, the pro-taxpayer aspects of the law ought to be interpreted liberally and the anti-abuse provisions ought to be read narrowly.

III. Overview of the Proposed Regulations on 351/453 Transactions

In 1981, Treasury issued temporary rules in order to give guidance to taxpayers engaging in transactions covered by the new Installment Sales Act. In defining “payment,” these rules made the following cryptic comment: “However, for special rules relating to the receipt of certain property with respect to which gain is not recognized, see paragraph

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65. The specific taxpayer abuse was installment sales between related parties, followed shortly thereafter by a disposition for cash.

This was the first official indication that section 351 transactions would be covered by newly enacted section 453(f)(6). At the time these rules were issued, paragraph (f) was non-existent. Nonetheless, the mere mention of section 351 in this temporary regulation indicated that Treasury viewed the receipt of boot notes in a section 351 transaction as analogous to the receipt of boot notes in a section 1031 transaction. Thus, it appeared to endorse the deferral of gain as well as to indicate that computation of the deferred gain would be made in accordance with the new rules contained in section 453(f)(6).68

On May 3, 1984, paragraph (f) of this regulation was issued in proposed form. It sets forth the rules for computing gain and basis for 1031/453 transactions, certain corporation reorganizations in which installment boot is distributed,69 351/453 transactions, and installment sales of principal residences under section 1034 in which there is partial gain recognition. This regulation still exists in proposed form.

A. Computation of Gain

In order to compute gain on a 351/453 transaction, the following rules apply:70

(1) Basis in the property transferred to the corporation will first be allocated to the stock and any nonrecognition securities received by the shareholders on the exchange, but not in an amount greater than the fair market value of the stock and securities.

(2) Any excess basis will then be allocated to the installment sale portion of the transaction.

(3) To determine gain on the installment sale portion of the transac-

68. The only official alternative method of computing gain was that set forth in Revenue Ruling 65-155, supra note 11. See also G.C.M. 36500, (Nov. 26, 1975), applying the principles of Revenue Ruling 65-155 to a 351/453 transaction, discussed in New York State Bar Association, Tax Section, A Report on Proposed Regulations Under Section 453(f)(6)—Installment Obligations Received in Certain Non-Recognition Exchanges, 24 TAX NOTES 297, 305 (July 16, 1984)[hereinafter cited as Report on Proposed Regulations].
69. 356/453 transactions.
70. The method for computing gain under the proposed regulations is essentially the same for all covered transactions, except § 1034 rollovers. Covered transactions, in addition to § 351 transfers, include exchanges under §§ 356, 1031, 1034, 1035, 1036, and 1037. The method for computing gain under a 1034/453 transaction is necessarily different since gain recognized does not depend on the amount of boot received, but instead on the purchase price of the new residence. The regulation also provides that § 302 redemptions will qualify under § 453. No special gain computations are necessary for redemptions, however, since redemption gains are recognized in full.
tion, any boot (cash and other nonqualified property) received in the year of the exchange will be treated as part of the selling price and contract price for purposes of determining the gross profit ratio, and a payment in the year of sale for purposes of determining gain recognized under the installment method.\textsuperscript{71}

(4) The nonrecognition property received (stock and securities) will be treated as neither part of the selling price nor a payment.

These principles can be demonstrated by referring to the earlier example involving $A$ and Blackacre:

\textit{Example}: $A$ transfers Blackacre (basis: 10, fair market value: 50) to Newco, Inc. in exchange for stock worth 25 and an installment obligation for 25. $A$'s realized gain is 40. Recognized gain, however, must be determined according to the foregoing rules. The basis of 10 is first allocated to the stock. There is no excess basis to subtract from selling price of 25. Thus gross profit is also 25 and the gross profit ratio is 100%. $A$ will recognize a gain of 25 when the installment note is paid. The remainder of the gain (15 out of total gain of 40) will be recognized if and when $A$ sells the stock.

To demonstrate one further point, change the example slightly so that $A$'s basis in Blackacre is 30. Now the excess basis is 5,\textsuperscript{72} which creates a gross profit of 20 and a gross profit ratio of 80%.\textsuperscript{73} $A$ will recognize the entire gain of 20 when the installment obligation is paid.\textsuperscript{74}

The point made by this second example is that there is no gain deferred under section 351.\textsuperscript{75} All of the deferral is covered by section 453 because all of the gain is allocated to the installment sales portion of the transaction.\textsuperscript{76} This will always be the case in a situation in which the basis of the shareholder's property transferred to the corporation exceeds the fair market value of the stock and securities received on the transfer. This result is consistent with the rule contained in section 351(b). Gain should be recognized to the full extent of the boot received. Any addi-

\textsuperscript{71} Gain recognized in any year will be equal to the gross profit ratio multiplied by the payment received.

\textsuperscript{72} Twenty-five of the basis is first allocated to the stock (up to its fair market value of 25) and the excess 5 is available to be allocated to the installment sales portion of the transaction.

\textsuperscript{73} Gross profit of 25 (face of note) minus excess basis of 5 equals 20. Total contract price is 25 (face of note). Thus, the gross profit ratio is 20/25 or 80%.

\textsuperscript{74} Eighty percent of the 25 payment equals 20 gain recognized.

\textsuperscript{75} Compare this result with the literal § 453 approach and the bifurcation approach, text accompanying \textit{supra} notes 3-10. In those examples, gain was deferred under both § 453 and § 351.

\textsuperscript{76} All of the basis in the transferred property is allocated to the stock. Contrast this approach with the bifurcation approach, \textit{supra} notes 8-10 and accompanying text, in which the basis is apportioned between the stock and the note.
tional gain will be deferred under section 351.\textsuperscript{77}

B. Basis Rules

The normal basis rules in a section 351 transaction provide for the shareholder to take a substituted basis in the stock received\textsuperscript{78} and for the corporation to take a carryover basis in the property it receives.\textsuperscript{79} Adjustments must be made when a shareholder, in addition to stock, receives taxable boot on the exchange.

1. Shareholder's Basis

The general rule for the shareholder is that the basis of the stock will be the same as the basis of the property transferred, decreased by the amount of boot received (amount of cash and fair market value of other property) and increased by the amount of gain.\textsuperscript{80} The shareholder's basis in the boot property will be its fair market value.\textsuperscript{81} To demonstrate the application of this rule, consider the prior example involving A. If the installment note for 25 were cash instead, then A's gain of 40 (first set of facts) would be recognized to the extent of the 25 cash. A's basis in the stock would be computed as follows: basis of Blackacre (10) minus cash (25) plus gain recognized (25) equals 10.

