

ASSUMPTION OF INDEBTEDNESS IN TAX-FREE EXCHANGES*

By STANLEY S. SURREY †

THE Revenue Acts have for some time exempted certain exchanges, principally those made in the course of corporate reorganizations, from the recognition of gain or loss at the time of the exchange. In corporate reorganizations, the transaction, to be exempt, must take the form of an exchange of corporate assets or stock or securities in the corporation solely for stock or securities in another corporation which is a party to the reorganization. If money or property other than such stock or securities is received, gain is recognized to the extent of the non-exempt property. Up to 1938 both taxpayers and the Government tacitly assumed that a corporate transferee's assumption of the obligations of a transferor corporation in such an exchange did not give rise to the receipt by the latter of such money or property as would necessitate the recognition of gain. The tax consequences of countless reorganizations were established on the basis of this belief. But in *United States v. Hendler*¹ the Supreme Court abruptly informed the Government and the tax bar that their joint belief could not be supported by the pertinent statutory language. This article deals with the effect of this decision upon corporate reorganizations and other transactions involving tax-free exchanges, and with the Congressional reaction to the decision, as expressed in the Revenue Act of 1939.

UNITED STATES V. HENDLER

On May 21, 1929, Hendler Creamery Co., Inc., entered into a formal contract to transfer all its assets to the Borden Co. on the following June 21. Hendler agreed to call for redemption its outstanding first mortgage bonds (\$534,000 in amount and redeemable at a 7½ per cent pre-

* A companion article by the same author on "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness" appears in (1940) 49 YALE L. J. 1153.

† Assistant Legislative Counsel, United States Treasury Department.

The views expressed are entirely those of the writer. Nothing herein is to be construed as the official opinion of the United States Treasury Department.

1. 303 U. S. 564 (1938).

mium) on July 1, 1929, and to satisfy its mortgage at or prior to the closing of title.² Hendler was presumably to borrow the money necessary to redeem these obligations.³ In return for Hendler's assets, Borden was to transfer to Hendler 106,306 shares of its stock and some cash, and to "assume and agree to pay all indebtedness and liabilities whatsoever of your company (Hendler) as the same shall exist at closing of title to us hereunder."⁴ On June 21, however, Hendler had not borrowed any money for redemption purposes and the bonds had not been redeemed. Borden nevertheless accepted the transfer — waiving in effect the requirement that the mortgage be satisfied on the closing date and, instead, assuming Hendler's bonded indebtedness.⁵ Hendler distributed to its stockholders the shares of Borden stock and cash received on the transfer and proceeded to dissolve pursuant to the contract.⁶ On July 1, 1929, Borden surrendered to the mortgage trustee in return for satisfaction of the mortgage \$7,000 of Treasury Hendler bonds, \$149,000 of Hendler bonds bought by it in the market, and \$381,225 in cash to cover the remaining bonds. The sum required to redeem the bonds was \$534,297.40. Hendler's remaining liabilities were likewise promptly paid: current bank loans amounting to \$1,050,000 were paid shortly after July 1 and merchandise accounts for \$130,410.78 were paid within thirty days thereafter.

Although Hendler realized a gain of over \$6,000,000, the Company asserted in its tax return that the transaction constituted a tax-free exchange: the transfer of all of its assets was a reorganization under Section 112(i) of the Revenue Act of 1928, and the cash was distributed to its stockholders in accordance with Section 112(d)(1). However, it claimed the unamortized discount on its bonds and the 7½ per cent premium payable on redemption as a deduction, which claim reduced its tax liability for the year by \$6,260.33. This deduction was proper, the Company argued, inasmuch as the \$534,297.40 paid to redeem the bonds could in effect be regarded as having been paid by Borden to Hendler and in turn by Hendler to the bondholders. The protest which it filed

2. Record on appeal, p. 12, *United States v. Hendler*, 303 U. S. 564 (1938). The record which was presented to the Supreme Court in this case will hereinafter be designated merely as "Record."

3. Record, pp. 10, 81, 82, 83.

4. Record, pp. 9, 154.

5. Record, p. 155. The District Court found (Record, p. 166):

"In closing the transaction before July 1, 1929, before the bonds were redeemed, and while they were still outstanding, Borden waived the requirement for satisfaction of the mortgage at the closing date and took the property subject to the bond issue, which then became one of the liabilities of Hendler assumed at the closing by Borden, just as it assumed the bank loans and current accounts payable; and Borden itself paid all of them within a month thereafter."

6. Record, p. 19. Actual dissolution was completed on Aug. 5, 1930. Record, p. 35.

with the Bureau of Internal Revenue when the deduction was questioned stated:

“When the Borden Company deposited with the Trustee sufficient funds to redeem the bonds it simply provided the Hendler Company with the means of discharging an obligation of the Hendler Creamery Company. It cannot be seriously urged that the effect of such transaction was to make the Borden Company the obligor of the bonds. The bonds never became those of the Borden Company, but on the contrary were at all times the bonds of the Hendler Creamery Company.”⁷

A canny Bureau acquiesced in this contention and then promptly asserted a deficiency — since the \$534,297.40 was “constructively received”⁸ by Hendler, it was money received on the exchange which, as it was not distributed to Hendler’s stockholders, resulted in recognized gain under Section 112(d)(2). The first round clearly belonged to the Government.

Perceiving no virtue in consistency, Hendler (or rather its principal stockholder, Mr. Hendler, against whom the deficiency was asserted under transferee liability) paid the deficiency of \$58,772.72 plus \$10,781.97 interest and sued for a refund. The Government played safe by claiming that the deduction for bond discount and premium should be disallowed. The case was now ready for the courts. The District Court held for Hendler:⁹ although Borden’s assumption of Hendler’s liabilities was part of the consideration received by Hendler for its assets and therefore to be considered in computing Hendler’s profit on the transfer, the assumption did not *per se* constitute the receipt of “other property or money” by Hendler within the meaning of Section 112(d), and hence was not taxable boot. Nor could the payment of the bonded indebtedness be regarded as a constructive receipt of the money by Hendler within the *Old Colony Trust Co. v. Commissioner*¹⁰ rule for, by reason of Borden’s assumption of Hendler’s liabilities,¹¹ the debt when paid was Borden’s and not Hendler’s debt. In other words, in form, Hendler did not receive the money; in substance, it was exchanging an equity in its assets for Borden stock and the incidental cash. The deduction, how-

7. Record, pp. 101, 160. As Borden had agreed to assume Hendler’s current income tax, excepting any tax liability arising out of the transfer of assets, Borden, not Hendler, stood to profit by allowance of the deduction.

8. Compare Record, p. 123, where, in denying a refund claim made after payment of the deficiency, the Commissioner stated that by reason of Borden’s payment, Hendler was in constructive receipt of cash.

9. *Hendler v. United States*, 17 F. Supp. 558 (D. Md. 1936).

10. 279 U. S. 716 (1929).

11. The District Court also held that if Hendler was to be regarded as in receipt of “money” by reason of Borden’s payment, it had distributed the money within the meaning of § 112(d)(1), as the words “distributed it in pursuance of the plan of reorganization” included a distribution among creditors and shareholders as well as to shareholders alone.

ever, was disallowed, the district court observing that Borden, not Hendler, had paid the redemption premium and that, as the obligation referable to the principal of the bonds had ceased to be Hendler's liability, it could lay no claim to the unamortized discount.¹²

The Government appealed on the main issue, but Hendler, once burned, did not press for the deduction. The Fourth Circuit Court of Appeals sustained the decision on much the same ground:¹³ while the payment of an obligation results in the receipt of income and the assumption of the bonded indebtedness must therefore be considered in computing profit, the question was one of the taxability of the gain at the time of the exchange. The pertinent sections, the court held, rested upon a policy of encouraging reorganizations through postponement of tax and, as the assumption of liabilities is a customary incident of reorganizations, considering this assumption as "other property or money" would defeat the purpose of these Sections.¹⁴ Both courts observed that the Government had not chosen to extend its contention to the bank loans and merchandise accounts assumed and paid by Borden, although their status seemed indistinguishable from that of the bonded indebtedness.

But the Supreme Court, when the case came before it, was not to be soothed by talk of reorganization policy and postponement of tax. It saw a gain and pounced upon it:

"We are unable to agree . . . that the gain to the Hendler Company, realized by the Borden Company's payment, was exempt from taxation under section 112.

"It was contended below and it is urged here that since the Hendler Company did not actually receive the money with which the Borden Company discharged the former's indebtedness, the Hendler Company's gain of \$534,297.40 is not taxable. The transaction, however, under which the Borden Company assumed and paid the debt and obligation of the Hendler Company is to be regarded in substance as though the \$534,297.40 had been paid directly to the Hendler Company. The Hendler Company was the beneficiary of the discharge of its indebtedness. Its gain was as real and substantial as if the money had been paid to it and then paid over by it to its creditors. The discharge of liability by the payment of the Hendler Company's indebtedness constituted income to the Hendler Company and is to be treated as such [citing *Old Colony Trust Co. v. Commissioner* and *Douglas v. Willcuts*].

"Section 112 provides no exemption for gains—resulting from corporate 'reorganization'—neither received as 'stocks or securities,'

12. This point is not clear. See discussion p. 21 *infra*.

13. *United States v. Hendler*, 91 F. (2d) 680 (C. C. A. 4th, 1937), (1937) 24 VA. L. REV. 203-4; Comment (1938) 24 VA. L. REV. 418.

14. While the Circuit Court of Appeals did not state that § 112(d)(1) covered a distribution to creditors, it argued that "other property or money" referred to property susceptible of distribution among stockholders.

nor received as 'money or other property' and distributed to stockholders under the plan of reorganization. In *Minnesota Tea Co. v. Helvering* it was said that this exemption 'contemplates a distribution to stockholders, and not payment to creditors.'¹⁵ The very statute upon which the taxpayer relies provides that 'If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized [taxed] . . .'

"Since this gain or income of \$534,297.40 of the Hendler Company was neither received as 'stock or securities' nor distributed to its stockholders 'in pursuance of the plan of reorganization' it was not exempt and is taxable gain as defined in the 1928 Act."¹⁶

The Government thereupon pocketed its \$69,554.69 in taxes and interest and surveyed the scene of battle. Then, for the first time, it realized that its victory was indeed Pyrrhic. The hollowness of this triumph is best revealed by an examination of the pre-*Hendler* treatment of assumption of indebtedness and the effect of the decision itself.

PRIOR TREATMENT OF ASSUMPTION OF INDEBTEDNESS

The Supreme Court early ruled that one person's payment of another's obligation might give rise to taxable income to the latter. Sample situations would be those in which an employer paid income tax due the Government from his employee on the latter's salary,¹⁷ or payment by a lessee of his lessor's income taxes.¹⁸ The Court observed that "the discharge by a third person of an obligation to him is equivalent to receipt by the person taxed,"¹⁹ and thereby permitted such a payment to be transmuted into a recognizable form of income, such as compensation

15. 302 U. S. 609, 612 (1938). In this case, decided in the same term, the transferor corporation had distributed the cash it received on the reorganization to its stockholders pursuant to a resolution under which the stockholders had assumed the corporation's debts. The Court held that the cash had not been distributed within the meaning of § 112(d)(1) and was taxable boot. Section 112(d)(1), it was held, requires a distribution to stockholders and does not extend to a distribution to creditors, so that if the corporation had itself paid the debts the cash would remain taxable boot. As the stockholders were here a mere conduit, payment of the corporation's indebtedness and not a dividend distribution to stockholders was effected, so that § 112(d)(1) was not satisfied. The Government's brief in the *Hendler* case relied almost exclusively on this decision. Cf. *West Texas Ref. & Dev. Co. v. Comm'r*, 68 F. (2d) 77 (C. C. A. 10th, 1933); see (1938) 38 COL. L. REV. 685 (discussing *Minnesota Tea Co. v. Helvering*, *supra*).

