We must unscramble a Rubik’s Cube of corporate tax law to determine the basis of a note contributed by a taxpayer to his wholly-owned corporation.

The Transaction

The taxpayer, Donald Peracchi, needed to contribute additional capital to his closely-held corporation (NAC) to comply with Nevada's minimum premium-to-asset ratio for insurance companies. Peracchi contributed two parcels of real estate. The parcels were encumbered with liabilities which together exceeded Peracchi's total basis in the properties by more than half a million dollars. As we discuss in detail below, under section 357(c), contributing property with liabilities in excess of basis can trigger immediate recognition of gain in the amount of the excess. In an effort to avoid this, Peracchi also executed a promissory note, promising to pay NAC $1,060,000 over a term of ten years at 11% interest.

The parties are not splitting hairs: Peracchi claims the basis of the note is $1,060,000, its face value, while the IRS argues that the note has a basis of zero. If Peracchi is right, he pays no immediate tax on the half a million dollars by which the debts on the land he contributed exceed his basis in the land; if the IRS is right, the note becomes irrelevant for tax purposes and Peracchi must recognize an immediate gain on the half million.

Gain Deferral: Section 358(a)

Peracchi contributed capital to NAC in the form of real property and a promissory note. Corporations may be funded with any kind of asset, such as equipment, real estate, intellectual property, contracts, leaseholds, securities or letters of credit. The tax consequences can get a little complicated because a shareholder’s basis in the property contributed often differs from its fair market value. The general rule is that an asset's basis is equal to its "cost." See I.R.C. § 1012. But when a shareholder like Peracchi contributes property to a corporation in a nonrecognition transaction, a cost basis does not preserve the unrecognized gain. Rather than take a basis equal to the fair market value of the property exchanged, the shareholder must substitute the basis of that property for what would otherwise be the cost basis of the stock. This preserves the gain for recognition at a later day: The gain is built into the shareholder's new basis in the stock, and he will recognize income when he disposes of the stock.

The fact that gain is deferred rather than extinguished doesn't diminish the importance of questions relating to basis and the timing of recognition. In tax, as in comedy, timing matters. Most taxpayers would much prefer to pay tax on contributed property years later - when they sell their stock - rather than when they contribute the property. Thus what Peracchi is seeking here is gain deferral: He wants the gain to be recognized only when he disposes of some or all of his stock.

Continuity of Investment: Boot and section 351(b)

Continuity of investment is the cornerstone of nonrecognition under section 351. Nonrecognition assumes that a capital contribution amounts to nothing more than a nominal change in the form of ownership; in substance the shareholder's investment in the property continues. To the extent a section 351 transaction resembles an ordinary sale, the nonrecognition rationale falls apart.
Thus the central exception to nonrecognition for section 351 transactions comes into play when the taxpayer receives "boot" - money or property other than stock in the corporation - in exchange for the property contributed. See I.R.C. § 351(b). 

Boot is recognized as taxable income because it represents a partial cashing out. It’s as if the taxpayer contributed part of the property to the corporation in exchange for stock, and sold part of the property for cash. Only the part exchanged for stock represents a continuation of investment; the part sold for cash is properly recognized as yielding income, just as if the taxpayer had sold the property to a third party.

Peracchi did not receive boot in return for the property he contributed. But that doesn't end the inquiry: We must consider whether Peracchi has cashed out in some other way which would warrant treating part of the transaction as taxable boot.

**Assumption of Liabilities: Section 357(a)**

The property Peracchi contributed to NAC was encumbered by liabilities. Contribution of leveraged property makes things trickier from a tax perspective. When a shareholder contributes property encumbered by debt, the corporation usually assumes the debt. And the Code normally treats discharging a liability the same as receiving money: The taxpayer improves his economic position by the same amount either way. **** NAC’s assumption of the liabilities attached to Peracchi’s property therefore could theoretically be viewed as the receipt of money, which would be taxable boot. ****

The Code takes a different tack. Requiring shareholders like Peracchi to recognize gain any time a corporation assumes a liability in connection with a capital contribution would greatly diminish the nonrecognition benefit section 351 is meant to confer. Section 357(a) thus takes a lenient view of the assumption of liability: A shareholder engaging in a section 351 transaction does not have to treat the assumption of liability as boot, even if the corporation assumes his obligation to pay. See I.R.C. § 357(a).

This nonrecognition does not mean that the potential gain disappears. Once again, the basis provisions kick in to reflect the transfer of gain from the shareholder to the corporation: The shareholder’s substitute basis in the stock received is decreased by the amount of the liability assumed by the corporation. See I.R.C. § 358(d), (a). The adjustment preserves the gain for recognition when the shareholder sells his stock in the company, since his taxable gain will be the difference between the (new lower) basis and the sale price of the stock.