Logically, the resulting basis of 10 should also represent A's basis in the stock in the combined 351/453 transaction. Since the basis of 10 is first allocated to the stock for purposes of determining gain recognized, the basis of 10 should remain allocated to the stock for purposes of determining any subsequent gain. In their current form, however, the proposed regulations do not take so direct an approach. The approach in the regulations is to use the statutory formula of section 358: basis equals basis in property transferred minus fair market value of boot plus gain recognized on the exchange. The problem in using this formula is that no gain is recognized on the exchange because section 453 defers recognition of gain until payment is received.\textsuperscript{82} Thus, in order to produce the logically necessary basis of 10, the proposed regulations state that "the taxpayer shall be treated as if the taxpayer elected not to report receipt of

\begin{itemize}
\item \textsuperscript{77} It is this rule contained in § 351(b) that undercuts the arguments in favor of the literal § 453 approach or the bifurcation approach.
\item \textsuperscript{78} \textit{E.g.}, the shareholder's basis in stock received is the same as the shareholder's basis in the property transferred. I.R.C. § 358.
\item \textsuperscript{79} The corporation will take shareholder's basis in the property. I.R.C. § 362.
\item \textsuperscript{80} I.R.C. § 358(a)(1).
\item \textsuperscript{81} I.R.C. § 358(a)(2).
\item \textsuperscript{82} See I.R.C. § 453(c). \textit{See also} Ginsburg, \textit{Future Payment Sales}, supra note 64, at 43-29 n.41.
\end{itemize}
the installment obligation on the installment method."\textsuperscript{83}

Thus, the approach of the regulations is to create a constructive election-out of section 453, which in turn creates constructive recognized gain on the exchange. This approach is necessary only to accomplish the production of the correct basis under a literal application of the section 358 basis formula.\textsuperscript{84} It is interesting to note that this approach is not considered necessary to compute the correct basis in a 356/453 transaction even though section 358 also applies to section 356 transactions.\textsuperscript{85}

2. \textit{Corporation’s Basis}

The general rule for corporations in a section 351 exchange that involves the receipt of boot by the shareholder is that the basis of property received will be the shareholder/transferor’s carryover basis “increased in the amount of gain recognized to the transferor on such transfer.”\textsuperscript{86} This basis rule is often referred to as derivative basis, in that the corporation derives its basis from the shareholder. To demonstrate, use the example of $A$’s transfer of Blackacre (basis of 10) in exchange for stock and 25 cash: Newco’s basis in Blackacre is equal to $A$’s basis in Blackacre (10) plus $A$’s recognized gain (25). This formula gives Newco a basis in Blackacre of 35.\textsuperscript{87}

Under the proposed regulations, if the 25 cash is instead an installment note for 25, application of the section 362 rule will literally produce

\textsuperscript{84} Basis in the stock (10) is equal to the basis in Blackacre (10) minus the fair market value of boot (25) plus the gain recognized (25).
\textsuperscript{85} See the examples in Proposed Regulation § 1.453-1(f)(2), which merely conclude that the basis of nonrecognition property received is the amount of basis assigned to it under the regulations (i.e., basis in transferred property up to fair market value of nonrecognition property received), with no reference to § 358.
\textsuperscript{86} I.R.C. § 362(a).
\textsuperscript{87} The rule of § 362 is simple and straightforward if the transfer by $A$ is of a single piece of property. Complications result if $A$ makes a multi-asset transfer under § 351 and receives boot. $A$ must recognize gain to the extent of the boot. To determine the character of the gain to $A$, the gain on each asset must be computed separately. Revenue Ruling 68-55, 1968-1 C.B. 140 sets forth this asset-by-asset approach. Thus, $A$ must first compute realized (as contrasted with recognized) gain on each asset. Then to determine the amount of recognized gain on each asset, $A$ must allocate a portion of the boot received to the assets in accordance with their relative values. There is, however, no comparable ruling or regulation to guide the corporation, Newco, in allocating its aggregate basis determined under § 362 among the multiple assets received. Both consistency and underlying policy suggest that Newco’s basis be computed similarly, using an asset-by-asset approach. Thus, each asset received by Newco from $A$ should have a basis equal to $A$’s basis in that property increased by the amount of gain recognized by $A$ on that asset. Since losses are never recognized in a § 351 exchange, the asset-by-asset approach will preserve the loss for the corporation to recognize when it sells the loss asset. See S. Lind, S. Schwartz, D. Lathrope & J. Rosenberg, Cases and Materials on Fundamentals of Corporate Tax 73 (1985).
the following: Newco's basis in Blackacre equals A's basis (10) plus gain recognized to A (0), for a total basis of 10 in Blackacre. The constructive election-out of section 453 with its resulting constructive gain recognized is only available for purposes of determining shareholder basis under section 358. For purposes of determining Newco's basis under section 362, gain recognition does not occur until payments are made to A on the installment note. Thus, the proposed regulations provide: "As the taxpayer recognizes gain on the installment method, the corporation will increase its basis in the property by an amount equal to the amount of gain recognized by the taxpayer."

If Newco no longer holds Blackacre at the time the note is paid to A, it will not be possible for Newco to increase basis in Blackacre by the amount of gain triggered to A. In such a case, Newco will be allowed to recognize a loss at time of payment equal to the amount of gain triggered to A. There is no indication as to the character of this loss.

IV. EVALUATION OF THE PROPOSED REGULATIONS

One of the difficulties with the proposed regulations is their initial assumption that section 453 applies to boot notes received in a section 351 transaction. As discussed earlier, Congress apparently made the same assumption with respect to boot notes received in a section 1031 exchange. Thus, it may not seem too surprising that Treasury has elected to extend that assumption to section 351 transfers. Transactions covered by these two sections are similar in that they involve nonrecognition of gain. This similarity, however, may not be sufficient to warrant the extension of section 453(f)(6) to section 351 transactions.

89. The regulations are silent with respect to the corporation's basis in a 356/453 transaction. Section 362(b) applies in such cases and it too depends on the amount of gain recognized by the transferor. In the reorganization context, however, the transferor is not the shareholder. The shareholder may be viewed as the transferor for purposes of applying § 453, but in actuality the transferor is the shareholder's corporation. In an "A" reorganization, for example, the shareholders of Target may end up with boot notes from Acquiring Corp. that qualify under § 453(f)(6), but the transaction for § 362 basis purposes involves a transfer of assets by Target to Acquiring. Acquiring takes the assets with straight carryover basis under § 362(b).
92. In the absence of a "sale or exchange" one might argue that the loss is ordinary. However, if the property had been sold by the corporation at a capital gain, presumably the loss would be capital under the Arrowsmith doctrine. See Arrowsmith v. Commissioner, 344 U.S. 6 (1952).
93. See supra note 56 and accompanying text.
94. The same assumption must have been made with respect to nontaxable boot notes received in a § 356 transaction since they are also included in § 453(f)(6).
Section 453, by its terms, applies only to “income from an installment sale.”\(^{95}\) Whereas section 1031 exchanges resemble sales,\(^{96}\) transfers that qualify under section 351 are not normally viewed as such.\(^{97}\) The distinction between a 351 transfer and a sale has been raised in so many different contexts\(^{98}\) that it is surprising that the distinction has been so ignored in the 351/453 context.\(^{99}\)

There is no evidence that Congress has ever considered the question of whether transfers to a controlled corporation, qualifying for partial nonrecognition under section 351(b), can also be considered an installment sale, qualifying for deferral of gain under section 453.\(^{100}\) In the absence of such consideration by Congress, Treasury’s decision to view a 351/453 transaction as an installment sale for purposes of gain deferral is

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95. Section 453(a) provides: “Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.” (emphasis added).

96. The sale analogy ought to hold for § 356 transactions as well since the boot note will only qualify for deferral if it is not a dividend. This means the transaction must qualify for sale or exchange treatment under § 302. See Prop. Reg. § 1.453-1(f)(2).


98. E.g., if there is a sale, loss may be recognized provided § 267 is not applicable, and the corporation will normally take a cost basis on a sale under § 1012. See Ellis, Tax Problems in Sales to Controlled Corporations, 21 VAND. L. REV. 196 (1968).

99. But see id. at 211-12 (arguing under pre-1980 law that installment reporting ought to be available for boot notes in a § 351 transfer because § 453 could be read to cover dispositions of property and not just leases). Prior to ISRA, § 453(b) allowed “income from a sale or other disposition” of property to be reported on the installment method. At least one pre-ISRA case held, despite this language, that for a disposition to qualify under § 453, it must be a sale. Billy Rose’s Diamond Horseshoe, Inc. v. United States, 448 F.2d 549 (2d Cir. 1971).