16. *United States v. Hendler*, 303 U. S. 564, 566 (1938).

17. *Old Colony Trust Co. v. Comm'r*, 279 U. S. 716 (1929); MAGILL, *TAXABLE INCOME* (1936) 207-212, and cases there cited.

18. *United States v. Boston & M. R. R.*, 279 U. S. 732 (1929); MAGILL, *op. cit. supra* note 17, at 207-212, 234.

19. *Old Colony Trust Co. v. Comm'r*, 279 U. S. 716, 729 (1929).

for services, rent, or trust income.²⁰ In sales of property, the courts established the like rule that the vendee's assumption of the vendor's debt was to be taken into account in measuring the consideration received by the vendor and thus in computing his taxable gain.²¹ It was against this background that questions raised by the tax-free exchange sections were to be decided. In an exchange otherwise "solely in kind," and therefore tax-free under Section 112(b), did one party's assumption of the other's liability constitute receipt by the latter of "other property or money," thereby rendering any gain on the exchange taxable to the amount of such "other property or money," or was assumption of the liability to be disregarded in ascertaining whether any gain should be recognized?²²

As far back as 1927, the Bureau of Internal Revenue ruled in what is now a Section 112(b)(1) situation²³ — the exchange of property held for productive use in trade or business or for investment for property of a like kind to be similarly held — that an assumption of a liability did constitute such "other property or money," thereby bringing the case within Section 112(c)(1) and rendering any gain realized on the exchange recognizable to the amount of the liability.²⁴ Thus, if *A* transfers an apartment house worth \$10,000 and mortgaged for \$4,000 in exchange for *B*'s apartment house worth \$6,000 and *B*'s assumption of the \$4,000 mortgage, *A* receives "money" to the extent of \$4,000. If the basis of the apartment in *A*'s hands is \$2,000, his realized gain will be \$8,000, and under Section 112(c)(1) that gain will be recognized to the extent of \$4,000, the "money" received. Although this interpretation was never seriously challenged by taxpayers, it did not receive explicit judicial approval until 1936 in the *Brons Hotels* decision by the Board of Tax

20. Compare *Burnet v. Wells*, 289 U. S. 670 (1933); *Douglas v. Willcuts*, 296 U. S. 1 (1935); *Helvering v. Blumenthal*, 296 U. S. 552 (1935); *MAGILL*, *op. cit. supra* note 17, at 236-247. Although the doctrine of constructive receipt, together with the parties' relationships, turns the assumption of the obligation into one of the customary types of income — rent, dividends, trust income, salary — that consequence is not necessary to taxation, so that if *A*, having no such special relation to *B*, assumes and pays a debt of *B*'s, the assumption and payment, if not a gift, would *per se* give rise to income to *A*.

21. *E.g.*, *Stevenson Consol. Oil Co.*, 23 B. T. A. 610 (1931); S. R. 1226, IV-1 CUM. BULL. 130 (1925); *United States v. Hendler*, 17 F. Supp. 558, 563 (D. Md. 1936); *cf.* *Burnet v. S. & L. Bldg. Corp.*, 288 U. S. 406 (1933); Regulations 103, § 19.22(a)-19.

22. The Government apparently had a third theory, for it contended in both upper courts in the *Hendler* case that if the assumption were not regarded as "other property or money," § 112(d) was not applicable. The case, it argued, must then be viewed as if § 112 were not involved, so that the assumption would result in taxable gain under the general rules. But that contention proves too much, for it makes the entire profit on the exchange taxable, as neither § 112(b)(4) nor § 112(d) would apply — a result not urged by the Government.

23. Unless otherwise indicated, the statutory references hereinafter made are to the Internal Revenue Code and corresponding sections of prior Revenue Acts.

24. G.C.M. 2641, VI-2 CUM. BULL. 16 (1927); G.C.M. 4935, VII-2 CUM. BULL. 112 (1928).

Appeals.²⁵ The Bureau had, however, made an exactly opposite ruling in a Section 112(b)(4) situation — the exchange, pursuant to a plan of reorganization, by a corporation, a party to a reorganization, of property solely for stock or securities in another corporation, also a party to the reorganization.²⁶ The Bureau had said that if *A* corporation transferred all of its assets to *B* corporation for *B* corporation stock (one of the cases termed a “reorganization” by the Revenue Acts) and *B* corporation assumed a liability of *A* corporation, whether a bank loan, mortgage, or merchandise account payable, the assumption would not constitute “other property or money” received by *A* corporation and the exchange remained “solely for stock or securities.” This interpretation was accepted without discussion as a tenet of reorganization tax law, and countless reorganizations in which liabilities were assumed went unquestioned by the Bureau,²⁷ the Board,²⁸ or the courts.²⁹ Finally, in a Section 112(b)(5) situation — the transfer of property by one or more persons to a corporation solely in exchange for the corporation’s stock or securities, where immediately after the exchange such person or persons are in control of the corporation — the Bureau’s practice was apparently to treat an assumption of a liability in the same fashion as in a Section 112(b)(4) situation. Here also it regarded the transfer as “solely in exchange for stock or securities.”³⁰

The varying treatments of liability assumptions in these exchanges were justified as implementing Congress’s policy of postponing the recognition of gain in reorganizations. Most reorganizations, whether they be statu-

25. *Brons Hotels, Inc.*, 34 B. T. A. 376 (1936), discussed p. 10 *infra*; see *Max Feldman*, 18 B. T. A. 1222 (1930) (problem not mentioned).

26. Compare *I. T. 2364*, VI-1 CUM. BULL. 13 (1927); *G.C.M. 7472*, IX-1 CUM. BULL. 184 (1930); see *I. T. 2392*, VI-2 CUM. BULL. 17 (1927).

27. “Situations similar to that presented in the *Hendler* case have arisen thousands of times in actual reorganizations and undoubtedly hundreds of times in cases actually litigated. In none of these cases of which there is any record did the Commissioner assert the tax on the basis claimed in the *Hendler* case.” PAUL & MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* (Mertens’ Cum. Supp. 1939) § 17.97; *id.* (1934 ed.) § 17.97. The Cumulative Supplement will hereinafter be referred to as *Mertens’ Cum. Supp. (1939)*.

28. *Fred L. Dickey*, 32 B. T. A. 1283 (1935); *Frank Kell*, 31 B. T. A. 212 (1934); *National Pipe & Foundry Co.*, 19 B. T. A. 242 (1930); *Tulsa Oxygen Co.*, 18 B. T. A. 1283 (1930). But see *Daily Tel. Co.*, 34 B. T. A. 101 (1936) (assumption of liabilities included without discussion in computation of “other property”); *Liquidating Co.*, 33 B. T. A. 1173 (1936) (situation similar to *Hendler* case, but transferee corporation, instead of assuming bonded indebtedness, transferred cash for redemption to trustee. Held taxable as “money” received by transferor. Whether assumption of liability involves receipt of “other property or money,” was not urged and not passed upon).

29. Compare *Hendler v. United States*, 17 F. Supp. 558, 562 (D. Md. 1936); *Schuh Trading Co. v. Comm’r*, 95 F. (2d) 404 (C. C. A. 7th, 1938); cases cited note 72 *infra*.

30. *Fashion Center Bldg. Co.*, 31 B. T. A. 167 (1934) expressly so held in denying a stepped-up basis. For discussion of the early authorities, see *Eichholz, Some Tax Risks in Assumptions of Liability* (1937) 22 CORN. L. Q. 543.

tory mergers or consolidations, transfers of corporate assets for stock, or mere changes in identity, form or place of organization, involve the assumption of liabilities, especially where the transaction includes the dissolution of the transferor corporation.³¹ Congress's decision to exempt from tax the gain realized on these reorganizations at the time they occur must have carried with it as a corollary the refusal to tax some of that gain merely because part of the consideration was in the form of an almost inevitable assumption of liabilities. Congress certainly did not intend, the argument ran, that a New York corporation which became a New Jersey corporation through transferring all of its assets and liabilities to a newly-organized New Jersey corporation should at that time pay a tax on any increase in the value of its assets over their basis up to the amount of the liabilities assumed.³² It was similarly argued that, as Section 112(b)(5) was in part designed to allow partnerships to incorporate, and as a partnership could scarcely be expected to discharge all of its liabilities prior to incorporation, Congress could not have intended gain to be recognized when a partnership transferred all its assets and liabilities to a corporation organized to continue its business.³³

But it is apparent that the wording of the Revenue Acts was inadequate to support the edifice thus erected. The words "other property or money" in Section 112(c)(1) could scarcely be interpreted to include an assumption of a liability in a Section 112(b)(1) exchange but not in a Section 112(b)(5) exchange. Nor could they mean one thing in Section 112(c) and another in Section 112(d).³⁴ Embarrassment, moreover, became even

31. In *Western Industries Co. v. Helvering*, 82 F. (2d) 461 (App. D. C. 1936), the Commissioner asserted that an exchange did not constitute a merger or consolidation unless the surviving corporation assumed the old corporation's liabilities.

32. The lower courts reiterated these arguments in the *Hendler* case. The Bureau also pointed to § 112(d) as indicating that the term "property" must refer to property susceptible of receipt and distribution, and hence does not include the assumption of a liability. It added that if the assumption is to be regarded as equivalent to the receipt of other property or money, it must, in any event, be considered as having been distributed within that Section's meaning. Where payment of the liability did not occur in the year of the reorganization, the distribution seems to be most "constructive." The Bureau advanced the opposite contention with respect to "distribution" in *Minnesota Tea Co. v. Helvering*, 302 U. S. 609 (1938). In accord with this view of liabilities is *Western Industries Co. v. Helvering*, 82 F. (2d) 461 (App. D. C. 1936), in which the court disregarded cash retained by the transferor to pay its liabilities in determining whether substantially all of the transferor's assets had been exchanged. Supplement R, which deals with exchanges and distributions in obedience to orders of the SEC, provides that debts or liabilities assumed, including a continuance of encumbrances subject to which the property was transferred, should be included in ascertaining the extent to which the gain should be recognized, except with respect to § 371(d) transactions.

33. Analogous arguments may, however, be thought pertinent to § 112(b)(1) exchanges. See p. 33 *infra*.

34. The distribution requirement in § 112(d) is not very helpful in finding a distinction. See note 32 *supra*.

more acute when the basis provisions were considered. Section 113(a)(6) provided that the basis of property acquired upon a tax-free exchange should be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of any gain recognized upon the exchange. Suppose that *A* corporation buys property worth \$100,000 for \$60,000 cash and a \$40,000 purchase money mortgage. The basis of this property in the hands of *A* corporation is \$100,000—its cost. Suppose that the property, which is *A* corporation's sole asset, increases in value to \$140,000 and is transferred to *B* corporation for *B* corporation stock worth \$100,000 and *B* corporation's assumption of the \$40,000 mortgage. Although the profit to *A* corporation is \$40,000, the ruling discussed above forbids recognition of gain at the time of the exchange, as the assumption does not constitute "other property or money," and Section 112(d) does not apply. *A* corporation then sells its *B* corporation stock for \$100,000. It reports no gain on this sale, for, literally following the Bureau's ruling, the stock's basis was the same as that of the property exchanged—\$100,000. If, however, *A* corporation's argument be sustained, it obviously has escaped tax on a \$40,000 profit. The reorganization sections would not only operate to postpone a tax at the time of the exchange but, together with the basis provisions, would, as respects *A* corporation, prevent the Government ever from catching up with the profit realized by it on the exchange.³⁵ The Bureau, rather than depart from its interpretation of the tax-free exchange sections, met this basis difficulty by main force. It ruled that the assumption of a liability, although not "other property or money" for the purpose of recognizing gain under Section 112(d), was to be considered "money received by the taxpayer" under Section 113(b)(6) for the purpose of computing the basis of the property acquired upon the exchange. This construction served to reduce the basis of the property acquired on the exchange by the amount of the liability assumed, thereby permitting a tax when that property was later sold. Thus, the basis of the stock of *B* corporation above would be \$60,000, and a tax would be imposed on a profit of \$40,000 when the stock was sold.