**Sasquatch and The Negative Basis Problem:** Section 357(c)

Highly leveraged property presents a peculiar problem in the section 351 context. Suppose a shareholder organizes a corporation and contributes as its only asset a building with a basis of $50, a fair market value of $100, and mortgage debt of $90. Section 351 says that the shareholder does not recognize any gain on the transaction. Under section 358, the shareholder takes a substitute basis of $50 in the stock, then adjusts it downward under section 357 by $90 to reflect the assumption of liability. This leaves him with a basis of minus $40. A negative basis properly preserves the gain built into the property: If the shareholder turns around and sells the stock the next day for $10 (the difference between the fair market value and the debt), he would face $50 in gain, the same amount as if he sold the property without first encasing it in a corporate shell.

But skeptics say that negative basis, like Bigfoot, doesn't exist. **** Basis normally operates as a cost recovery system: Depreciation deductions reduce basis, and when basis hits zero, the property cannot be depreciated farther. At a more basic level, it seems incongruous to attribute a negative value to a figure that normally represents one's investment in an asset. Some commentators nevertheless argue that when basis operates merely to measure potential gain (as it does here), allowing negative basis may be perfectly appropriate and consistent with the tax policy underlying nonrecognition transactions. **** Whatever the merits of this debate, it seems that section 357(c) was enacted to eliminate the possibility of negative basis. ****

Section 357(c) prevents negative basis by forcing a shareholder to recognize gain to the extent liabilities exceed basis. Thus, if a shareholder contributes a building with a basis of $50 and liabilities of $90, he does not receive stock with a basis of minus $40. Instead, he takes a basis of zero and must recognize a $40 gain.

Peracchi sought to contribute two parcels of real property to NAC in a section 351 transaction. Standing alone the contribution would have run
afoul of section 357(c): The property he wanted to contribute had liabilities in excess of basis, and Perachhi would have had to recognize gain to the extent of the excess, or $566,807:

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Basis</th>
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<tbody>
<tr>
<td>Property #1</td>
<td>1,386,655</td>
</tr>
<tr>
<td>Property #2</td>
<td>161,558</td>
</tr>
<tr>
<td></td>
<td>1,548,213</td>
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</tbody>
</table>

Excess 357(c) 566,807

The Grift: Boosting Basis with a Promissory Note

Peracchi tried to dig himself out of this tax hole by contributing a personal note with a face amount of $1,060,000 along with the real property. Peracchi maintains that the note has a basis in his hands equal to its face value. If he’s right, we must add the basis of the note to the basis of the real property. Taken together, the aggregate basis in the property contributed would exceed the aggregate liabilities:

<table>
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<tr>
<td>Property #2</td>
<td>161,558</td>
</tr>
<tr>
<td>Note</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>1,548,213</td>
</tr>
</tbody>
</table>

Under Peracchi’s theory, then, the aggregate liabilities no longer exceed the aggregate basis, and section 357(c) no longer triggers any gain. The government argues, however, that the note has a zero basis. If so, the note would not affect the tax consequences of the transaction, and Peracchi’s $566,807 in gain would be taxable immediately.

Are Promises Truly Free?

Which brings us (phew!) to the issue before us: Does Peracchi’s note have a basis in Peracchi’s hands for purposes of section 357(c)? The language of the Code gives us little to work with. The logical place to start is with the definition of basis. Section 1012 provides that “the basis of property shall be the cost of such property . . . .” But “cost” is nowhere defined. What does it cost Peracchi to write the note and contribute it to his corporation? The IRS argues tersely that the “taxpayers in the instant case incurred no cost in issuing their own note to NAC, so their basis in the note was zero.” Building on this premise, the IRS makes Peracchi out to be a grifter: He holds an unenforceable promise to pay himself money, since the corporation will not collect on it unless he says so.

It’s true that all Peracchi did was make out a promise to pay on a piece of paper, mark it in the corporate minutes and enter it on the corporate books. It is also true that nothing will cause the corporation to enforce the note against Peracchi so long as Peracchi remains in control. But the IRS ignores the possibility that NAC may go bankrupt, an event that would suddenly make the note highly significant. Peracchi and NAC are separated by the corporate form, and this gossamer curtain makes a difference in the shell game of C Corp organization and reorganization. Contributing the note puts a million dollar nut within the corporate shell, exposing Peracchi to the cruel nutcracker of corporate creditors in the event NAC goes bankrupt. And it does so to the tune of $1,060,000, the full face amount of the note. Without the note, no matter how deeply the corporation went into debt, creditors could not reach Peracchi’s personal assets. With the note on the books, however, creditors can reach into Peracchi’s pocket by enforcing the note as an unliquidated asset of the corporation.

The key to solving this puzzle, then, is to ask whether bankruptcy is significant enough a contingency to confer substantial economic effect on this transaction. If the risk of bankruptcy is important enough to be recognized, Peracchi should get basis in the note: He will have increased his exposure to the risks of the business - and thus his economic investment in NAC - by $1,060,000. If bankruptcy is so remote that there is no realistic possibility it will ever occur, we can ignore the potential economic effect of the note as speculative and treat it as merely an unenforceable promise to contribute capital in the future.