The current statute allows installment reporting for “installment sales.” An installment sale is then statutorily defined as “a disposition of property where at least 1 payment is to be received after . . . the year [of] disposition.” I.R.C. § 453(b)(1). Thus, it is still possible to read the statute as applying to any disposition of property, whether it is technically a sale or not, provided it involves a deferred payment. “Payment,” however, suggests “sale,” and it is unlikely that disposition was meant to include leases and other nonsale dispositions. See discussion infra p. 84.


100. Although a case could be made for allowing taxpayers to defer gain on a nonsale transaction in which deferred payment obligations are received, there is no current statutory support for such a rule. In a § 351 transaction, the rule set forth for such obligations is found in subsection (b): gain shall be recognized to the extent of the obligations’ fair market value.
at least questionable. Once characterized as a sale for gain deferral purposes, however, consistency would suggest that the transaction remain a sale for basis purposes. The Treasury position in the regulations results in a hybrid approach which may lack statutory authority.\footnote{101}{The few commentators who have considered the possibility of a 351/453 combination have similarly assumed that deferral of gain would be permitted because, in keeping with § 453, there is a disposition of property and there is at least one deferred payment. See articles cited supra note 99.}

A. Authority to Regulate Under Section 453: A Closer Look

In the absence of specific statutory authority, the validity of the regulations is subject to challenge. Installment sales regulations have been subjected to such challenges in the past. Indeed, the very first installment regulations were held invalid by the Board of Tax Appeals due to the absence of any statutory authority for the installment method of reporting gain.\footnote{102}{B.B. Todd, Inc. v. Commissioner, 1 B.T.A. 762 (1925).} Congress responded by enacting the forerunner to current section 453,\footnote{103}{Revenue Act of 1926, ch. 27, § 212(d), 44 Stat. 9.} creating the necessary statutory authority, but the correctness of that early opinion restricting the Treasury's authority to create new law via regulations remains.

The Secretary of the Treasury is authorized to draft general interpretative regulations pursuant to section 7805(a) of the Internal Revenue Code (the Code). In addition, section 453(j) provides as follows:

(1) In general.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section.

(2) Selling price not readily ascertainable.—The regulations prescribed under paragraph (1) shall include regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.\footnote{104}{I.R.C. § 453(j).}

Usually, specific grants of authority such as this are viewed as a delegation of legislative power. Thus, regulations drafted pursuant to this grant are known as legislative regulations and are much more difficult to attack in court than are interpretative regulations.\footnote{105}{See United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982); Commissioner v. South Tex. Lumber Co., 333 U.S. 496 (1948).} Generally, legislative regulations are authorized in areas that are considered highly technical.\footnote{106}{See G. RICHMOND, FEDERAL TAX RESEARCH 18 (2d ed. 1985).}

Because of the many complexities that can arise in reporting gain on the installment method, Congress no doubt intended to give the Treasury
the power to resolve a broad range of technical problems through the issuance of specific regulations. Indeed, throughout the history of installment reporting, the regulations have played a critical role in determining technical issues left unaddressed by the statute.\textsuperscript{107} Although the validity of such regulations has been challenged, the courts have generally upheld the Commissioner, tending to recognize the necessity for broad discretion in answering the specific questions that arise with respect to installment reporting of gain.\textsuperscript{108}

Thus, to the extent the proposed regulations set forth mechanical rules that answer technical questions under section 453(f)(6), they are certainly within the scope of legislative authority. The decision to include section 351 transactions, however, is not a mere technical matter. It is a policy decision. At the first level, it is a policy decision to extend deferral of gain benefit under section 453 to a transaction that otherwise has very little similarity with most installment sales. Viewed in this way, the proposed regulations appear to exceed the specific grant of legislative power to "prescribe such regulations as may be necessary or appropriate to carry out the provisions of [section 453]."\textsuperscript{109}

\textsuperscript{107} The installment method of reporting gain was first recognized by the Treasury Department in 1918 when, in the absence of any statutory provision, it issued regulations prescribing the method. Reg. § 33, art. 120 (1918), 1918 CORPORATION TRUST COMPANY INCOME TAX SERVICE 422. Thus, the installment method began solely as a creature of the regulations. When the method was subsequently adopted by Congress, the statutory language provided:

Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed, bears to the total contract price.

Revenue Act of 1926, ch. 27, § 212(d), 44 Stat. 9.

For a complete history of the early installment sales provisions, see Cain, Installment Sales, supra note 49, at 2-6.

Prior regulations have gone beyond the statutory language, addressing such issues as:


(2) the authorization of installment treatment for certain revolving credit plan sales prior to congressional action on this matter. Reg. § 1.453-2(d), T.D. 6682, 1963-2 C.B. 197. See Cain, Installment Sales, supra note 48, at 9, n.49.

(3) the proper treatment for deferred payment sales that did not qualify for the installment method. Reg. § 1.453-6(a) (1958). See generally Cain, Taxation of Promises to Pay, 8 Ga. L. REV. 125, 152 (1973) (suggesting that § 1001, rather than § 453, might be a more appropriate source of statutory authority for dealing with this issue).


\textsuperscript{109} I.R.C. § 453(j) (emphasis added). There is no provision in § 453 regarding § 351, nor is it a matter that was ever contemplated by Congress during the 1980 revisions of § 453.

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The proposed regulations are not necessarily invalid, however, solely because they exceed the specific authority delegated in section 453(j). They must also be tested as general interpretative regulations under section 7805(a). The test, as articulated by the Supreme Court, is "that as 'contemporaneous constructions by those charged with administration of' the Code, the Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes,' and 'should not be overruled except for weighty reasons.'" 110

The evaluation that follows is not intended to set up a serious challenge to the validity of the proposed regulations in the event they are finalized without amendment.111 Reasons are set forth as to why the regulations ought to be rethought and amended.112 Whether these reasons are "weighty" enough to convince a court to overrule the regulations is an entirely different matter.113

B. Evaluating the Gain Question: Should Gain Be Deferred Under Section 453(f)(6)?

As noted earlier,114 the proposed regulations begin with the assumption that section 453 deferral is as appropriate for section 351 transfers as it is for section 1031 exchanges. It was suggested that this assumption is incorrect since, unlike section 1031 transfers, section 351 transfers do not resemble a sale.

I. Legislative History and the Meaning of Installment Sale

Section 453 makes the installment method of reporting gain available for "income from an installment sale."115 From its inception, how-

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111. It is unlikely that the regulations, as proposed, would ever be challenged in court to the extent that they extend § 453 deferral benefits to a § 351 transferor. On the other hand, the proposed rule regarding basis might well be subjected to judicial scrutiny as the result of a taxpayer challenge. But see the discussion in text accompanying infra notes 177-90, suggesting that even basis challenges are likely to be few.
112. To some extent, these reasons also call for a congressional rethinking of § 351 generally.
113. Readers of this article are likely to have differing opinions as to the amount of weight sufficient for overruling a regulation, depending upon their view as to the appropriate amount of deference a court ought to accord administrative interpretations of the Code. Personally, I align myself with those who favor increased deference to the Service's interpretation despite the fact that I often question the quality of the interpretation.
114. See discussion supra p. 78.
115. Section 453(a) provides: "Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method."
ever, the statute has never provided a satisfactory definition of "installment sale." In its historical context, the installment method was intended as a relief measure for a narrow class of sellers, those who sold on the "installment plan." Typically such sellers received only a small down payment together with a buyer's obligation for significantly deferred additional payments. Early cases tended to view an installment sale as one that included all the trappings of the traditional "installment plan."  