The Bureau's interpretation no doubt had a common sense appeal, especially where, as in the above case of the purchase money mortgage, the liability assumed related directly to the cost of the asset transferred.³⁶

35. The transferee, *B* Corporation, would, however, take the basis of the transferor, \$100,000, under § 113(a)(7), so that it would have to pay tax on the \$40,000 profit on later sale of the property. But as in many cases this sale may never occur or the property may decline in value, the profit may go untaxed.

36. Where the liability assumed did not relate directly to the cost of the asset transferred, as where the transferor had placed a mortgage on the property after its acquisition so that its basis was unaffected, or where the liability was not a lien on the property, the transferor would receive tax-free the amount of the liability if the basis of the new prop-

Six Board members dissenting in the *Brons Hotels* case were willing to support this view.³⁷ But it is equally true that the Revenue Acts furnished little foundation for the Bureau's solution of the basis difficulty, and the remaining Board members in the *Brons Hotels* case refused to accept this interpretation of the basis provisions. To avoid the escape from tax which a consistent interpretation of Section 112(c) and (d) and Section 113(a)(6) would produce,³⁸ they therefore took the alternative course of treating the assumption as "money" — thus permitting a tax at the time of the exchange. While the *Brons Hotels* case involved a Section 112(b)(1) situation and its result accorded with Bureau rulings on that Section, its logic leads to the same result in other Section 112(b) exchanges.³⁹ But the Bureau persisted in its practice in Section 112(b)(4) and (5) cases, so that the whole elaborate structure of the reorganization provisions continued to rest upon a shaky foundation.

PROBLEMS CREATED BY THE *HENDLER* DECISION

With an irony often present in tax cases, the Government itself, in the *Hendler* case, knocked over the structure. In almost cavalier disregard of its well-established practice, as the lower courts and counsel for the taxpayer pointedly observed, it claimed that *Hendler's* assumption of the bonded indebtedness resulted in the receipt of "other prop-

erty were not reduced upon the assumption of the liability. The Bureau's rule left this money tax free but reduced the basis of an unrelated asset, the stock in the transferee corporation acquired by the transferor.

37. The dissenting members argued: "The basis prescribed for property received in tax-free exchanges, namely, 'the same as in the case of property exchanged' can . . . with perfect reasonableness be held to mean the cost to the transferor less any return of cash which he has received as by the assumption of the mortgage in the present case; the basis will then be adjusted for recognized gain or loss as prescribed." 34 B. T. A. 376, 383 (1936). *Accord*, Mertens' Cum. Supp. (1939) § 17.97, n. 46. In *Robinson v. Comm'r*, 97 F. (2d) 552 (C. C. A. 9th, 1938), the taxpayer agreed to furnish an adequate water supply to a real estate subdivision in exchange for pipes, mains, etc., worth \$170,000, to be transferred to him. Later he transferred his assets to a corporation organized by him in exchange for its stocks and bonds and its assumption of the obligation to supply the water. The basis of the assets, exclusive of the mains, etc., was \$35,000. The taxpayer then sold the securities and claimed a basis of \$35,000 plus \$170,000. The court held that on the exchange the corporation relieved the taxpayer of his obligation, valued at \$170,000, and that its assumption of performance constituted full recovery by the taxpayer of the consideration given by him for those particular assets, so that his basis for the securities must be considered as \$35,000.

38. In a § 112(b)(1) case, unlike the situation in § 112(b)(4) or (5) exchanges (see note 35 *supra*), the profit escapes tax entirely, as the second party to the exchange does not take the first party's basis.

39. In the *Brons Hotels* case, the Board expressly overruled its prior decision in *Fashion Center Bldg. Co.*, 31 B. T. A. 167 (1934), which had held an assumption not to constitute other property or money in a § 112(b)(5) case.

erty or money" under Section 112(d).⁴⁰ The Supreme Court agreed with this contention in an opinion which gave no consideration to the difficulties present. The decision had two immediate and far-reaching consequences. Those taxpayers who, believing that Section 112(b)(4) and (5) prevented a tax, previous to the decision had transferred property to corporations in exchange for stock and an assumption of liabilities, were faced with the immediate threat of deficiency assessments in every case where the statute of limitations had not closed the year of the exchange. If, moreover, the case involved the transfer in a taxable year beginning after December 31, 1933, of substantially all of a corporation's assets in return for stock and an assumption of liabilities (and which because of lack of control could not qualify as a reorganization under Section 112(g)(1)(C)), the recognized gain would not be limited merely to the amount of liabilities assumed but would extend to the entire profit on the exchange. This followed from the change which the Revenue Act of 1934 effected in Section 112(g) (which defined the term "reorganization") whereby under clause (B) such a transfer of assets was included only if the assets were exchanged "solely for . . . voting stock." If an assumption of liabilities was to be regarded as equivalent to the receipt of "other property or money," so that the exchange was not "solely for stock or securities" under Section 112(b)(4), the Government might likewise argue that it was not "solely for . . . voting stock" within the meaning of Section 112(g)(1)(B), and thereby make the entire transfer taxable.⁴¹ Taxpayers were also confronted with the future prospect of being unable to effect corporate reorganizations involving the assumption of liabilities without paying a tax at the time of the reorganization.

The Government was threatened with a possible loss of a very large amount of revenue through the operation of the basis provisions. As observed above, the basis of the assets transferred by the transferor corporation became, under Section 113(a)(6), the basis of the stock which it received on the exchange, decreased in the amount of any money received, and increased in the amount of any gain recognized on the exchange. When an assumption of liabilities was involved, the Bureau, to make the basis provisions operate properly, had treated the assumption as "money" received by the transferor and accordingly had reduced the basis of the assets transferred. As this assumption was not treated

40. Although the Government did not assert a tax on the bank loans and merchandise accounts which Borden assumed and paid, it did not even attempt to distinguish their status from that of the bonded indebtedness. If a distinction existed, it was indeed difficult to perceive.

41. Compare MONTGOMERY, FEDERAL INCOME TAX HANDBOOK (1938) 101. Before the *Hendler* decision, the Bureau apparently took the position that an assumption of liabilities did not prevent the exchange from being solely for voting stock within the meaning of § 112(g)(1)(B).

as the receipt of "other property or money" under Section 112(d), no gain was recognized and there was therefore no amount to be added to the basis thus reduced. The phrase in Section 113(a)(6), "amount of gain . . . recognized upon such exchange under the law applicable to the year in which the exchange was made," refers, however, to the gain recognizable under such law and not to the gain actually recognized in a particular case.⁴² Transferors were therefore in a position after the *Hendler* decision to claim that the basis of the stock they had received on prior exchanges should be increased by the amount of gain that should have been recognized and taxed by reason of the transferee corporation's assumption of liabilities, even though this gain had not been actually taxed. If, moreover, the exchange occurred after 1933 and was of the Section 112(g)(1)(B) type, the increase in basis would extend to the entire gain realized, as the transfer, not being "solely for . . . voting stock," did not constitute a tax-free exchange. If the exchange occurred in a taxable year beginning after December 31, 1931, Section 820 of the Revenue Act of 1938 would afford the Government some protection against such a claim for a stepped-up basis,⁴³ but for exchanges prior to 1932, when the majority of the reorganizations took place, the door was wide open.⁴⁴

The transferee corporation which assumed the liabilities and was most likely to pay tax on any profit with respect to the assets could also in many cases claim a stepped-up basis for the assets it had acquired upon the exchange. Under Section 113(a)(7) and (8), its basis for these assets was their basis in the hands of the transferor at the time of the exchange, increased in the amount of gain recognized to the transferor under the law applicable to the year in which the exchange occurred.⁴⁵ Section 820

42. *Corpus Christi Terminal Co.*, 38 B. T. A. 944 (1938); *David B. Gann*, 23 B. T. A. 999, 1003-4 (1931), *aff'd*, 61 F. (2d) 201 (C. C. A. 7th, 1932), *cert. denied*, 287 U. S. 650 (1932); PAUL & MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* (1934 ed.) § 18.111; S. M. 2723, III-2 CUM. BULL. 26 (1924).

43. *Maguire, Surrey & Traynor, Section 820 of the Revenue Act of 1938* (1939) 48 YALE L. J. 509, 719, 764-5. The section is now INT. REV. CODE § 3801.

44. The doctrine of estoppel affords slight support—all the facts were known, there was only a mistake of law. *Helvering v. Williams*, 97 F. (2d) 810 (C. C. A. 8th, 1938); *United States v. Dickinson*, 95 F. (2d) 65 (C. C. A. 1st, 1938); and *Helvering v. Salvage*, 297 U. S. 106 (1935) are more pertinent than *Alamo Nat. Bank v. Comm'r*, 95 F. (2d) 622 (C. C. A. 5th, 1938), *cert. denied*, 304 U. S. 577 (1938); *Robbins v. United States*, 21 F. Supp. 403 (Ct. Cl. 1937); *Larken v. United States*, 78 F. (2d) 951 (C. C. A. 8th, 1935). But see *Becker v. Bemis*, 104 F. (2d) 871 (C. C. A. 8th, 1939), *cert. denied*, 308 U. S. 613 (1939).

45. If the exchange were in a taxable year beginning prior to Jan. 1, 1936, and 50% control did not exist after the transfer, the transferee took cost to it as its basis. Thus, in the *Hendler* case itself, Borden had as its basis the cost to it of the acquisition of the *Hendler* assets, so that, as its basis already reflected the assumption of the bonded indebtedness, it was immaterial to Borden whether the assumption would result in the recognition of gain.

offered no protection to the Government against such a claim by the transferee.⁴⁶ As to reorganizations consummated before the *Hendler* case, these claims by transferor and transferee for a stepped-up basis were tenable not only where the stocks or assets had been sold in a prior year still open, but also if the sale were to occur in any later year. The Government, however, could not assert deficiencies against transferors unless the year of the reorganization were still open, so that a Government which gained \$69,554.69 in the *Hendler* case stood to lose perhaps millions of dollars as a result of that victory.

These consequences would result if the *Hendler* case were given its broadest possible interpretation — that any assumption of a liability, or even the acquisition of property subject to a liability, involves the receipt of “other property or money.” But it was apparent that both taxpayers and Government would fight to restrict the *Hendler* decision wherever a limitation appeared advantageous. As there had been literally thousands of prior reorganizations in which the assumption of liabilities had not been treated as “other property or money,” a widespread battle between taxpayers and Government appeared inevitable. Like much tax litigation — witness the *Hendler* case — the fighting promised to be catch-as-catch-can, with Government and taxpayer urging a position which would mean victory in the particular instance, regardless of the case’s effect as a precedent.⁴⁷ Thus, after the *Hendler* decision, in a case in which the Government was resisting a transferee’s claim for a stepped-up depreciation basis with respect to a transfer that occurred in 1929,⁴⁸ the Second Circuit Court of Appeals stated that no gain should have been recognized to the transferor⁴⁹ as the liability had not been paid during 1929. But a Government asserting a deficiency for 1933 against a transferor in a Section 112(b)(5) exchange in that year, though the liabilities were apparently not all paid in the year of exchange, was later able to convince the Board of Tax Appeals that payment was immaterial.⁵⁰ This meant, however, that when the Board had before it, with respect to a

46. See note 43 *supra*. Nor would the doctrine of estoppel help the Government, for if the transferee had taken any position, it was only one to its detriment in computing depreciation or depletion on the assets at a lower basis than it should have employed. Under the *Hendler* decision, the transferee would be entitled to a higher basis for depreciation or depletion, as well as for gain or loss, though this would in part help the Government by reason of § 113(b)(1)(B).

