Rev. Rul. 80-198

ISSUE

Under the circumstances described below, do the nonrecognition of gain or loss provisions of section 351 of the Internal Revenue Code apply to a transfer of the operating assets of an ongoing sole proprietorship (including unrealized accounts receivable) to a corporation in exchange solely for the common stock of a corporation and the assumption by the corporation of the proprietorship liabilities?

FACTS

Individual A conducted a medical practice as a sole proprietorship, the income of which was reported on the cash receipts and disbursements method of accounting. A transferred to a newly organized corporation all of the operating assets of the sole proprietorship in exchange for all of the stock of the corporation, plus the assumption by the corporation of all of the liabilities of the sole proprietorship. The purpose of the incorporation was to provide a form of business organization that would be more conducive to the planned expansion of the medical services to be made available by the business enterprise.

The assets transferred were tangible assets having a fair market value of $40,000 and an adjusted basis of $30,000 and unrealized trade accounts receivable having a face amount of <Page 114> $20,000 and an adjusted basis of zero. The liabilities assumed by the corporation consisted of trade accounts payable in the face amount of $10,000. The liabilities assumed by the corporation also included a mortgage liability, related to the tangible property transferred, of $10,000. A had neither accumulated the accounts receivable nor prepaid any of the liabilities of the sole proprietorship in a manner inconsistent with normal business practices in anticipation of the incorporation. If A had paid the trade accounts payable liabilities, the amounts paid would have been deductible by A as ordinary and necessary business expenses under section 162 of the Code. The new corporation continued to utilize the cash receipts and disbursements method of accounting.

LAW AND ANALYSIS

The applicable section of the Code is section 351(a), which provides that no gain or loss shall be recognized when property is transferred to a corporation in exchange solely for stock and securities and the transferor is in control (as defined by section 368(c)) of the transferee corporation immediately after the transfer.

In Hempt Bros., Inc. v. United States,490 F.2d 1172 (3rd Cir. 1974), cert. denied, 419 U.S. 826 (1974), the United States Court of Appeals for the Third Circuit held, as the Internal Revenue Service contended, that a cash basis transferee corporation was taxable on the monies it collected on accounts receivable that had been transferred to it by a cash basis partnership in a transaction described in section 351(a) of the Code. The corporate taxpayer contended that it was not obligated to include the accounts receivable in income; rather the transferor partnership should have been taxed on the stock the partnership received under the assignment of income doctrine which is predicated on the well established general principle that income be taxed to the party that earned it.

The court in Hempt Bros. solved the conflict between the assignment of income doctrine and the statutory nonrecognition provisions of section 351 of the Code by reasoning that if the cash basis transferor were taxed on the transfer of the accounts receivable, the specific congressional intent reflected in section 351(a) that the incorporation of an ongoing business should be facilitated by making the incorporation tax free would be frustrated.

The facts of the instant case are similar to those in Hempt Bros. in that there was a valid business purpose for the transfer of the accounts receivable along with all of the assets and liabilities of A's proprietorship to a corporate transferee that would continue the business of the transferor. Further, A had neither accumulated the accounts receivable nor prepaid any of the account payable liabilities of the sole proprietorship in anticipation of the incorporation, which is an indication that, under the facts and circumstances of the case, the transaction was not designed for tax avoidance.

HOLDING

The transfer by A of the operating assets of the sole proprietorship (including unrealized accounts receivable) to the corporation in exchange solely for the common stock of the corporation and the assumption by the corporation of the proprietorship liabilities (including accounts payable) is an exchange within the meaning of section 351(a) of the Code. Therefore, no gain or loss is recognized to A with respect to the property transferred, including the accounts receivable. For transfers occurring on or after November 6, 1978 (the effective date of the Revenue Act of 1978, Pub. L. 95-600, 1978-3 C.B. (Vol. 1) 1, 88, with respect to sections 357(c)(3) and 358(d)(2) of the Code) the assumption of the trade accounts payable that would give rise to a deduction if A had paid them is not, pursuant to section 357(c)(3), considered as an assumption of a liability for purposes of sections 357(c)(1) and 358(d). See Rev. Rul. 80-199, this page, this Bulletin, for transfers occurring before November 6, 1978, which holds that trade accounts payable transferred to a corporation in a transaction to which section 351(a) applies are not liabilities for the purposes of sections 357(c) and 358(d) if the transferor of the accounts payable could have deducted the amounts paid in satisfaction thereof under section 162 if the transferor had paid these amounts in satisfaction of the payables prior to the exchange. The corporation, under the cash receipts and disbursements method of accounting, will report in its income the account receivables as collected, and will be allowed deductions under section 162 for the payments it makes to satisfy the assumed trade accounts payable when such payments are made.

A's basis in the stock received in the exchange of property for stock under section 358(a)(1) of the Code is $20,000 which is calculated by decreasing A's $30,000 basis in the assets transferred by the $10,000 mortgage liability under sections 358(a)(1)(A)(ii) and 358(d)(1). No adjustment to such basis is made under section 358(a)(1)(A)(ii) because of the assumption by the corporation of the $10,000 in accounts payable inasmuch as the general rule of section 358(d)(1), which requires the basis in the stock received to be decreased by the liabilities assumed, does not apply by reason of section 358(d)(2), which provides that section 358(d)(1) does not apply to the amount of any liabilities defined in section 357(c)(3) such as accounts payable that would have been deductible by A as ordinary and necessary business expenses under section 162 in the taxable year paid if A had paid these liabilities prior to the exchange. See Rev. Rul. 80-199, with respect to transfers which have occurred before November 6, 1978 (the <Page 115> date of the enactment of the Revenue Act of 1978).

LIMITATIONS

Section 351 of the Code does not apply to a transfer of accounts receivable which constitute an assignment of an income right in a case such as Brown v. Commissioner,40 B.T.A. 565 (1939), aff'd 115 F.2d 337 (2d Cir. 1940). In Brown, an attorney transferred to a corporation, in which he was the sole owner, a one-half interest in a claim for legal services performed by the attorney and his law partner. In exchange, the attorney received additional stock of the corporation. The claim represented the corporation's only asset. Subsequent to the receipt by the corporation of the proceeds of the claim, the attorney gave all of the stock of the corporation to his wife. The United States Court of Appeals for the Second Circuit found that the transfer of the claim for the fee to the corporation had no purpose other than to avoid taxes and held that in such a case the intervention of the corporation would not prevent the attorney from being liable for the tax on the income which resulted from services under the assignment of income rule of Lucas v. Earl,281 U.S. 111 (1930). Accordingly, in a case of a transfer to a controlled corporation of an account receivable in respect of services rendered where there is a tax avoidance purpose for the transaction (which might be evidenced by the corporation not conducting an ongoing business), the Internal Revenue Service will continue to apply assignment of income principles and require that the transferor of such a receivable include it in income when received by the transferee corporation.

Likewise, it may be appropriate in certain situations to allocate income, deductions, credits, or allowances to the transferor or transferee under section 482 of the Code when the timing of the incorporation improperly separates income from related expenses. See Rooney v. United States,305 F.2d 681 (9th Cir. 1962), where a farming operation was incorporated in a transaction described in section 351(a) after the expenses of the crop had been incurred but before the crop had been sold and income realized. The transferor's tax return contained all of the expenses but none of the farming income to which the expenses related. The United States Court of Appeals for the Ninth Circuit held that the expenses could be allocated under section 482 to the corporation, to be matched with the income to which the expenses related. Similar adjustments may be appropriate where some assets, liabilities, or both, are retained by the transferor and such retention results in the income of the transferor, transferee, or both, not being clearly reflected.