With the passage of time, those sales that could meet the minimal statutory requirements came to be viewed as installment sales for purposes of section 453 reporting. As a result, section 453 deferral became available for a broader class of sellers than those originally intended to benefit from its provisions. Thus, for retailers, revolving credit sales qualified even though they involved short-term debt, as opposed to the long-term debt that the original drafters envisioned. The availability of the method for sellers of realty experienced a similar expansion as new methods of real estate seller financing were created. Thus, sales for deferred payments came in various shapes and sizes and many of these sales had little in common with the historical "installment sale." Consequently, qualifying for the installment method depended not on whether the sale was an "installment sale" in the historical sense, but on other factors.

The main purpose behind ISRA was to eliminate the mechanical line-drawing that had evolved with respect to which sales qualified under section 453 and which did not. It is in this context that one must read the current definition of "installment sale." Section 453(b)(1) provides: "The term 'installment sale' means a disposition of property where at

117. Thus, courts decided cases relying on the "generic meaning of sales 'on the installment plan.'" Consolidated Dry Goods Co. v. United States, 180 F. Supp. 878, 882 (D. Mass. 1960). This approach resulted in such requirements as the two-payment rule. See Baltimore Baseball Club, 481 F.2d 1283; 10-42 Corp., 55 T.C. 593.
118. The sales also had to meet the nonstatutory requirement of two payments. See supra note 117.
119. See Reg. § 1.453-2(d)(1958) (covering certain revolving credit plan sales before Congress considered the issue in 1964). For further details, see Cain, Installment Sales, supra note 49, at 8-9.
120. Casual sellers of personality also benefitted from the expansion.
121. The original drafters, for example, had in mind a limited number of methods for sellers to secure against default. See Cain, Installment Sales, supra note 49, at 7, n.35. Today, a seller can qualify even though payment is secured by a standby letter of credit issued by a bank. See Sprague, 627 F.2d 1044. The result in Sprague was specifically approved in ISRA. See S. Rep. No. 1000, 96th Cong., 2d Sess. 18 (1980).
122. E.g., meeting the 30% test and the two-payment rule. See generally, Solomon & Kirkelie, supra note 48, at 669.
least 1 payment is to be received after the close of the taxable year in which the disposition occurs.’\textsuperscript{123}

Congress’ specific intent in choosing this particular language was to eliminate the 30% down payment rule and the two-payment rule. Thus, any disposition of property, regardless of how large a payment is received initially, will qualify provided only that there is one deferred payment. There is no indication as to why the term “disposition” was used instead of the more restrictive term “sale.”\textsuperscript{124}

Once the transaction qualifies, the transferor will report gain only as payments are received. Payment does not include “the receipt of evidences of indebtedness of the person acquiring the property,”\textsuperscript{125} unless it is “payable on demand”\textsuperscript{126} or “issued by a corporation or a government or political subdivision thereof and is readily tradable.”\textsuperscript{127}

Thus, under current law, any disposition of property involving a deferred payment and an “evidence of indebtedness” appears to fit within the literal application of section 453. This seems to be the case whether or not the disposition of property constitutes a “sale.” In support of this position, one might argue that if Congress had intended to restrict section 453 to sales, it would have used the word “sale” rather than “disposition” in section 453(b)(1).\textsuperscript{128}

On the other hand, one might argue that, historically, installment reporting was intended to be available only to sellers. Although the word “disposition” is certainly broader than the word “sale,” it ought not to be read broadly enough to include dispositions that are totally dissimilar to sales. For example, no one should seriously argue that a lessor could rent Blackacre to A for five years in exchange for A’s promissory note and rely on section 453 for deferral of gain until the note is paid. Although it can be argued that the lessor has engaged in a disposition of property which involved a deferred payment and an “evidence of indebtedness of the person acquiring the property,” she has not engaged in the type of disposition normally associated with section 453.

\textsuperscript{123} I.R.C. § 453(b)(1).
\textsuperscript{124} The term “disposition” was also used in the pre-ISRA version of § 453. See supra note 99. See also § 1001(a) which sets forth the rule for determining “gain from the sale or other disposition of property” (emphasis added). Compare that language with the rule regarding recognition of gain in § 1001(c): the entire gain “on the sale or exchange of property shall be recognized.” Although arguments can be made regarding the varying definitions of “sale,” “exchange,” and “disposition,” it is not clear that Congress ever had such varying definitions in mind.
\textsuperscript{125} I.R.C. § 453(f)(3).
\textsuperscript{126} I.R.C. § 453(f)(4)(A).
\textsuperscript{127} I.R.C. § 453(f)(4)(B).
\textsuperscript{128} But see supra note 124.
Another argument against too broad an interpretation of the term “disposition” in section 453 is that it might result in substituting section 453 deferral of gain for the more restricted deferral available under section 351. Any transfer of property to a corporation can be viewed as a disposition. To the extent the transferor receives stock and securities for the property, an argument can be made that gain should be reported pursuant to section 453. Gain would be deferred at least with respect to the securities, assuming that they qualify as an “evidence of indebtedness” and are not “readily tradable.” Thus gain could be deferred whether or not the control requirements of section 351 were met. In addition, a transfer for stock and securities that failed to qualify under section 351 would raise the question of whether the corporate stock could be treated as an “evidence of indebtedness” for purposes of section 453 deferral. If it could not, then an anomalous situation would result in which gain on the generally more solid corporate debt instrument could be deferred whereas gain on the more risky, less liquid corporate stock could not.

Although the better rule might be to allow deferral in every event involving transfers of property to a closely-held corporation in exchange for either stock or debt instruments, the view up until now has been that section 351 is the appropriate provision for granting such deferral and thus its requirements must be met. There is no indication that the revised definition of installment sale in section 453 was intended to change the section 351 requirements. Thus, it seems inappropriate to read

131. In order to defer gain under § 351, the transferors must be in control of the corporation. Control is defined as 80% ownership. See I.R.C. § 368(c).
132. Under § 453(f)(4), the stock could not qualify if it were “readily tradable.” The stock would be “readily tradable” if it had a market in an established securities market. See I.R.C. § 453(f)(5).
133. Subject, of course, to the possibility that the transaction might be classified as “open” rather than “closed” under the Logan principle. See Logan, 283 U.S. 404 (allowing cost recovery method of accounting for gain if consideration received has no ascertainable fair market value).
134. The expanded coverage of § 453 suggests at the least that § 351 transactions involving closely-held corporations ought to be given deferral benefits on the same terms as installment sales. The Service and the courts, however, have tended to view § 351 issues separately without considering the potential coverage of § 453. Thus, for example, in Revenue Ruling 73-472 the Service held that taxpayer D could not claim nonrecognition under § 351 because he
“disposition” so broadly that it includes all section 351 transfers.

Legislative history, as well as common sense, supports a restrictive interpretation of the term “disposition” as used in section 453. The suggested restriction is that the term be limited for section 453 purposes to those dispositions that have some similarity with sales transactions. The proposed regulations would expand section 453’s coverage to section 351 dispositions in which the shareholder receives a “boot note.” In the following section, the evaluation will continue by focusing on whether the existence of boot notes is sufficient to characterize a section 351 transaction as a sale.