47. For the reasons underlying this characteristic of tax litigation, see Traynor, *Administrative and Judicial Procedure for Federal Income, Estate, and Gift Taxes—a Criticism and a Proposal* (1938) 38 COL. L. REV. 1393, 1406-1411.

48. *Bickford’s, Inc. v. Helvering*, 98 F. (2d) 568 (C. C. A. 2d, 1938). The depreciation deduction involved the tax for 1931.

49. The taxpayer had not raised the point below, as the *Hendler* case had not then been decided, so that the court’s observation was not necessary to the decision. The Government presumably had not mentioned the point.

50. *Walter F. Haass*, 37 B. T. A. 948 (1938).

sale in 1934, a transferee corporation's claim for stepped-up basis on assets acquired in an exchange in 1931 involving an assumption of liabilities as to which there was no evidence that the tax had been paid by the transferor, the increased basis was allowed though the transferee did not pay all the liabilities during the year of the exchange.⁵¹ And in taxing a transferor in a Section 112(b)(1) exchange, the Government successfully contended that the other party's acquisition of the transferor's property subject to a liability involved the receipt of "money" by the transferor in the same manner as if the liability had been assumed, though this interpretation when applied to Section 112(b)(4) and (5) exchanges would serve to increase the claims for stepped-up bases.⁵²

It became only too apparent both to Government and taxpayers that this retroactive departure from an accepted practice constituted thoroughly unsound tax administration, especially as the extent of the departure was to be determined only by the protracted process of judicial decision. Until future Supreme Court decisions staked out the limits of the *Hendler* case, taxpayers would be forced to plan and consummate their reorganizations in an atmosphere of extreme tax uncertainty. Both Government and taxpayers therefore joined in requesting that Congress furnish a statutory solution to these difficulties.⁵³ Congress answered with Section 213 of the Revenue Act of 1939.

SOLUTION ADOPTED BY THE REVENUE ACT OF 1939

Congress's method of response was restoration of the pre-*Hendler* treatment of Section 112(b)(4) and (5) exchanges — a solution which seems highly justifiable. As assumption of the transferor's liabilities is an integral part of most reorganizations, a broad interpretation of the *Hendler* case would seriously hamper, perhaps nullify, the effectiveness of the reorganization provisions. While the wisdom of many of the reorganization provisions may be debatable, and cogent arguments have been advanced for their elimination or amendment,⁵⁴ the broad policy questions involved should be met head-on. There has never been a thorough, impartial investigation of the operation of the reorganization pro-

51. *Corpus Christi Terminal Co.*, 38 B. T. A. 944 (1938), *remanded to the Board in Comm'r v. Corpus Christi Terminal Co.*, 110 F. (2d) 651 (C. C. A. 5th, 1940). See note 86 *infra*.

52. *Estate of Theodore Ebert, Jr.*, 37 B. T. A. 186 (1938).

53. Compare MONTGOMERY, *op. cit. supra* note 41, at 121-2; Mertens' Cum. Supp. (1939) § 17.97; AMERICAN BAR ASSOCIATION, ADVANCE PROGRAM (1938) 102-3; *Hearings before Committee on Ways and Means on Revenue Revision*, 76th Cong., 1st Sess. (1939) 44-52, 59-62, 91-93, 106, 260-261.

54. Sandberg, *The Income Tax Subsidy to "Reorganizations"* (1938) 38 COL. L. REV. 98; SUBCOMM. OF HOUSE WAYS AND MEANS COMM. PRELIM. REP., 73rd Cong., 2d Sess. (1934) 8-9. On the reorganization sections in general, see Fahey, *Income Tax Definition of "Reorganization"* (1939) 39 COL. L. REV. 933.

visions. Until such an inquiry is undertaken, the subject cannot be dealt with fairly, for emotional arguments are scarcely a substitute for investigation. Permitting stocks and securities to be received without the recognition of gain but taxing the assumption of liabilities scarcely seems realistic. Unless and until it is decided to discard the reorganization sections it is the part of tax wisdom to see that they function sensibly. That the assumption of a liability should not result in the recognition of gain is an essential of sensible operation of the provisions.

Section 213(a) of the 1939 Act adds new subsection (k) to Section 112 of the Internal Revenue Code. This new subsection states in part:

“(k) Assumption of Liability Not Recognized — Where upon an exchange the taxpayer receives as part of the consideration property which would be permitted by subsection (b) (4) or (5) of this section to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as ‘other property or money’ received by the taxpayer within the meaning of subsection (c), (d), or (e) of this section and shall not prevent the exchange from being within the provisions of subsection (b) (4) or (5). . . .”⁵⁵

The amount of the liability is thus to be considered in computing the amount of gain or loss *realized* on the exchange but is to be disregarded in ascertaining the amount of the realized gain which is to be *recognized* at that time. The provision that the assumption or acquisition shall not prevent the exchange from being within the provisions of Section 112-(b) (4) or (5) removes the difficulties caused by the requirement in those subsections that the exchange be “solely” for stock or securities. Although these changes would be effective in preventing the assumption or acquisition from resulting in the recognition of gain on the exchange,⁵⁶ they might easily be subject to abuse. Suppose, for example, that *A* intends to transfer some assets to *B* corporation, which he controls, for \$100,000 worth of *B* corporation stock and \$50,000 cash. To avoid the provision of Section 112(c) (1) which taxes the receipt of cash, *A* borrows \$50,000 from a bank prior to the transfer and *B* corporation assumes

55. The Regulations state that in addition to the transferee's assumption of a personal liability of the transferor, the new subsection includes an acquisition of property subject to a liability, whether or not the transferor was personally liable, and the assumption of a liability where the property transferred was held by the transferor merely subject to the liability. Regulations 103, § 19.112(a)-2.

56. Where the liability “assumed” is that of the transferor to the transferee, so that the debt is thus paid and cancelled, gain would presumably be recognized to the transferor, as the transaction can scarcely be considered the “assumption” of a liability. Cf. R. D. Walker, 34 B. T. A. 983 (1936). But the case does not differ materially from the normal situation where the debt is owed to a third party.

his note to the bank. If such an assumption were not to result in the recognition of gain, *A* would have his \$50,000 in cash tax-free at the time of the exchange.⁵⁷ New subsection 112(k) therefore provides that:

“except that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid Federal income tax on the exchange, or if not such a purpose, was not a bona fide business purpose, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this section, be considered as money received by the taxpayer upon the exchange.”

Under this exception, *B* corporation's assumption of the \$50,000 liability is tantamount to the receipt of \$50,000 by *A*. It should also be noted that if *B* corporation had assumed *A*'s alimony obligations, not for the purpose of avoiding income tax on the transfer, but to concentrate *A*'s obligations in a corporation with assets sufficient to pay them, the type of business ordinarily conducted by *B* corporation might be such that the assumption could scarcely be considered as having a bona fide business purpose.

As the tax-free exchange sections are themselves designed to avoid federal income tax, the test set up by Section 112(k) may cause trouble. Suppose that a reorganization had been planned prior to the Revenue Act of 1939 in which the transferor was to pay the debts with part of the cash to be received from the transferee (the *Hendler* case had made the method of payment immaterial). Before the exchange was consummated, the Act became effective and the parties thereupon arranged for the transferee to pay the debts, thus reducing the amount of cash to be received. Or suppose that parties, in arranging an exchange after 1939, have come to the question of which corporation shall pay the debts. “The transferee,” say the lawyers with one voice, “so that we can reduce taxes.” Is the principal purpose one to avoid the federal income tax?⁵⁸ The test

57. In a § 112(b) (4) exchange where the reorganization takes the form of a transfer of substantially all of one corporation's properties for voting stock of the acquiring corporation (§ 112(g) (1) (B)), the requirement that substantially all the properties be transferred serves to limit the possibilities of abuse, as the retention of a large amount of cash prevents the transfer from satisfying that requirement. As to what is “substantially all” the assets, see *Schuh Trading Co. v. Comm'r*, 95 F. (2d) 404 (C. C. A. 7th, 1938); *Milton Smith*, 34 B. T. A. 702 (1936) and cases therein cited. The possibility of abuse could have been limited by making an assumption of liabilities tax free only if the transferor liquidated, although the protection afforded by the liquidation requirement would depend in part upon how a court would view the segregation in another corporation prior to the reorganization of the cash, or property purchased by such cash, made available by the transferee's assumption of the liability.

58. If the Commissioner finds the assumption to be “money” under the exception, and the taxpayer contends otherwise, as where the transferor resists a deficiency on the exchange, new subsection (k) requires the taxpayer to sustain his burden of proof by a

adopted, although admittedly vague, seems the best available under the circumstances. Tests based upon the type of debt: bonds, bank loans, accounts receivable, long or short-term obligations; or the time the debt was incurred: one, two, three years, etc. prior to the exchange; or the time the transferee satisfied the liability; or upon similar factors would prove far less satisfactory. As the Commissioner in the past has permitted liabilities to be assumed tax-free, he cannot be expected to be too restrictive in applying the test adopted in Section 112(k). A case on all fours with the *Hendler* case would presumably go the other way under the Section 112(k) test, as the transferee's immediate payment of the liability it assumed should not of itself make the assumption mala fide.

Finally, the definition of "reorganization" in subsection 112(g) was altered to provide that, in ascertaining whether one corporation's acquisition of substantially all of another corporation's properties was in exchange "solely" for the former's voting stock, the assumption of a liability of the transferor or the acquisition of property subject to a liability shall be disregarded.⁵⁹ This rule applies whether or not the assumption or acquisition is regarded as "money" under subsection (k), so that the taxpayer's risk in the close case is merely that gain will be recognized up to the amount of the liability, and not that the exchange will cease to be tax-free.⁶⁰

clear preponderance of the evidence. If it is the taxpayer who is claiming that the assumption shall be considered as "money," as where the transferor or transferee is claiming a stepped-up basis, then this requirement is not placed upon him nor is a corresponding requirement placed upon the Commissioner. Cf. § 102 (also has standard of "clear preponderance of the evidence").

59. Section 112(g) (1) (B) is now restricted to the acquisition of 80% of the stock for voting stock, as to which the requirement of "solely" for voting stock is kept, and § 112(g) (1) (C) now relates to the transfer of substantially all the properties for voting stock. The succeeding clauses in § 112(g) (1) have been relettered.

60. While the exception in § 112(k) states that it shall be considered as money "for the purposes of this Section," new § 112(g) (1) (C) should be deemed to govern in a case where the assumption is considered as money, as it specifically states that the assumption shall be disregarded in determining whether the exchange is solely for voting stock. See H. R. REP. NO. 855, 76th Cong., 1st Sess. (1939) 19. But cf. Mertens' Cum. Supp. (1939) ¶ 17.60.

The rule of *Minnesota Tea Co. v. Helvering*, 302 U. S. 609 (1938) that § 112(d) (1) is confined to a distribution to stockholders is still operative. If the assumption of a liability is considered as "money" under the exception, gain will therefore be recognized to the transferor under § 112(d) (2) as the "money" has not been distributed to stockholders. Gain will also be recognized if the transferee, instead of assuming the liabilities, transfers cash to the transferor and the latter uses this cash to discharge the liabilities. But if the transferee assumes the liabilities and discharges them by payment of cash to the creditors, this cash cannot be regarded as being constructively received by the transferor. While the tax consequences of the treatment of the transferor's liabilities thus turn on the mechanics of the transfer, it was apparently thought advisable, in order to minimize possible tax avoidance, not to permit any cash to pass tax free directly to the transferor.

