Thatcher v. Commissioner, 61 T. C. 28, 1973 U. S. Tax Ct. LEXIS 42, 61 T. C. No. 4 (1973)

When liabilities assumed in a Section 351 exchange exceed the basis of the transferred assets, the excess is treated as taxable gain.

Summary

Thatcher v. Commissioner addresses the tax implications of a partnership transferring its assets and liabilities to a newly formed corporation under Section 351 of the Internal Revenue Code. The partnership, operating on a cash basis, included accounts receivable and payable in the transfer. The court held that the excess of liabilities assumed over the basis of the transferred assets was taxable under Section 357(c). This case clarifies the treatment of accounts receivable and payable in such transactions and the determination of the basis of stock received in the exchange. Additionally, the court upheld the IRS's determination of reasonable compensation for a corporate employee.

Facts

Wilford E. Thatcher and Karl D. Teeples operated a general contracting business as a partnership. In January 1963, they incorporated their business, transferring all assets and liabilities of the contracting business to Teeples & Thatcher Contractors, Inc. in exchange for all the corporation's stock. The partnership used the cash receipts and disbursements method of accounting. The transferred assets included cash, loans receivable, fixed assets, and unrealized receivables amounting to $317,146. 96, while liabilities included notes, mortgages payable, and accounts payable amounting to $164,065. 54. After the transfer, the corporation continued the business, paying off the accounts payable and collecting the receivables.

Procedural History

The IRS determined deficiencies in the petitioners' federal income taxes for the years 1963 and 1964, asserting that the excess of liabilities over the basis of the transferred assets was taxable. The case was heard before the United States Tax Court, which consolidated the cases of the individual partners and the corporation.

Issue(s)

1. Whether the liabilities transferred to the corporation exceeded the basis of the assets acquired by the corporation, making Section 357(c) applicable?
2. What is the basis of the stock acquired by the transferor in the exchange?
3. Whether the IRS properly disallowed deductions to the corporation for salary payments made to Karl D. Teeples?

Holding

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1. Yes, because the liabilities assumed by the corporation, including accounts payable, exceeded the total adjusted basis of the transferred assets, resulting in taxable gain under Section 357(c).
2. The basis of the stock acquired by the transferor is zero, as calculated by adjusting the partnership's basis in the transferred assets by the gain recognized and the liabilities assumed.
3. Yes, because the payments made to Teeples were not for services actually rendered and thus were not reasonable compensation deductible under Section 162(a)(1).

Court's Reasoning

The court applied Section 357(c), which treats the excess of liabilities over the basis of transferred assets as taxable gain. The court rejected the petitioners' arguments that accounts receivable should have a basis equal to the accounts payable or that accounts payable should not be considered liabilities under Section 357(c). The court found that the accounts receivable had a zero basis since they had not been included in income under the partnership's cash method of accounting. The court also determined that the accounts payable were liabilities under Section 357(c), despite arguments to the contrary based on the Bongiovanni case. The court emphasized the mechanical application of Section 357(c) and its purpose to prevent tax avoidance. Regarding the salary payments to Teeples, the court found that the payments made during his absence were not for services rendered and thus not deductible as reasonable compensation.

Practical Implications

This decision impacts how cash basis taxpayers must account for liabilities and receivables in Section 351 incorporations. It requires careful consideration of the tax consequences of transferring liabilities that exceed the basis of transferred assets. The ruling may influence business planning for incorporations, particularly in ensuring that the basis of assets transferred matches or exceeds liabilities assumed to avoid unexpected tax liabilities. The case also serves as a reminder of the IRS's scrutiny over compensation arrangements and the importance of linking payments to actual services rendered. Subsequent cases, such as Bongiovanni, have debated the interpretation of "liabilities" under Section 357(c), but Thatcher remains a significant precedent in the application of this section to cash basis taxpayers.

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