2. Section 351 Transfers: Sale or Nonsale?

With respect to a pure section 351 transaction (i.e., no boot), the Fifth Circuit observed in 1934:

The transaction described in the statute lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interest of the transferors in the transferred property, after the consummation of the transaction the transferors continue to be beneficially interested in the transferred property and have dominion and control over it by virtue of their control of the new corporate owner of it.¹³⁵

Perhaps the judicial view of a sale in 1934 was correct in focusing on the extinguishing of beneficial interest. Today, however, sales have been recognized in contexts involving significant retention of beneficial interests by the sellers either in the form of additional security for the promised future payment of the selling price¹³⁶ or in the form of retained use of the property.¹³⁷ Indeed, if extinguishing one’s beneficial interest in the property is the appropriate test, then a transfer from a sole shareholder to a controlled corporation could never qualify as a “sale.”¹³⁸

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¹³⁵ American Compress & Warehouse Co. v. Bender, 70 F.2d 655, 657 (5th Cir. 1934) (emphasis added).
¹³⁷ See Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2d Cir. 1959) (sale and leaseback recognized as a sale rather than a § 1031 exchange); see also Frank Lyon Co. v. United States, 435 U.S. 561 (1978).
¹³⁸ My personal opinion is that “no sale” is the appropriate finding in such cases. But “sale” versus “no sale” is not the ultimate issue. Here, for example, the ultimate issue is qualifying for deferral of gain. In most cases involving controlled corporations, a step-up in basis is the ultimate issue. Although asking the question, “Is it a sale?” may be helpful in resolving the underlying issues, to make the answer determinative, relying on dictionary definitions, is too superficial an approach. It is an approach I have eschewed elsewhere with respect to the sale or exchange requirement for capital gains. See Cain, From Crane to Tufts: In
In the section 351 context, the "sale" issue only tends to arise when some form of debt instrument has been issued as consideration by the corporation. Courts have focused on the nature of the debt instrument in determining whether a sale exists. If the debt is reclassified as stock, then the transaction will be viewed as a section 351 equity contribution instead of a sale. If the debt is classified as a security, the transaction will likewise be viewed as a section 351 equity contribution rather than a sale. On the other hand, if the debt withstands scrutiny as a nonequity instrument, the transaction will normally be viewed as a sale, instead of a section 351 transaction.

Most cases involve a separate sale for an installment note rather than a distribution of boot notes incident to an otherwise tax-free section 351 transfer. As a result, courts have tended to focus on the separate

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Search of a Rationale for the Taxation of Nonrecourse Mortgagors, 11 Hofstra L. Rev. 11, 42 (1982).

139. However, the issue does not arise in all such cases. If the transaction is a single transfer of assets with stock and notes distributed to the shareholder, the transaction may be viewed as a § 351 transfer with boot and the issue of "sale" versus "nonsale" simply does not arise. See supra note 18 and example (1) in the Introduction.

140. See, e.g., Burr Oaks Corp., 43 T.C. 635 (initial incorporation by brothers and their wives, followed by a sale for notes by real parties in interest; notes recharacterized as preferred stock and steps collapsed to single § 351 transaction); Gooding Amusement Co., 23 T.C. 408 (short-term notes reclassified as equity).

141. Campbell v. Carter Found. Prod. Co., 322 F.2d 827 (5th Cir. 1963). The court never explicitly held that the debt was a security, always referring instead to "stock or security." Presumably it intended to so hold, since it did explicitly rule that the debt was debt for purposes of deducting interest at the corporate level. However, it concluded with the following rather cryptic comment: "[T]he promissory notes . . . were the substantial equivalent of equity securities, no matter what their legal (or tax) status for other purposes might be." Id. at 835. This language suggests that the court might have viewed the same instrument as debt for interest deduction purposes and as nondebt equity for 351/362 basis issues. See also Camp Wolters Enter., Inc. v. Commissioner, 230 F.2d 555 (5th Cir. 1956) (notes held to be securities thus reducing corporate basis under 351/362).

142. Curry v. Commissioner, 43 T.C. 667 (1965), acq., 1965-2 C.B. 4, nonacq., 1968-2 C.B. 3. A corporation was formed by two persons to buy property owned by one shareholder’s family, issuing notes therefor. Notes were not stock. Thus, the transaction was a sale and the court said there was no need to consider the alternative argument by the Service that the notes were a security. This latter portion of the holding is clearly in error and demonstrates the court’s confusion with respect to the sale versus the § 351 issue. See also Brown, 27 T.C. 27 (separate installment sale of assets to newly formed corporation recognized). But see supra note 139 (fact situation in which classification as boot note does not raise the "sale" issue).

143. But see example (1) in the Introduction supra and cases cited supra note 18. See also supra note 139. Although the two transactions, incorporation followed by a "sale," are subject to collapse under the step transaction doctrine, the courts tend to collapse them only if the notes are reclassified as equity. If they retain their character as nonequity notes then generally the separate sale transaction will be recognized. Curry, 43 T.C. 667. It would be feasible, of course, to honor the notes as nonequity notes but nonetheless collapse the steps so that the notes were viewed as boot in the underlying § 351 transaction. In most cases, the gain and basis consequences would be the same whether the notes were considered as boot or as pay-
sale transaction, asking whether it ought to be reclassified as a section 351 exchange. For example, in response to a taxpayer's argument that installment obligations issued by a corporation in exchange for property should be viewed as stock or securities issued in a section 351 exchange, the Tax Court said: "Holding, as we do, on the basis of the foregoing discussion, that the transaction was a sale, it follows, for the same reasons, that it was not an exchange within the meaning of [section 351]."¹⁴⁴

Thus, it is typical to find courts expressing the view that if a transfer constitutes a sale it cannot be a section 351 transaction, and similarly, if the transfer qualifies under section 351, it cannot be a sale. The bottom line, however, is that true debt tends to support sale characterization.

It might be helpful to phrase the question somewhat differently. For example, although a pure section 351 transaction is not normally viewed as a sale,¹⁴⁵ does the existence of boot, in the form of cash or short-term notes, somehow convert the transaction into a sale, or at least a part-sale?¹⁴⁶ It is certainly arguable that such is the case. If cash is paid for Blackacre, the transaction would normally be viewed as a sale. And since short-term notes are sufficiently similar to cash, one could argue that they too indicate sale characteristics. Furthermore, the argument is consistent with existing case law which recognizes sales between shareholders and their controlled corporations so long as the consideration received by the shareholder is not an equity instrument.¹⁴⁷

On the other hand, one might argue that cash or short-term notes, if received by a 100% shareholder, are never sufficient to support sale characterization. First, the shareholder retains a significant, although indirect, interest in the property transferred. Second, the shareholder can be viewed as already owning the cash received or to be received from the corporation. Under this argument, a shareholder who owns sufficient stock to control the corporation can never enter into a true sale transaction with the controlled corporation. This latter argument is not consistent with existing case law which often recognizes valid sales between

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¹⁴⁵ American Compress & Warehouse Co., 70 F.2d 655.
¹⁴⁶ No case has considered this issue directly, and it is difficult to imagine why the issue might arise. The presence of boot will trigger gain under § 351(b). Calling the transaction a sale or part-sale should not affect that result. Similarly, since boot triggers gain, it will also increase the basis to the corporation under § 362 in much the same way that a sale would give the corporation an increased cost basis under § 1012. See supra note 87.
¹⁴⁷ E.g., Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982).
shareholders and their controlled corporations.\textsuperscript{148}

The traditional wisdom has been that corporations must be viewed as separate from their shareholders for tax purposes.\textsuperscript{149} Once the corporation's separate identity has been established, courts are reluctant to accept legal arguments based on the theory that in reality the shareholder and corporation are but alter egos of a single identity.\textsuperscript{150} Thus, a court would be reluctant to view a section 351 transfer with boot as a nonsale solely because of the mixed identity of shareholder and corporation.\textsuperscript{151}

Sale versus nonsale is, of course, not the ultimate issue to be resolved. Instead, the ultimate issue\textsuperscript{152} is whether gain ought to be deferred. Of course, if a 351/453 transaction sufficiently resembles a sale, then deferral under section 453 is appropriate. To the extent that there is some question as to the sale versus nonsale issue, however, one must turn to other justifications for deferral.