The requirement of "solely for voting stock" had been inserted by the Revenue Act of 1934 to prevent tax-free transfers for some voting stock plus short-term notes, bonds, or other obligations which did not differ greatly from cash and whose presence made the exchange very similar to an outright sale.⁶¹ Thus, if property were transferred to a new corporation in connection with a reorganization and the old corporation's bondholders received stocks and bonds of the new corporation in exchange for their bonds, and the stockholders received some stock, there would not be a reorganization within the meaning of former Section 112(g) (1)(B), because the transfer of bonds made the exchange run afoul of the "solely for voting stock" requirement.⁶² If the bonded indebtedness were in terms assumed by the new corporation, it might perhaps be argued that the amendment to Section 112(g) (1) would make this a reorganization under new (C): the new corporation would have issued voting stock and assumed the old corporation's bonded indebtedness; its issuance of stock and bonds directly to the bondholders might be taken to constitute payment of the indebtedness, leaving the exchange as one of assets for voting stock and assumption of the indebtedness. Presumably, no gain or loss would be recognized to the bondholders on such a payment as the payment would seem to be an exchange pursuant to a plan of reorganization within the meaning of Section 112(b)(3). If assets should be transferred and the old corporation's stockholders, who were also its creditors, should receive voting stock and also some short-term notes (the latter being equal to the old corporation's indebtedness to them) the transfer may also be a reorganization, as the notes could be considered payment of the debts assumed. This does not mean that the abuses possible prior to the Revenue Act of 1934 have again been introduced, for the field which such obligations may occupy under the amendment to Section 112(g) (1) now is limited to the old corporation's indebtedness whereas it previously extended to the net worth, and the obligations now must go to the old corporation's creditors. If the provision for the exchange of stock and bonds for bonds in the transfer first considered above were regarded as an obligation of the new to the old corporation

61. See Fahey, *Income Tax Definition of "Reorganization"* (1939) 39 Col. L. Rev. 933, 949-954, 959.

62. *Comm'r v. Kitzelman*, 89 F. (2d) 458 (C. C. A. 7th, 1937), *cert. denied*, 302 U. S. 709 (1937); *Comm'r v. Newberry Lumber & Chem. Co.*, 94 F. (2d) 447 (C. C. A. 6th, 1938); *cf. Frederick L. Leckie*, 37 B. T. A. 252 (1938); *Marlborough House, Inc.*, 40 B. T. A. No. 133 (1939); *Alabama Asphaltic Limestone Co.*, 41 B. T. A. No. 51 (1940). Cases such as these imply that, if the old corporation were insolvent, such an exchange would be a reorganization under former § 112(g) (1) (C), as control is possessed by the bondholders (if they received the proper percentage of the stock) who, under these facts, may be considered as shareholders of the old corporation. These decisions hardly seem to interpret the reorganization sections properly. See *Le Tulle v. Scofield*, 308 U. S. 415 (1940); dissenting opinions in *Alabama Asphaltic Limestone Co.*, *supra*.

and hence as additional consideration for the assets, the transaction might be ruled not to be a reorganization inasmuch as the transfer would not be solely for voting stock and an assumption of indebtedness. Moreover, if the plan did not provide for an express assumption of the indebtedness, the transaction might also be held not to be a reorganization unless such an assumption or an acquisition subject to the indebtedness were implied from the transaction itself.

With respect to the basis provisions, Congress remedied the defect in the existing law by adding the following sentence to Section 113(a)(6):

"Where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this paragraph, be considered as money received by the taxpayer upon the exchange."

This reduction occurs whether or not the assumption of liability is "money" for the purposes of recognition of gain under Section 112(k), as it is always regarded as "money" under Section 113(a)(6). If the assumption is taxed as "money" under the exception provided in Section 112(k), the basis is of course increased by the amount of gain so recognized. Under Section 113(a)(6) as amended, it is mathematically possible for a minus basis to occur in cases where the assumption is tax-free. If *A* corporation exchanges assets having a basis of \$5,000 but worth \$20,000 for *B* corporation stock worth \$14,000 and *B* corporation's assumption of a \$6,000 liability of *A* corporation, a literal reading of Section 113(a)(6) would result in the basis of the stock in *A* corporation's hands being \$5,000 minus \$6,000, or minus \$1,000. Although the amendment is silent on this point, the Bureau presumably will be governed by its previous practice of eliminating a minus basis by raising it to zero.⁶³ If the amendment had met this problem by taxing the transferor at the time on so much of the assumption as is equal to the minus basis, thereby producing a zero basis (in the above example this solution would produce a tax on \$1,000 and require the addition to the basis of \$1,000, the amount recognized as gain, thus making it zero), the corollary would have been an increase in the transferee's basis by the amount of gain so recognized. The solution adopted, that of leaving the matter to Bureau practice, permanently relieves the transferor of tax on so much of the assumption as produces the minus basis and leaves the transferee potentially liable for this tax as the transferee's basis is not increased when the transferor's basis is raised to zero without recognition of gain.⁶⁴

63. A minus basis may also occur by reason of § 112(d)(1). Suppose, in the exchange in the text, *B* corporation, instead of assuming the liability, paid *A* corporation \$6,000 cash which the latter distributed to its stockholders.

64. This solution accords with the policy underlying the requirement that the transferee takes a substituted basis in these cases, so that the Government may look primarily

Both the exception in new subsection 112(k) and the sentence added to Section 113(a) (6) consider the assumption of a liability or the acquisition subject to a liability as "money" in the "amount of the liability."⁶⁵ There is therefore ordinarily no occasion to value the liability. The assumption of a \$1,000 demand note bearing interest at six per cent and of a \$1,000 ten-year note bearing interest at three per cent are both treated as equivalent to the receipt of \$1,000 in money.⁶⁶ The reliance upon the "amount of the liability" also makes unnecessary a valuation of the transferee's express or implied promise to pay the liability. The assumption of a \$100,000 note by a financially sound corporation, or by a corporation whose assets barely exceed its liabilities so that its ultimate full payment of the note is doubtful, both result in \$100,000 of "money" to be deducted from the transferor's old basis. The transferee's acquisition of property subject to a \$100,000 mortgage is also treated as "money" in the amount of \$100,000, regardless of the property's value.⁶⁷

Although this solution accords with the run of the mill case and eliminates the problems which attend valuation, it may necessitate adjustments as a result of the transferee's later action. If the transferee fails to pay either the liability which it assumed or to which it took subject, and the transferor is called upon to make payment, he seems entitled to a deduction either under Section 23(e) (2) for a loss incurred in a transaction entered into for profit in the case of an individual transferor, or under Section 23(f) in the case of a corporation, or possibly also under Section 23(k) for a bad debt—that of the transferee to the transferor where the former assumed the liability. The deduction will thus result in an ordinary loss, although the reduction in basis caused by the assumption may result in capital gain. The alternative course of valuing the transferee's promise and reducing the basis by an amount less than the liability would have meant that the transferee's later payment of the full amount

to the transferee for the tax. Thus, the reduction in basis provided for in the amendment to § 113(a) (6) itself becomes immaterial where the transferor liquidates.

65. Where the liability assumed is the joint liability of two transferors, the "amount of the liability" must refer to the amount of each transferor's ultimate share of the liability, even though, as respects the creditor, each may be liable severally for the entire amount. The contrary interpretation would produce too large a reduction in basis.

66. The "amount of the liability" is the amount of unpaid principal plus any accrued interest unpaid. Where the liability is a contract obligation, valuation difficulties may occur. Suppose that corporation *A* has contracted to deliver a hotel's coal requirements for a year, for which it has received payment in advance. It transfers its assets to corporation *B* in exchange for *B* stock and the assumption of the hotel contract. Here the obligation assumed by corporation *B* must be valued in order to obtain the basis of the stock in corporation *B*'s hands. Cf. *Robinson v. Comm'r*, 97 F. (2d) 552 (C. C. A. 9th, 1938) (similar situation). The term "liability" certainly seems broad enough to cover any obligation of the transferor.

67. This solution follows the Bureau and Board practice on this point; see notes 24 and 25 *supra*.

of the liability would have resulted either in gain, presumably capital gain, to the transferor, or a further reduction of basis if the transferor still held the stock acquired upon the exchange. This would have required express statutory language and would have placed upon the Government the onerous burden of keeping an eye upon the transferee's later actions.

The transferee's basis is not affected by its later action in regard to the liability. Its assumption of the liability is part of its cost, but under Section 113(a)(7) and (8) its basis is fixed not by the cost to it of the property acquired but by the property's basis in the transferor's hands prior to the exchange. Later full or part payment of the liability hence will not affect the transferee's basis;⁶⁸ nor will the transferee be able to obtain a deduction for the payment as a business expense.⁶⁹ Any interest paid by the transferee on the liability would be deductible, except that which accrued prior to the assumption and is therefore part of the cost along with the principal.⁷⁰ If the indebtedness assumed by the transferee were cancelled under circumstances which would otherwise give rise to taxable income, it seems that the cancellation would result in income to the transferee, even though payment of the liability would not have had a tax consequence.⁷¹

The courts have held that if corporation *A* merges or consolidates with corporation *B*, the latter may continue to deduct *A* corporation's remaining unamortized bond discount over the life of the bonds, but that if corporation *A* transfers its assets to corporation *B* in exchange for stock and an assumption of its liabilities in a tax-free reorganization which is not a strict merger or consolidation, corporation *B* will not be allowed this deduction.⁷² The transferee, it seems, should not normally

68. H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 20 states that "No amendment is made to Section 113(a)(7) or (8), because the payment by the transferee of the liabilities assumed, or to which the property was subject, does not give rise to any increase or adjustment of the basis of the property transferred."

69. In *Athol Mfg. Co. v. Comm'r*, 54 F. (2d) 230 (C. C. A. 1st, 1931) a corporation which had assumed liabilities upon an acquisition of assets claimed that later payment of the liabilities entitled it to a deduction for an ordinary and necessary business expense. The court denied the deduction, stating that the payment constituted part of the consideration for the assets and hence was a capital item. *Accord*, *Falk Corp. v. Comm'r*, 60 F. (2d) 204 (C. C. A. 7th, 1932); *Sigmund Spitzer*, 23 B. T. A. 776 (1931); *Caldwell & Co.*, 26 B. T. A. 790 (1932); *F. Tinker & Sons Co.*, 1 B. T. A. 799 (1925).

70. Compare *Harvey M. Toy*, 34 B. T. A. 877 (1936) with *Automatic Sprinkler Co.*, 27 B. T. A. 160 (1932).

71. The income realized on this cancellation would presumably be measured by reference to the amount of the obligations assumed by the transferee, less appropriate deductions for amortized discount, etc. But see discussion in text following. The transferor would not be affected by this cancellation, even though its basis had been reduced by the full amount of the liability. The discussion on p. 20 *supra* relates to a situation in which the transferor is later called upon to make payment. *Cf.* *Anheuser-Busch, Inc.*, 40 B. T. A. No. 170 (1939), discussed note 98 *infra*.

72. *Helvering v. Pennsylvania Water & Power Co.*, *Helvering v. Metropolitan Edison Co.*, 306 U. S. 522 (1939) (deduction allowed where merger either statutory or de facto);

be entitled to the deduction, as the discount is a part of the obligation which it assumed and hence is part of the cost.⁷³ While the transferee may deduct interest accruing after the assumption, and bond discount is in effect equivalent to a higher rate of interest, it seems more similar in this respect to interest already accrued, which is not deductible. There is therefore no inequity in denying the deduction as such to the transferee. Although the consideration received by the transferor will be less by the amount of the obligation, and although the previous money obtained tax-free is less than the amount of the obligation due to the discount, the amended basis provisions nevertheless require the transferor to deduct the full amount of the obligation from its old basis, so that through the reduction in basis it suffers a tax disadvantage equal to the amount of the unamortized discount. To achieve a proper result here, it seems that the deduction from basis should be the amount of the liability less unamortized discount — in fact, the amount of the liability less any accrued liability required to be deducted from basis and not previously reflected either as tax-free income or as a deduction.

