Erlich v. Commissioner, 53 T. C. 63 (1969)

In a Section 351 transfer, a transferor does not have to include the bad debt reserve as income when the value of securities received equals the net worth of the transferred accounts receivable.

Summary

Erlich, operating a poultry business as a sole proprietorship, transferred his business assets, including accounts receivable with a bad debt reserve, to a newly formed corporation under Section 351. The IRS sought to include the bad debt reserve as taxable income. The Tax Court, following the U. S. Supreme Court's decision in Nash v. United States, held that because Erlich received securities equal in value to the net worth of the accounts transferred, the bad debt reserve should not be included in his income. This ruling underscores the principle that no income should be recognized from a bad debt reserve in such transfers where the securities received are limited to the net value of the receivables.

Facts

Israel J. Erlich operated a poultry business as a sole proprietorship known as I. J. Erlich Co. He used the reserve method for accounting bad debts. On May 31, 1965, Erlich transferred all business assets, including accounts receivable with a reserve for bad debts, to a newly formed corporation, I. J. Erlich Co. , Inc. , in exchange for stock. This transfer qualified under Section 351 of the Internal Revenue Code. The IRS issued a deficiency notice for 1965, including the bad debt reserve in Erlich's income.

Procedural History

Erlich contested the IRS deficiency notice. The case was heard by the U. S. Tax Court, which ruled in favor of Erlich, citing the precedent set by the U. S. Supreme Court in Nash v. United States.

Issue(s)

1. Whether a sole proprietorship using the reserve method for bad debts must restore the reserve to income when it transfers its accounts receivable to a corporation in a Section 351 transfer.

Holding

1. No, because the transferor received securities equal in value to the net worth of the accounts transferred, and thus, the bad debt reserve should not be included in income, as per the precedent established in Nash v. United States.

Court's Reasoning

The Tax Court relied heavily on the U. S. Supreme Court's decision in Nash v. United States, which stated that if the securities received by the transferor in a Section 351 transfer are limited to the net worth of the accounts receivable (face value less the bad debt reserve), then the transferor does not have to add the unused amounts in the bad debt reserve to income. The court quoted Nash, emphasizing that "All that petitioners received from the corporations were securities equal in value to the net worth of the accounts transferred, that is the face value less the amount of the reserve for bad debts. " The court found the facts in Erlich's case indistinguishable from Nash and thus applied the same reasoning.

Practical Implications

This decision clarifies the treatment of bad debt reserves in Section 351 transfers, ensuring that transferors do not face unexpected tax liabilities. Legal practitioners should advise clients that when transferring accounts receivable to a corporation in a Section 351 exchange, and receiving securities equal to the net value of the receivables, the bad debt reserve should not be included as income. This ruling impacts how businesses structure such transfers and may influence corporate tax planning strategies. Subsequent cases have followed this precedent, reinforcing its application in similar situations.