3. Other Justifications for Deferral of Gain

If one believes that there can be no "sale" unless beneficial interest is extinguished,\textsuperscript{153} that does not necessarily end the inquiry regarding deferral under section 453. The ability to defer is, after all, the ultimate issue and it makes better sense to discuss that issue directly rather than attempting to resolve the issue solely by focusing on the technical definition of "sale." The question under this approach becomes: is a section 351 transferor entitled to defer gain on receipt of boot notes as a matter of general policy, consistent with existing statutory provisions?

a. Justification Under Section 453

The most obvious justification for deferral is that to include section 351 transferors in the installment sales provisions is in keeping with the primary goal of ISRA: to expand section 453's coverage to all deferred

\textsuperscript{148} Id.

\textsuperscript{149} See Eisner v. Macomber, 252 U.S. 189 (1920).

\textsuperscript{150} See Moline Properties, Inc. v. Commissioner, 319 U.S. 438 (1943).

\textsuperscript{151} My personal opinion is that courts often give too much weight to the separate corporate identity argument, at least in cases involving sole shareholder corporations. In writing this article, I have come to question whether a sole shareholder ought ever to be viewed as engaging in a sale transaction with his or her controlled corporation. A full defense of this position is beyond the scope of this article, but see infra note 164 for related arguments.

\textsuperscript{152} The ultimate issue in this part of the article.

\textsuperscript{153} See supra notes 136-38 and accompanying text. As acknowledged earlier, the validity of this concept of sale may be questionable after the Supreme Court's decision in Brown. That case, however, did not involve a sale to a controlled corporation. There was at least another party involved in that transaction who, despite the mutual benefit produced by their enterprise, the Court was willing to view as unrelated to the "seller." See Commissioner v. Brown, 380 U.S. 563 (1965).
payment sales of property. The congressional decision to expand, however, must be read in light of the specific legislative concerns that led to expanded coverage.\textsuperscript{154} Congress, for example, did not expand section 453's coverage because it wanted to encourage seller financing or credit sales generally.\textsuperscript{155} The legislative history shows instead that Congress' main concern was with simplification. Specifically, the intent was to provide one method for reporting gain from deferred payment sales of property in order to avoid the complexity of determining which of a number of alternatives\textsuperscript{156} ought to apply to a given sale. Thus, the expanded coverage is best understood as a measure intended to reduce administrative burdens that might otherwise be present. The decision to read section 453 as expanding coverage to section 351 transferors\textsuperscript{157} should be tested in light of this statutory history and purpose.

If allowing a section 351 transferor to defer gain serves to avoid the type of complexity that ISRA sought to eliminate, then deferral is justified. For example, deferral might be justified if it avoided the question of whether the section 351 transferor ought to report the boot notes in accordance with the closed transaction method or open transaction method.

To some extent, deferral of gain will avoid this question. Absent deferral, for example, gain would be reported under the normal boot rules of section 351(b).\textsuperscript{158} A determination would have to be made regarding the note's marketability.\textsuperscript{159} If the note had no readily ascertain-

\textsuperscript{154} See section II of this article.

\textsuperscript{155} Since installment reporting provides a benefit for those who qualify, it can be viewed as a subsidy that encourages the casual seller to provide credit to potential purchasers. Traditional tax policy analysis questions whether such subsidies are justified. See Cain, Installment Sales, supra note 48, at 22-27 (testing the benefit that installment reporting provides for dealers in personal property against recognized economic goals). See generally Sneed, The Criteria of Federal Income Tax Policy, 17 STAN. L. REV. 567 (1965).

\textsuperscript{156} In addition to the installment method, taxpayers might report on the closed transaction method (with different rules for accrual and cash sellers) or the open transaction method. See generally Cain, Taxation of Promises to Pay, supra note 107.

\textsuperscript{157} Although I characterize the issue as whether § 453 coverage should be expanded to include § 351 transfers, it is not clear that such transfers were excluded prior to ISRA. The issue simply did not arise under pre-ISRA law. Presumably, it was a rare case in which a shareholder in a § 351 exchange received less than 30% of the total consideration in the form of stock. Since pre-ISRA receipt of stock constituted a payment for purposes of the 30% limitation, most § 351 transfers that included boot notes simply would not qualify.

\textsuperscript{158} That is, gain would be recognized to the extent of the boot's fair market value.

\textsuperscript{159} If they are cash basis taxpayers, they should only be taxed upon the receipt of cash or its equivalent. Reg. § 1.446-1(c)(1)(i) (1957) (establishing the note's marketability establishes its cash equivalency). See generally Cain, Taxation of Promises to Pay, supra note 107. In addition, a determination would have to be made as to the exact fair market value of the note because boot in a § 351 exchange is taxed to the extent of its fair market value. See I.R.C. § 351(b)(1)(B).
able fair market value, then it should not be taxed upon receipt. If it were marketable, the exact value would have to be determined in order to compute gain under section 351(b). This is precisely the type of determination that the expansion of section 453 was intended to avoid. Thus, expanding the coverage of section 453 to section 351 transferors would appear to be consistent with the simplification and administrative case purposes that Congress had in mind when it enacted ISRA.

b. Justification Under Section 351

A strong argument can be made that all corporate debt obligations issued to a controlling shareholder of a closely-held corporation in exchange for property ought to be viewed as equity securities. Under this view, classifying the debt as a long-term "security" or a short-term "boot note" is inappropriate. Length to maturity is, as a practical matter, immaterial. Accordingly, a section 351 shareholder who receives any type of debt instrument in exchange for property has "not really cashed in on the theoretical gain," and thus should not be taxed in advance of payment.

Thus, boot notes received in a 351/453 transaction should be treated

160. See Logan, 283 U.S. 404. This case is the model for claiming cost-recovery or "open transaction" reporting.
161. In which case the taxpayer would be reporting on the closed transaction method.
162. The main purpose of ISRA was to establish one method of accounting for deferred payment sales, and to eliminate the closed versus open transaction inquiry which can only be answered by determining marketability.
163. There is, however, one additional consideration regarding the inquiry into the note's marketability. In a § 351 context, the determination of marketability must be made for reasons other than determining when the gain is to be recognized. The factors that tend to establish a note's nonmarketability are also likely to establish that the note is not a boot note at all, but instead represents an equity interest in the corporation. Thus, in cases in which the Service views the boot note as an abusive attempt to claim unwarranted interest deductions or a step-up in basis at the corporate level, the inquiry regarding marketability and value must be made in any event.
164. This is most obvious in the case of a sole shareholder, although the argument goes beyond sole shareholder cases. Since the sole shareholder case is easiest to make, however, consider for a moment that case. What possible difference can it really make to a sole shareholder, absent tax consequences, whether the corporation is to pay the debt off at the end of five years or at the end of ten years? Whatever the corporation owns, the shareholder owns indirectly and can, for all practical purposes, own directly if the shareholder so chooses. Thus, all debt is essentially the same to a sole shareholder.
165. Reliance on Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933), for the proposition that short-term notes are not securities is misplaced. Pinellas involved a corporate seller who received notes and no stock. The Court held the transaction was not a reorganization because the corporation received no equity interest in the purchasing corporation. Id. at 470. See also Griswold, "Securities" and "Continuity of Interest," 58 HARV. L. REV. 705 (1945).
166. Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940).
no differently from securities in a pure section 351 transfer. Since the policy of section 351 is to defer gain recognition when the consideration is a corporate obligation, all corporate obligations issued under section 351, whether classified as boot notes or securities, should be entitled to deferral. For simplification purposes, it would be better to have one single rule for all corporate debt rather than one rule for securities and another for boot notes. The initial granting of gain deferral to boot notes is a step towards establishing such a single rule.\(^\text{167}\) Even though the deferral may be viewed as justified under section 351 principles, the proposed regulations' grant of deferral under section 453 is not inappropriate.