This adjustment in basis will not, however, help the transferor if it liquidates, as it always does where there is a merger or consolidation. As the deduction will be lost unless granted to some one, and as in a strict merger or consolidation the transferee is really the transferor in another form, the courts are perhaps justified in allowing the transferee to take the deduction. But in other reorganization cases, the inequity to the transferor is scarcely cancelled by allowing the transferee the deduction. Nor is there any reason to give the transferee such a windfall, for it paid less by assuming the discount obligation; in any event, its basis is fixed regardless of actual cost. The transferor, however, might possibly claim the entire amount of the unamortized discount as a deduction in the year of the exchange, inasmuch as the consideration which it received

General Gas & Elec. Corp. v. Comm'r, 306 U. S. 530 (1939) (allowed where statutory merger); American Gas & Elec. Co. v. Comm'r, 85 F. (2d) 527 (C. C. A. 2d, 1936) (allowed where statutory merger; not allowed where merely reorganization); Turner-Farber-Love Co. v. Helvering, 68 F. (2d) 416 (App. D. C. 1933) (disallowed where merely reorganization); American Gas & Elec. Co. v. United States, 17 F. Supp. 151 (Ct. Cl. 1936) (allowed where statutory merger; not allowed where merely reorganization).

73. A premium payable on redemption should be deductible by the transferee, as the expense had not occurred when the bonds were assumed, unless, as in the *Hendler* case, the bonds had been called for redemption by the transferor. *Coast Counties Gas & Elec. Co.*, 36 B. T. A. 385 (1937), *modifying* 33 B. T. A. 1199 (1936), and *American Gas & Elec. Co. v. United States*, 85 F. (2d) 527 (C. C. A. 2d, 1936) allow deduction for the premium whether the transfer is by way of merger or consolidation or by ordinary reorganization; *Pennsylvania Water & Power Co.*, 36 B. T. A. 467 (1937) and *Metropolitan Edison Co.*, 35 B. T. A. 1110 (1937) (*issue not involved on appeal in 306 U. S. 522 (1939)*) allowed the deduction in cases involving statutory and de facto mergers; the point of call by the transferor has not been discussed.

was reduced through the transferee's assumption of payment of this amount and in that sense the discount was "paid" by the transferor.⁷⁴

The final change made by Section 213 concerns Section 112(b)(5). Under a proviso, that Section is applicable to an exchange by two or more persons "only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange." The purpose of this proviso is not clear.⁷⁵ As the Section was presumably adopted to permit individuals or partnerships to incorporate, it may have been thought appropriate to require that the same degree of control should exist in the corporation as previously existed in the partnership. But a provision designed to perpetuate the previous degree of control over the transferred property becomes meaningless if the property was not previously jointly owned by the transferors. As the Section has usually been regarded as applicable to a case where *A* transfers to the corporation property which he owned entirely and *B* transfers other property which he owned, so that their control over the property is appreciably altered, this suggested reason for the proviso is of little value.⁷⁶ While the perpetuation of control in the partnership case and the application of the proviso to non-partnership cases prevents what are, in effect, sales for cash and stock, this purpose neither seems necessary, inasmuch as the cash would be taxed under Section 112(c)(1), nor in harmony with the treatment accorded to "boot" on the other Section 112(b) exchanges.⁷⁷ If the proviso is intended to preserve the financial *status quo* and to prevent one transferor from obtaining more than his share, it disregards both the bargaining ability of the other transferor and the fact that the first transferor would still retain his old basis, so that his tax would ultimately be greater.⁷⁸

The few cases that have considered this proviso indicate two possible interpretations: (1) the percentage of each transferor's interest in the stock and securities received must be substantially the same as the percentage of his interest in the total property transferred to the corpora-

74. But *cf.* *Hendler v. United States*, 17 F. Supp. 558 (D. Md. 1936) and discussion pp. 3-4 *supra*; *American Gas & Electric Co. v. Comm'r*, 85 F. (2d) 527, 529, 531 (C. C. A. 2d, 1936) (indicating that transferor may not take deduction).

75. The legislative history is not helpful. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938) 332, 690, 789, 898.

76. *Snead v. Jackson Securities & Investm. Co.*, 77 F. (2d) 19 (C. C. A. 5th, 1935), *cert. denied*, 296 U. S. 599 (1935) (Sibley, J., dissenting); *American C. & W. Co. v. Bender*, 70 F. (2d) 655 (C. C. A. 5th, 1934), *cert. denied*, 293 U. S. 607 (1934).

77. Compare dissenting opinion in *Samuel E. Diescher*, 36 B. T. A. 732, 745 (1937), discussed note 83 *infra*.

78. PAUL & MERTENS, THE LAW OF FEDERAL INCOME TAXATION (1934 ed.) § 17.43, half suggests that both the stocks and the securities received must each be in the requisite proportion. But this can scarcely be so. The value test clearly disregards any such requirement and the Revenue Act of 1939 is likewise premised upon a lack of differentiation between stocks and securities. See pp. 25-26 *infra*.

tion; (2) the value of the stock and securities received by each transferor must be substantially the same as the value of the property which he transferred to the corporation. Although both tests would reach the same result in many situations, the second test is far more exacting inasmuch as slight variations in the percentage of interest may, where large amounts are involved, account for significant differences between the property's value and the value of the stock. Thus the situation in *United Carbon Co. v. Commissioner*⁷⁹ met the first test, for the greatest difference in the percentage of interest was 1.36 per cent and the difference exceeded one per cent with respect to but two out of the fourteen transferors involved. But the second test was not satisfied as one transferor received stock whose value represented a net gain of 21.93 per cent over his property's value (his property was worth \$256,293 and his stock \$312,499, the difference in percentage of interest being plus .57 per cent — 2.58 per cent as compared with 3.15 per cent), another received a net gain of 12.17 per cent, another a net gain of 11 per cent, another a net loss of 9.10 per cent, and another a net loss of 28.41 per cent. While the first test seems to accord more closely with the proviso's language — the amount received must be substantially in *proportion* to the interest in the property, and not substantially equal in value to the interest in the property — the cases now favor the second view.⁸⁰

Aside, however, from the problem of interpretation, there remained the question of the treatment of the assumption of a liability. Suppose that *A* transferred a \$10 asset to a corporation for ten shares of stock and *B* transferred a \$10 asset subject to a \$4 mortgage for six shares of stock and the assumption of the mortgage. If the words in the proviso,

79. 90 F. (2d) 43 (C. C. A. 4th, 1937) (involving claim for stepped-up depreciation basis; Government unsuccessfully urged first interpretation).

80. In accord with the *United Carbon* case is *Comm'r v. Lincoln-Boyle Ice Co.*, 93 F. (2d) 26 (C. C. A. 7th, 1937) (holding proviso not satisfied where percentages in property were 46.77%, 26.74%, 9.11% and 17.36%, percentages of stock 54.59%, 17.31%, 14.19% and 13.89%, and percentages of gain or loss in value, plus 16.71%, minus 35.23%, plus 55.71%, and minus 20.00%; transferee's claim for stepped-up basis also involved here; Government unsuccessfully urged first interpretation); *Snead v. Jackson Securities & Investm. Co.*, 77 F. (2d) 19 (C. C. A. 5th, 1935), *cert. denied*, 296 U. S. 599; *Portland Oil Co. v. Comm'r*, 109 F. (2d) 479 (C. C. A. 1st, 1940). But see *Diescher v. Comm'r*, 110 F. (2d) 90 (C. C. A. 3d, 1940).

The Board originally adopted the percentage test without discussion of the value test. *Ared Corp.*, 30 B. T. A. 1080 (1934); *Record Petroleum Co.*, 32 B. T. A. 1270 (1935); *cf. Hillyer, Edwards, Fuller, Inc. v. United States*, 52 F. (2d) 742 (E. D. La. 1931). The Board now apparently prefers the value test. *Gladstone Corp.*, 37 B. T. A. 174 (1938); *Cyrus S. Eaton*, 37 B. T. A. 715 (1938) (statement quoted from *United Carbon* case that the clause requires comparison "between the value of the share of each transferor in the total assets before the exchange and the value of its shares of stock or interest in the corporation after the exchange"). While the Commissioner acquiesced in this decision, 1938-2 CUM. BULL. 10, there seems to be no established Bureau practice on the point. The Regulations take no position. Regulations 103, § 19.112(b)(5)-1, 2.

"his interest in the property" are deemed to refer to equities, the "property" transferred is \$16, *A*'s "interest" is 10/16 and *B*'s "interest" 6/16. As they received stock in the same proportion, the first test is satisfied. As the stock is worth \$1 a share, *A* has exchanged a \$10 asset for \$10 of stock and *B* a \$6 equity in an asset for \$6 of stock, so that the second test is also satisfied. If, however, the mortgage were disregarded in determining the property transferred, *A*'s interest would be 10/20 and *B*'s interest would be 10/20, but *A*'s stock interest would be 10/16 and *B*'s 6/16 and neither test would be satisfied. Without discussion of the point, the Board, in several cases adopted the view that the equities governed.⁸¹ But these decisions were bottomed on the belief that the assumption of a liability was not "other money or property." Having eliminated that obstacle to the application of Section 112(b)(5), it would of course have been fruitless to interpret the proviso to raise a barrier in these cases. It would, however, have been difficult to reach the same interpretation after the *Hendler* decision as the Court there regarded the assumption as cash received by the transferor, in which case the second set of fractions seem to apply.

As Section 213 had adopted the policy of not making the assumption of a liability an occasion for recognizing gain, it became necessary to alter the proviso in Section 112(b)(5). A new sentence was therefore added to that subsection which provided:

"Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as 'other property or money') shall be considered as stock or securities received by such transferor."

In the example above *B* will be considered as having received \$4 worth of stock in addition to the six shares actually received, so that both *A* and *B* have received in value \$10 of stock and in percentage 50 per cent of the stock. Both the property which *B* has transferred and *B*'s interest in the property must now be considered as worth \$10, for otherwise neither the first nor second test will be satisfied and the amendment

81. In *Ared Corp.*, 30 B. T. A. 1080 (1934), where *A* and *B* each transferred property for stock and the assumption of a liability, the Board, in computing the value of the property transferred and the interest of each therein, deducted the amount of the liabilities assumed. See *Cyrus S. Eaton*, 37 B. T. A. 715 (1938); *Edwin L. Dana*, 36 B. T. A. 231 (1937); but *cf. Schuh Trading Co. v. Comm'r*, 95 F. (2d) 404 (C. C. A. 7th, 1938) (in determining whether assets transferred were substantially all of transferor's assets, transferee's assumption of liabilities held not to decrease quantity of assets transferred but merely to lessen amount paid for them); *Milton Smith*, 34 B. T. A. 702 (1936).

made to Section 112(b)(5) will be rendered nugatory.⁸² The amendment thus disregards the equity test as the method of removing the obstacle of the proviso; the other side of the equation has instead been increased through hypothetical consideration of the assumption of a liability as the equivalent of the transferor's receipt of stock or securities in the amount of the liability. If the assumption is considered as "money" under the exception provided in subsection 112(k), the hypothetical treatment as stock or securities for the purpose of Section 112(b)(5) is not operative, and the assumption is equivalent to the receipt of cash. However, the same treatment of the property transferred by *B* and his interest therein (*i.e.*, \$10 in each case) would continue, as Congress must have intended to treat the case as one in which *B* had exchanged \$10 of property owned outright for \$6 of stock and \$4 of cash.⁸³ Otherwise, if *B*'s interest were considered as \$6, the proviso would be satisfied, as *A* had received \$10 of stock for \$10 of property and *B* \$6 of stock for \$6 of property.