When the question is posed this way, the answer is clear. Peracchi’s obligation on the note was not conditioned on NAC’s remaining solvent. It represents a new and substantial increase in Peracchi’s investment in the corporation. The Code seems to recognize that economic exposure of the shareholder is the ultimate measuring rod of a shareholder’s in-
vestment. **** Peracchi therefore is entitled to a step-up in basis to the extent he will be subjected to economic loss if the underlying investment turns unprofitable. ****

The economics of the transaction also support Peracchi’s view of the matter. The transaction here does not differ substantively from others that would certainly give Peracchi a boost in basis. For example, Peracchi could have borrowed $1 million from a bank and contributed that to NAC along with the properties. Because cash has a basis equal to face value, Peracchi would not have faced any section 357(c) gain. NAC could then have purchased the note from the bank for $1 million which, assuming the bank’s original assessment of Peracchi’s creditworthiness was accurate, would be the fair market value of the note. In the end the corporation would hold a million dollar note from Peracchi - just like it does now - and Peracchi would face no section 357(c) gain. The only economic difference between the transaction just described and the transaction Peracchi actually engaged in is the additional costs that would accompany getting a loan from the bank. Peracchi incurs a "cost" of $1 million when he promises to pay the note to the bank; the cost is not diminished here by the fact that the transferee controls the initial transferee. The experts seem to agree: "Section 357(c) can be avoided by a transfer of enough cash to eliminate any excess of liabilities over basis; and since a note given by a solvent obligor in purchasing property is routinely treated as the equivalent of cash in determining the basis of the property, it seems reasonable to give it the same treatment in determining the basis of the property transferred in a § 351 exchange." Bittker & Eustice Par. 3.06[4][b].

We find further support for Peracchi’s view by looking at the alternative: What would happen if the note has a zero basis for Peracchi, so too for NAC. See I.R.C. § 362(a). But what happens if NAC - perhaps facing the threat of an involuntary petition for bankruptcy - turns around and sells Peracchi’s note to a third party for its fair market value? According to the IRS’s theory, NAC would take a carryover basis of zero in the note and would have to recognize $1,060,000 in phantom gain on the subsequent exchange, even though the note did not appreciate in value one bit. That can’t be the right result.

Accordingly, we hold that Peracchi has a basis of $1,060,000 in the note he wrote to NAC. The aggregate basis exceeds the liabilities of the properties transferred to NAC under section 351, and Peracchi need not recognize any section 357(c) gain.

**Genuine Indebtedness or Sham?**

The Tax Court never reached the issue of Peracchi’s basis in the note. Instead, it ruled for the Commissioner on the ground that the note is not genuine indebtedness. The court emphasized two facts which it believed supported the view that the note is a sham: (1) NAC’s decision whether to collect on the note is wholly controlled by Peracchi and (2) Peracchi missed the first two years of payments, yet NAC did not accelerate the debt. These facts certainly do suggest that Peracchi paid imperfect attention to his obligations under the note, as frequently happens when debtor and creditor are under common control. But we believe the proper way to approach the genuine indebtedness question is to look at the face of the note and consider whether Peracchi’s legal obligation is illusory. And it is not. First, the note’s bona fides are adequate: The IRS has stipulated that Peracchi is creditworthy and likely to have the funds to pay the note; the note bears a market rate of interest commensurate with his creditworthiness; and the note has a fixed term. Second, the IRS does not argue that the value of the note is anything other than its face value; nothing in the record suggests NAC couldn’t borrow against the note to raise cash. Lastly, the note is fully transferable and enforceable by third parties, such as hostile creditors. On the basis of these facts we hold that the note is an ordinary, negotiable, recourse obligation which must be treated as genuine debt for tax
purposes. See Sacks v. Commissioner, 69 F.3d 982, 989 (9th Cir. 1995).

The IRS argues that the note is nevertheless a sham because it was executed simply to avoid tax. Tax avoidance is a valid concern in this context; section 357(a) does provide the opportunity for a bailout transaction of sorts. For example, a taxpayer with an unencumbered building he wants to sell could take out a nonrecourse mortgage, pocket the proceeds, and contribute the property to a newly organized corporation. Although the gain would be preserved for later recognition, the taxpayer would have partially cashed out his economic investment in the property: By taking out a nonrecourse mortgage, the economic risk of loss would be transferred to the lender. Section 357(b) addresses this sort of bailout by requiring the recognition of gain if the transaction lacks a business purpose.

**Conclusion**

We hold that Peracchi has a basis of $1,060,000 in the note, its face value. As such, the aggregate liabilities of the property contributed to NAC do not exceed its basis, and Peracchi does not recognize any section 357(c) gain.

The decision of the Tax Court is **REVERSED**.

The case is remanded for entry of judgment in favor of Peracchi.