4. Conclusion

Gain deferral under section 453 is appropriate if a 351/453 transaction is viewed as a sale. Even if not viewed as a sale, gain deferral is appropriate under broader policy considerations. The proposed section 453(f)(6) regulations are consistent with current law in viewing a 351/453 transaction as one that is similar to a sale. Although that view is subject to criticism, it is not unreasonable given the current state of the law with respect to shareholder-corporation transactions.\(^\text{168}\)

\(^{167}\) A true single rule would require not only that both be entitled to deferral, but also that the computation of the amount of gain upon payment of both be the same. Under current law, gain is computed differently. The question then arises as to which computation method is preferable, the one for securities, or the one for boot notes. Under current law, if highly appreciated property is transferred in a 351/453 transaction, the boot note will trigger more gain upon payment than will a security. Refer to the discussion in the Introduction, regarding the bifurcation approach and the § 453(f)(6) approach for a demonstration of this difference. The gain under the bifurcation approach is the same as the gain would be if the note were a security.

\(^{168}\) \textit{i.e.}, that shareholder and corporation should be treated as two separate entities and thus are capable of engaging in a sale with each other. I think it is time to rethink this principle of separate identity, especially in the context of "sales" to controlled corporations. Distinguishing between a boot note and a security in such cases is a triumph of form over substance and tends to cloud the true issue which is step-up in basis. In this context, the first two examples in § 1.453-1(f)(3)(iii) of the proposed regulations should be noted. They both involve transfers of appreciated property by a sole shareholder to a newly formed corporation in exchange for stock and an installment obligation. In both examples, the proposed regulations state that "the installment obligation is not a 'security' within the meaning of section 351(a)." Example (1) involves a debt:equity ratio (based on fair market value) of 3:4 and example (2) involves a 1:2 ratio. The debt instrument in each example withstands scrutiny under traditional debt versus equity analysis. In my view, however, the security versus boot note analysis lacks substance since both examples involve single shareholder corporations. \textit{See supra} note 164.
C. Evaluating the Basis Question: Should Basis Step-Up Be Deferred Under Section 362 Because Gain Is Deferred Under Section 453?

1. Sale Versus Section 351: The Theory

As was suggested earlier in this article, the “sale” question might be more soundly tested by focusing on issues other than the form of the debt. Additionally, it was suggested that the existence or nonexistence of a sale is the wrong focus. The ultimate issue is when, if ever, a controlled corporation ought to get a step-up in basis with respect to property it receives from a shareholder. As an ultimate issue, however, its resolution is beyond the scope of this article.

As a policy matter, the basis question ought to be resolved by using a consistent theoretical approach to the 351/453 transaction. For now, that approach must be based on current law, which recognizes sales between shareholders and their controlled corporations so long as the consideration withstands the boot note versus equity test. If it does, and the sale has been structured as a transaction separate from a section 351 transfer, then the sale will produce an immediate step-up in basis to the corporation under section 1012 and the Crane rule.

At its core, then, the basis question for 351/453 transactions is whether derivative basis under section 362 ought to be the rule instead of cost basis under section 1012. The difficulty is that a 351/453 transaction is neither purely a section 351 nonrecognition transaction nor purely a sale for deferred payments. It is instead some combination of the two. In recognition of both aspects of the transaction, the basis rule under section 362 could be applied, but then, the corporation ought to be

169. Specifically, the suggestion was that the test might be whether or to what extent the shareholder relinquishes the beneficial interest in the property. This is a test, which if applied strictly, would prohibit the finding of a “sale” on any transfer between a sole shareholder and a controlled corporation. See supra notes 138 & 153.

170. See supra note 138.

171. My resolution of the issue begins, however, with the proposition that selling property to a new solely owned corporation for installment notes generally ought not to be sufficient to create a basis step-up. I am sympathetic to the need to cash out long-term appreciation on real estate at capital gains rates prior to developing the property for “sale to customers,” but I think the problem ought to be resolved legislatively rather than by creating straw corporations.

172. The most recent example of this approach is Bradshaw, 683 F.2d 365 (Ct. Cl. 1982), finding a “sale” by a sole shareholder for notes despite a debt:equity ratio of 50:1. The court disregarded the high debt:equity ratio since the debt represented purchase money notes for real estate of sufficient value to assure payment of the debt whether the corporation was successful in generating further profits or not.

173. Crane, 331 U.S. 1.

174. If it is a § 351 transaction, then § 362 derivative basis ought to apply.

175. If it is a sale, then § 1012 cost basis and the Crane rule ought to apply.
allowed a step-up immediately despite shareholder deferral of gain. The immediate step-up would recognize the sale aspects of the transaction and thus allow the corporation to compute basis as though the boot note had already been paid in full.176 This is in keeping with the Crane rule for basis which allows purchasers on credit to compute basis as though they had paid for the property in cash.177

2. Sale Versus Section 351: The Practice

The conflict over the basis computation is the only portion of the 351/453 proposed regulations likely to produce taxpayer challenges. As a practical matter, however, the likelihood of any significant challenge based on a predominantly section 351 transaction178 is slight. One can assume from the absence of cases and rulings involving section 351 boot transactions that such transactions are rare.179

The more likely challenges will come from those shareholders who have structured their transactions predominantly as sales for the purpose of gaining an immediate step-up in basis. Of course, any such shareholder who wishes to avoid the proposed deferred basis rule can do so by electing out of section 453 thereby triggering immediate gain, which in turn triggers immediate basis increase. This leaves as the real challengers those who wish to defer recognition of gain at the shareholder level while at the same time claiming cost basis at the corporate level.

This mismatch in timing of gain and basis increase can create significant tax benefits in the right fact situation.180 For example, if the prop-

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176. If paid in full, the boot note would trigger immediate gain to the shareholder, thereby triggering a basis increase under § 362.

177. Note that the Crane rule is specifically reversed by §§ 351 and 362 in the case of securities that are received by the shareholder. Securities are debt instruments and if Crane applied to all debt issued by a taxpayer corporation in exchange for property, then the corporation ought to be entitled to a step-up in basis to the extent that it issues securities in a § 351 exchange. Furthermore, even though a shareholder will recognize gain when the corporation pays off a matured security that had been previously issued for appreciated property in a § 351 transaction, no step-up is allowed the corporation under § 362 for that deferred gain. Thus, under current tax law, deferred recognition of gain at the shareholder level is not viewed as a justification for basis increase. Under current tax law, it is the nature of the debt instrument that is determinative.

178. Predominantly § 351 transactions are transfers primarily for stock or securities with a minimal amount of boot.


180. Or, if structured as a 351/453 transaction, those who wish to claim a step-up under § 362 despite the deferral of gain at the shareholder level.

181. Revenue is lost so long as a seller is able to defer gain and the buyer is entitled to an immediate tax benefit from the basis step-up. It is as though the government is floating an interest-free loan to the taxpayers. Note that in 1984, Congress partially remedied the "tax float" problem by enacting § 453(i) which requires the seller to pay tax immediately on any
erty "sold" is depreciable, the corporate purchaser will enjoy immediate
tax benefits in the form of increased depreciation deductions even though
the shareholder has paid no tax on the gain.\textsuperscript{182} Although this benefit
creates an opportunity for some taxpayer abuse in any installment sale of
depreciable property,\textsuperscript{183} Congress has chosen only to address the poten-
tial abuse in sales between certain related parties. In the corporate con-
text, Congress has specifically restricted the potential abuse only in
situations involving sales of depreciable property by an 80% shareholder.
In such situations, the shareholder cannot defer gain under section
453.\textsuperscript{184} Instead the transaction results in immediate recognition of gain
and the proposed deferred basis rule will not be applicable. Thus, this
 provision effectively removes such transferors from the group of potential
challengers.