Section 213(e) applies all of the amendments discussed above (Section 213(a)–(d)) to taxable years beginning after December 31, 1938. Subsections 213(f)–(i), however, contain practically identical amendments which reach as far back as 1924, so that the whole problem of the effect of the assumption of a liability in Section 112(b)(4) and (5) exchanges has been settled by the adoption of uniform rules for the entire period.⁸⁴ By retroactively confirming the prior practice, Congress has spared taxpayers and the Government the tremendous problems which upsetting the practice would entail.⁸⁵ As the assumption of a liability is

82. Regulations 103, § 19.112(b)(5)-2 so indicate.

83. The amount of "other property or money" received by a transferor, although taxable under § 112(c)(1), is not deducted from the property transferred in determining its value for the purpose of the proviso. *Diescher v. Comm'r*, 110 F. (2d) 90 (C. C. A. 3d, 1940). But see Samuel E. Diescher, 36 B. T. A. 732, 745 (1937) (dissenting opinion).

84. The retroactive counterpart of subsection (k) applies to exchanges occurring in taxable years ending after Dec. 31, 1923, and beginning before Jan. 1, 1938, and affects the Revenue Act of 1924 and subsequent Acts through the Revenue Act of 1938. The retroactive basis and § 112(b)(5) amendments also apply to those Acts. The amended definition of "reorganization" in § 112(g) extends only to the Revenue Acts of 1934, 1936 and 1938, which were the only prior Acts to contain the "solely" requirement. The letter designations in § 112(g)(1) are not retroactively altered. As exchanges in a taxable year ending in 1924 are governed by both the Revenue Act of 1921 and the Revenue Act of 1924, these amendments do not disturb this joint effect, but extend only to the application of the Revenue Act of 1924 to these exchanges.

85. H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 20 states:

"The amendments to the Code and the retroactive application of similar provisions to prior revenue acts taken together establish a system under which the treatment of recognition of gain and determination of basis will be under uniform equitable rules for the periods covered. Since transactions entered into under such acts were made under the understanding of the law that such assumption

not to be considered as "other property or money," the Government may not obtain deficiencies with respect to exchanges in years not closed by the statute of limitations on which no gain had been reported although liabilities were assumed. Nor may transferors or transferees obtain stepped-up bases on the ground that gain should have been recognized on these prior exchanges.⁸⁶

A difference should be noted between the new subsection 112(k) in the Code and its counterpart in prior Revenue Acts. As the latter provision makes no exception for an assumption of a liability involving an attempt to avoid tax or not having a bona fide business purpose, such an assumption in an exchange in prior years presumably remains tax-free. If, on the other hand, gain was recognized by reason of an assumption in a decision of the Board or a court which became final before September 26, 1939,⁸⁷ or in a closing agreement, whenever it became final, determining the tax liability of a taxpayer for the taxable year in which the exchange occurred, this assumption shall be considered as money received by the transferor in the amount of the liability considered in computing the gain. This exception was designed to preserve the effect in the particular cases of the *Hendler* decision and other decisions which

of, and taking subject to, liabilities did not give rise to recognizable gain, it is necessary, in order to prevent hardship on taxpayers and to prevent tax avoidance, to provide retroactively for the application of the rule above provided."

T. D. 4934, § 20A.2, states that the amendments in general confirm the Bureau practice.

86. The phrase in §§ 113(a) (6) (7) and (8) "under the law applicable to the year in which the exchange was made" picks up the amendment made to the prior acts by § 213(f), especially in view of § 213(f) (2). The retroactive amendments were applied in *Schweitzer & Conrad, Inc.*, 41 B. T. A. No. 80 (1940). In *Comm'r v. Corpus Christi Terminal Co.*, 110 F. (2d) 651 (C. C. A. 5th, 1940) the Board, in a decision prior to the Revenue Act of 1939 and relying on the *Hendler* decision, had allowed the transferee's claim to a stepped-up basis, in regard to a 1931 sale, on assets acquired in a tax-free exchange in 1931 in which the transferee had assumed liabilities of the transferor. The circuit court remanded, stating that it was necessary to know if and when the transferee had discharged the liabilities assumed. The additional evidence desired, however, seems irrelevant to the case. Under retroactive § 213(f), the assumption does not result in recognized gain to the transferor, whether or not the liabilities were discharged in the year of assumption or at all, so that a stepped-up basis could not be claimed on the ground of recognition of gain to the transferor. Nor could such an increase be warranted because the transferee had paid the liabilities assumed. See p. 21 *supra*. While there appears to be no doubt, either as to statutory construction or constitutionality, that the retroactive amendments reach the case and require a reversal of the Board's decision, the court may avoid the necessity of passing on the question by following the *Bickford* case if it finds that the liabilities were not paid in the year of assumption. But payment should not be a prerequisite to recognition of gain to a transferor under the *Hendler* doctrine (see p. 29 *infra*) so that the additional evidence should not be material on this score.

87. That is, the decision must have become final before the 90th day after the date of enactment of the Revenue Act of 1939.

treated the assumption as "other property or money,"⁸⁸ and to prevent reduction of either the transferor's or the transferee's basis where it had been increased by reason of the gain so recognized. If the Bureau has closed any cases in which an assumption was so treated, and the settlement was not by closing agreement, the taxpayer may sue for a refund if the period of limitations has not expired, or the lower basis may be asserted by the Government. But suits of this nature are not to be expected, as such cases are few in number, if they exist at all. The parties involved, moreover, may at any time enter into closing agreements ratifying their prior action for, unlike the judicial decisions, the closing agreement need not have become final prior to September 26, 1939.⁸⁹ While the above exception regarding final court decisions would have frozen the *Hendler* case itself, Congress provided in Section 910 of the Social Security Act Amendments of 1939 that the exception should not be applied to that case and authorized a refund of the tax which Hendler paid.⁹⁰ An obscure burial stone in a foreign field thus marks the demise of the Government's victory in the *Hendler* case.

FURTHER PROBLEMS RESPECTING SECTION 112(b)(1)

The Bureau practice, supported by Board decisions and general taxpayer acquiescence, was, as has been pointed out, to recognize gain upon the assumption of a liability in Section 112(b)(1) exchanges. The *Hendler* decision affirmed the general principle which underlay that practice. Inasmuch as subsection 112(k) added by the 1939 Act and its retroactive counterpart are restricted to Section 112(b)(4) and (5) exchanges, Congress must have intended the ratification of the prior practice in respect to Section 112(b)(1) exchanges.⁹¹ While the phrase

88. *E.g.*, Daily Tel. Co., 34 B. T. A. 101 (1936); Walter F. Haass, 37 B. T. A. 948 (1938).

89. The retroactive § 112(b)(5) contains a proviso similarly preserving a treatment of the liability different from that effected by the amendment, so that the cases mentioned in note 81 *supra* are not disturbed.

90. The section states that the provisions of § 213(f) shall apply without regard to the exception if the taxpayer is a corporation, the determination is by a Board or court decision, under the law applicable to the taxable year in which the exchange occurred the transferee's basis is cost to the transferee rather than the transferor's basis, and the transferor has, in pursuance of the plan of reorganization, effected a complete liquidation. Apparently, the only case that satisfies these requirements is the *Hendler* case itself, so that this elaborate modification of § 213(f) is no more than an expression of Congress's desire to relieve Hendler of the tax which he paid.

91. Section 112(b)(2) and (3) exchanges do not necessarily involve an assumption of liabilities, nor is an assumption of liabilities necessary to their effective operation. Where §§ 112(b)(3) and (4) overlap so that an exchange is subject to both sections, an assumption of liabilities will be tax free. While a parent may assume its subsidiary's liabilities in a liquidation under § 112(b)(6), the problems under consideration do not arise as gain is not realized upon a liquidation (§ 113(a)(15) makes the subsidiary's basis the

"other property or money" in Section 112(c)(1) therefore continues to include the assumption of a liability in a Section 112(b)(1) type of exchange,⁹² the precise scope of the coverage remains uncertain.

In recognizing gain because of the assumption of a liability, the Board looked no further than the fact of assumption to ground a tax for the year of the exchange, and did not inquire whether the liability assumed had actually been paid in the taxable year of the transferor. But in the *Hendler* case the Court spoke of "assumption and payment" and said that the "discharge of liability by the payment of the . . . indebtedness constituted income."⁹³ This stress on payment apparently occasioned a later dictum that "To assume the debts of a company is not to pay 'property or money' to the promisees."⁹⁴ This statement implies that mere assumption without payment would not result in recognized gain at the time in a Section 112(b)(1) exchange—a view for which there seems to be little warrant. The question of the proper taxable year rarely arose in the earlier cases dealing with the assumption of a liability for income tax.⁹⁵ When the question did arise, the courts were not concerned with the year of payment of the liability but with the year in which the tax liability assumed became fixed and definite.⁹⁶ As the amount of the liability is known in the exchange cases and as the assumption by the transferee relieves the transferor of payment of that amount, it seems immaterial whether the transferee paid that liability, either in accordance

basis of the parent without any provision for increase by reason of gain recognized upon the exchange). The parent's basis would not be increased on payment of the liabilities. See p. 21 *supra*.

92. Regulations 103. §§ 19.112(b)(1)-1, 112(c)(1) so provide. The same construction applies to §§ 112(b)(2) and (3) exchanges.

93. 303 U. S. 564, 566 (1938).

94. *Bickford's, Inc. v. Helvering*, 98 F. (2d) 568, 569 (C. C. A. 2d, 1938).

95. In *Old Colony Trust Co. v. Comm'r*, 279 U. S. 716 (1929) the corporation in 1916 resolved to pay any income tax thereafter due and payable on its officers' salaries. The tax paid by the corporation was held income to the officer, presumably on a cash basis, for the year of payment. In *United States v. Boston & M. R. R.*, 279 U. S. 732 (1932) the lessor's 1917 tax, presumably on the accrual basis, paid by the lessee in 1918 was income to the lessor for 1917. In neither case was the question of the proper year raised.

96. *Appeal of Providence & W. R. R.*, 5 B. T. A. 1186 (1927) (as lessor's tax for 1920 did not accrue until 1921, when it became due and payable, lessee's payment of the tax in 1921 held income to the lessor for 1921, not 1920); *accord*, *Appeal of Norwich & W. R. R.*, 2 B. T. A. 215 (1925), *aff'd sub nom. United States v. Norwich & W. R. R.*, 16 F. (2d) 944 (1st Mass. 1926); *Belt Ry. of Chicago*, 9 B. T. A. 304 (1927), *aff'd on other issues*, 36 F. (2d) 541 (App. D. C. 1929), *cert. denied*, 281 U. S. 742 (1930). *Contra*: *Comm'r v. Terre Haute Elec. Co.*, 67 F. (2d) 697 (C. C. A. 7th, 1933) (lessee's payment of tax held income for year in which tax was due); *Acme Coal Co. v. United States*, 44 F. (2d) 95 (Ct. Cl. 1930) (vendee's payment of tax on vendor's profit on sale held income to vendor for year of sale as part of sale profit); *C. B. Shaffer*, 29 B. T. A. 1315 (1934) (payment treated as income for year tax was payable, as vendor's liability was uncertain and speculative until then); *accord*, *E. A. Hughes*, 32 B. T. A. 1248 (1935).

with the terms of the liability or otherwise, in the year of the exchange or any subsequent year.⁹⁷ If the assumption were not to result in recognized gain to the transferor until payment by the transferee, the Government would lose many taxes through its inability to make a careful check upon all cases.⁹⁸

While there seems to be no magic attached to the fact of payment, that event does finally measure the value of the transferee's promise to pay the liability and answers the question that is begged by the previous use of the words "relieves the transferee of payment." Can we say that the transferee's mere assumption of a \$1,000 liability payable two years afterward is worth \$1,000 to the transferor, or must we inquire further into the transferee's financial status and the value of his promise? If it appears very unlikely that the transferee will actually pay, shall we assign some rough value, or even no value, to the promise, and wait until actual payment before we collect the full tax? The prior practice and the Board cases found no difficulty with this point. The assumption of liability was regarded as falling not within the term "property" in the phrase "other property or money," but within the term "money."⁹⁹ Valuation difficulties were thus avoided and the assumption considered as money in the amount of the liability.

The Revenue Act of 1939 confirms this practice for, wherever pertinent, the assumption is expressly treated as money in the amount of

97. But *cf.* James M. Butler, 19 B. T. A. 718 (1930) where the lessee's assumption of the lessor's mortgage was held not to result in income to the lessor in the year of assumption, but only as lessee made payments; lessor was still liable on mortgage and his liability reduced only as lessee made payments on mortgage principal.

98. Regulations 103, § 19.113(a)(6)-2 indicate that gain is to be recognized whether or not there is payment by the transferee.

The contention that the mere assumption of the liability constitutes the receipt of "money," and that it is not necessary to postpone recognition of gain until the liability is paid, is an assertion that the *Hendler* case does not rest upon the doctrine of "constructive receipt." Observe that in the *Hendler* case the Court relied on *Old Colony Trust Co. v. Comm'r*, 279 U. S. 716 (1929), which is a "constructive receipt" case also involving the discharge of the assumed debt. Compare *Anheuser-Busch, Inc.*, 40 B. T. A. No. 170 (1939) in which *A*'s debt of \$500,000 to *B* had been assumed and discharged by *C* for \$484,687.50 after *C*'s acquisition of *A*'s assets. Although the Commissioner asserted that the \$484,687.50 was part of the consideration, the Board stated "It may be that the correct amount would have been \$500,000, since that is the measure of the benefit to Melrose (*A*) accruing from the discharge of the obligation. Since, however, respondent has elected to proceed upon a theory involving a small deficiency, we find it unnecessary to decide the point. At least to the extent of the figures stated, Melrose received a taxable consideration." Compare also *Federal St. & P. V. Ry. v. Comm'r*, 84 F. (2d) 972 (C. C. A. 3d, 1936).

99. In *Brons Hotels, Inc.*, 34 B. T. A. 376, 381 (1936) the Board said "We are not unmindful of the fact that the assumption of a mortgage is not money in a true legal sense. It is, however, part of the consideration received; it is the equivalent of money, and . . . must be treated as money for the purposes of this case."

the liability.¹⁰⁰ This position, as stated above, accords with the normal case and permits simple adjustment in the few instances where the transferee does not make full payment. Where the property is merely transferred subject to a liability, without any assumption by the transferee, the extent to which the transferor is relieved of payment depends largely on the relation of the property's value to the liability. However, as the property is generally sufficient to cover the debt, the same treatment has been applied and gain has been recognized to the amount of the liability.¹⁰¹ If the transferor is himself not personally liable, as where he has taken the property subject to the liability, his gain may not seem so clear when the transferee takes subject to the liability. But if *A* acquires for \$60 property worth \$100 but subject to a \$40 liability, his cost, and hence the basis of the property in his hands, is \$100 — just as it would be if he had assumed the liability — as it is expected that he will pay the liability so as to keep the property. By means of this credit in advance for the expected payment, it is possible to keep the basis for depreciation linked to the property's value. When *A* in turn transfers the property subject to the liability, the amount of the liability must therefore be regarded as gain to him.¹⁰² The Revenue Act of 1939 does not distinguish between the assumption of a liability and the acquisition of property subject to a liability, and no distinction should be made in a Section 112(b)(1) type of exchange.¹⁰³

It is a frequent occurrence in Section 112(b)(1) exchanges for both properties involved to be encumbered by mortgages, so that the exchange

100. Under the prior law, if the assumption were treated as "property" and valued at less than the liability's face amount, a lesser amount of gain would be recognized at the time of the exchange. The assumption as "property" would receive such value as its basis under § 113(a)(6). As the amount of gain by which the old basis must be increased and the amount by which it must be decreased (the portion allocated to the assumption) are thus equally lower, the tax-free property would have the same basis as if gain were recognized to the amount of the liability. If all went well, therefore, no gain would permanently escape tax. Under the Revenue Act of 1939 amendment to § 113(a)(6), however, the assumption must be treated as "money" to the amount of the liability and the old basis reduced by such amount. Unless the assumption also is treated as "money" for the purpose of recognition of gain, the basis of the tax-free property will be too low, for the increase in the old basis would be less than the amount by which it had been so reduced. Proper coordination between the recognition of gain provisions and the basis provisions, as amended, therefore also requires the assumption to be treated as "money" to the amount of the liability for the purpose of recognition of gain. Of course, although the assumption is treated as "money" for the recognition of gain, it is not twice deducted from the basis, once as "money" under the old wording and again as "money" under the amendment.

101. Estate of Theodore Ebert, Jr., 37 B. T. A. 186 (1938).

102. Where the transferor himself placed the obligation upon the property after its acquisition and received the money, the basis is unaffected; unless the transferee's assumption of this obligation is considered income, the transferor will have received money on which he will have paid no tax.

103. Regulations 103, § 19.113(a)(6)-2, follow this approach and treat the liability as money whether it is assumed or only taken subject to.

is made subject to the respective mortgages, or each party assumes the other's mortgage. Suppose that *A* has property with a \$20,000 basis, worth \$45,000, and subject to a \$15,000 mortgage. He exchanges his property for property of *B*, worth \$30,000 but subject to a \$10,000 mortgage, and \$10,000 cash. Each assumes the mortgage on the property he receives. The Bureau has ruled that the amount of "money" which *A* receives by reason of *B*'s assumption of the mortgage is measured by the "net reduction" in his indebtedness — here, \$15,000 minus \$10,000, or \$5,000.¹⁰⁴ *A*, under this ruling, has a realized gain of \$30,000 plus \$10,000 cash plus \$5,000 in net reduction of indebtedness, or \$45,000, less the \$20,000 basis, or \$25,000. This gain is recognized to the extent of the "other property or money"—\$10,000 plus \$5,000, or \$15,000. *A*'s basis for the new property is his old basis, \$20,000, decreased by the money received, \$15,000, increased in the amount of gain recognized, likewise \$15,000, or \$20,000. The computations would presumably be made on the same principle if there were a net increase in indebtedness.¹⁰⁵ The same rule seems to apply if *C* exchanges property worth \$30,000 for property of *D* worth \$25,000 but subject to a \$4,000 mortgage which *C* assumes, and \$9,000 cash, so that the gain which *C* realizes is recognized only to the extent of \$5,000 and not the full \$9,000 in cash.

The Board has followed this ruling in its computations, although the point has not been specifically discussed and apparently has not been considered.¹⁰⁶ The Revenue Act of 1939, however, may raise some doubts as to the ruling's validity. The treatment which it accords to the assumption of a liability departs from the concept of the transfer of an equity by the transferor, and treats the assumption in theory as valuable consideration, in the nature of cash, received by the transferor, although the assumption, for policy reasons, does not result in the recognition of gain. More specifically, the basis provision, Section 113(g)(6), states that the assumption shall be considered as money received by the transferor in the amount of the liability.¹⁰⁷ This approach arguably would fix the "money" received by *A* in the above example at \$20,000 — the \$10,000 cash plus the assumption by *B* of a \$10,000 liability of *A*. The realized gain would remain the same, \$25,000, though computed differently — \$30,000 plus \$10,000 less \$20,000 (the basis of the old property) plus \$5,000 (the additional cost to *A* by reason of his assumption

104. G. C. M. 2641, VI-2 CUM. BULL. 16 (1927).

105. Thus, as *B* had a net increase in indebtedness, no gain would be recognized to him even if his property were worth \$40,000 so that no actual cash would have had to pass.

106. *Brons Hotels, Inc.*, 34 B. T. A. 376 (1936); *Estate of Theodore Ebert, Jr.*, 37 B. T. A. 186 (1938). The point was immaterial in both cases as the net decrease in indebtedness was more than the profit on the transaction.

107. Although new subsection (k) does not extend to a § 112(b)(1) type of exchange, the amendment to § 113(a)(6) applies to such an exchange as well as to those affected by subsection (k). Regulations 103, § 19.113(a)(6)-2.

of *B*'s mortgage) — but it would be recognized to the extent of \$20,000. The basis of the new property would be higher — \$20,000 (the basis of the old property) plus \$5,000 (the basis of *A*'s assumption of liability)¹⁰⁸ less \$20,000 of "money" plus \$20,000 gain recognized, or \$25,000. This approach may be answered by the argument that if the assumptions are to be treated as "money," it is only sensible to offset them against each other to find the net amount of "money" that is received — the way the parties themselves would treat the situation if, by chance, cash were actually to pass.

The "net reduction in indebtedness" approach results in a smaller tax at the time of the exchange and a lower basis for the property received, so that if all goes well the Government will later obtain a tax on the remainder of the gain. The other view yields a greater tax at the time of the exchange and consequently a higher basis.¹⁰⁹ Perhaps the decision between the two will turn on the treatment given to Section 112(b)(1) exchanges. It is somewhat significant, and also somewhat puzzling, that, in the Revenue Act of 1939, Congress treated these exchanges differently from corporate reorganizations and Section 112(b)(5) transfers. Some may believe that there is little warrant for the difference; if the policy underlying Section 112(b)(1) is sound, there is just as much reason to fulfill that policy by postponing the tax in the case of an assumption of a liability as there is in the reorganization cases. As most corporations have liabilities which must be assumed on reorganization, most property is similarly encumbered with mortgages which, under current conditions, must be assumed upon an exchange. The reason for the diversity of treatment may perhaps be that through long experience taxpayers have been habituated to considering the assumption of a liability as "money" on a Section 112(b)(1) exchange but not on a Section 112(b)(4) or (5) transfer, so that the *Hendler* decision came as no shock to the real estate profession. Congress was certainly not urged to alter the Section 112(b)(1) rule; the demand concerned only reorganizations. The reason may lie in the added complexity which a minus basis causes in Section 112(b)(1) cases — as the transferee does not take a substituted basis, so that the gain cannot be taxed through him at a later

108. If a taxpayer exchanges property and \$10,000 cash for like property of another taxpayer, § 112(b)(1) still applies, as the word "solely" refers to what is received and not to what is given. *W. H. Hartman Co.*, 20 B. T. A. 302 (1930); *George E. Hamilton*, 30 B. T. A. 160 (1934). For the purpose of § 113(a)(6), the "property exchanged" is both the property and the cash; the amount of the cash hence must be added to the property's basis. As the assumption of a liability is considered equivalent to the exchange of money, the amount of the assumption must therefore be added to the basis of the property, as indicated in the text.

109. Whichever approach is adopted for the purposes of recognition of gain under § 112(c)(1), the same approach must be used in determining the basis under § 113(a)(6).

date, the transferor, if his basis is to be brought to zero, must be taxed at the time of the exchange on the difference between the minus figure and zero if that portion of the gain is to be taxed at all. But this problem could be solved without too much difficulty.¹¹⁰ In any event, Congress chose not to extend relief to Section 112(b)(1), so that problems concerning the assumption of a liability on exchanges under that section still remain unsettled.

110. If new subsection (k) were extended to § 112(b)(1), it would not be necessary to choose between the two approaches discussed in the text.