For the most part, this leaves as potential challengers sellers of raw
land and noncontrolling shareholders\textsuperscript{185} who sell depreciable property.
The sellers of depreciable property, however, will have to report an im-
mediate gain to the extent of any depreciation recapture.\textsuperscript{186} In the end,
then, it is mainly the seller of raw land and other nondepreciable prop-
erty who will qualify for full deferral under section 453.\textsuperscript{187} Partial deferr-
al will be available to the noncontrolling shareholder who sells
appreciated section 1245 property,\textsuperscript{188} or section 1250 property.\textsuperscript{189}

\begin{footnotes}
\item[182] Deferred basis may serve as an additional remedy to the "tax float" problem,
but if it is to be justified as such it should be applied beyond the 351/453 context and it should
be adopted as such by Congress. See letter from Calvin Johnson to David Brockway, Chief of
Staff of the Joint Comm. on Tax'n, reprinted in 23 Tax Notes 765 (May 19, 1984).
\item[183] Id. See also Professor Johnson's comments in the ISRA Hearings. 1979 Senate
Hearings supra note 35, at 189.
\item[184] The deferral of gain to the seller until the note is paid, coupled with the Crane rule
allowing the buyer to include the note in basis, creates an incentive to inflate the selling price.
The seller reaps an immediate benefit in the form of interest payments on an increased prin-
cipal amount and the buyer benefits from higher depreciation deductions. If the selling price is
inflated too much, the transaction will be subject to attack. See, e.g., Estate of Franklin v.
Commissioner, 544 F.2d 1045 (9th Cir. 1976).
\item[185] See I.R.C. § 453(g).
\item[186] Noncontrolling shareholders are those who own less than 80% of the corporation's
stock. See I.R.C. §§ 453(g), 1239.
\item[187] This gain is not subject to deferred reporting under § 453. See § 453(i), which re-
quires §§ 1245 and 1250 recapture gain to be reported whether or not payment has been re-
ceived. This provision was added by the Tax Reform Act of 1984, enacted after the proposed
regulations were first issued. See example (3) of § 1.453-1(f)(3)(iii) of the proposed regulations,
which will have to be redrafted in light of this statutory change.
\item[188] Section 453 deferral is also not available for sales of inventory. I.R.C. § 453(b)(2)(B).
Dealer sales of inventory, however, are separately covered under § 453A.
\item[189] Appreciated § 1245 property will produce both recapture income and capital gain, if
it so qualifies under § 1231. The capital gain portion of the gain can be deferred.
\end{footnotes}
If the sale is of nondepreciable property, there is no immediate benefit to be obtained from the basis step-up. Thus, these sellers are not serious challengers. A step-up in basis for nondepreciable property creates no tax benefit prior to the property's sale. Presumably once the property is sold, the shareholder will be paid, thereby triggering gain\(^1\) and entitling the corporation either to a contemporaneous basis step-up to offset against sales proceeds or to a loss which should have the same effect. The only real mismatch-in-timing benefit, then, appears to occur in a transfer of depreciable property by a non-80% shareholder provided the property contains deferrable capital gain. Thus, as a practical matter, the serious challengers to the deferred basis rule will be few.

3. More Theory

Since the class of potential challengers is so narrow, the deferred basis rule is perhaps more startling in theory than it is in practice. It raises, for example, a number of points that suggest certain inconsistencies. First, it suggests that corporations and shareholders are not really to be considered separate entities with respect to the basis issue even though the issue of basis only arises because they are viewed as sufficiently separate to create a true debtor/creditor relationship. Secondly, it places too much emphasis on the correlation between gain recognition and basis step-up. This is a correlation that has not existed historically.\(^2\) Furthermore, the correlation is contrary to the statutory interpretation of section 362 which allows no deferred basis step up at the corporate level for the deferred recognition of gain on securities.

If the deferred basis rule could be justified on the basis of some recognized tax theory or tax policy, these suggested inconsistencies could be explained or minimized. There is, however, no obvious theory upon which the deferred basis rule is grounded. Indeed, the only justification for the deferred basis rule in a combined 351/453 transaction appears to be that it is consistent with a literal application of the derivative basis rule of section 362: corporate basis is derived from shareholder basis plus gain recognized on the transfer. This justification, however, is not a sufficient reason to retain the rule, given the complexities it can create.\(^3\)

\(^1\) producing both ordinary recapture income and capital gain due to the fact that only excess depreciation is taxed as recapture income.

\(^2\) Or, alternatively, if the parties are related and the sale by the corporation is within two years of the initial transfer, gain will be triggered to the shareholder under § 453(e) whether or not payment is made.

\(^3\) Historically, installment sellers have been allowed to defer gain yet their purchasers have been allowed an immediate step-up in basis under the \textit{Crane} rule.

\(^4\) Such complexities include: (1) recomputing basis at the corporate level whenever gain is recognized at the shareholder level (which can happen either upon payment or upon a
It is especially insufficient in light of the rule's limited application and thus its limited value in protecting the revenues.

In the end, the issue of real concern is whether the corporation's issuance of boot notes to a controlling shareholder\textsuperscript{193} in exchange for property is a transaction of sufficient substance to warrant a basis step-up at the corporate level in any event. The proposed regulations recognize, in keeping with existing judicial authority, that boot notes can serve to trigger a basis increase so long as they do not constitute securities. Once that hurdle is crossed, however, there is no justifiable reason to force the shareholder-transferor to recognize gain before increasing corporate basis. Congress has required immediate gain recognition in those areas that it perceives as potential abuse areas. In cases that do not involve abuse, it is a petty display of literalism to read section 362 as though it were ever intended to create a deferred basis rule for 351/453 transactions.

V. CONCLUSION

A 351/453 transaction combines a "nonsale" transaction with a "sale" transaction. Given the nature of the transaction, both the "nonsale" portion and the "sale" portion are entitled to gain deferral. True 351/453 combinations appear to be rare. The section 453 portion of the transaction is more often structured as a separate sale transaction. Since deferral of gain ought to be available in any event, there is little reason for the Service to combine the separate transactions merely for purposes of recomputing a gain.

By contrast, the proposed 351/453 regulations create an incentive for the Service to combine separate transactions if the issue is corporate basis rather than gain deferral. In a combined 351/453 transaction, the regulations prevent a step-up at the corporate level until gain has been recognized at the shareholder level. Because opportunity to benefit from the gain/basis timing mismatch is limited, forcing a corporation to use the deferred basis rule cannot be viewed as protecting the corporate fisc.

In determining the appropriate tax treatment of 351/453 transactions, whether combined by the taxpayer or the Service, a consistent theoretical approach is needed. In order to co-exist with present tax law, the best approach is to treat boot notes consistently as payment made in a "sale" transaction. As such, they should be taxed to the shareholder disposition of the obligation); (2) allocating the basis increase amongst the appropriate assets and determining whether a loss should be claimed for those assets that are no longer owned by the corporation; and (3) determining the character of the loss if a loss is to be claimed.

\textsuperscript{193} Issuance to one shareholder in a control group triggers the same concern.
using the installment method. They should also serve to give the corporation an immediate step-up in basis. Although the concept of deferred basis is intriguing, it is inconsistent with existing law\textsuperscript{194} and is a rule that ought not to be promulgated by the Treasury in regulations.

\textsuperscript{194} Cf. Crane, 331 U.S. 1, and supra note 177.