Rosen v. Commissioner, 62 T. C. 11 (1974)

A transferor realizes gain under section 357(c) when the liabilities assumed by a transferee corporation exceed the adjusted basis of the transferred assets, even if the transferor remains personally liable.

Summary

David Rosen transferred his insolvent cinebox business to Filmotheque, a corporation he fully owned, on July 1, 1967. The liabilities assumed by Filmotheque exceeded the adjusted basis of the assets transferred by $147,315. 25. The Tax Court held that Rosen realized a taxable gain under section 357(c) due to this excess, classifying it as ordinary income under section 1245. This ruling negated any net operating loss for 1967, disallowing a carryback to 1965. The decision underscores the application of section 357(c) even when the transferor retains personal liability for the transferred debts.

Facts

David Rosen operated a cinebox business as a sole proprietorship, incurring significant losses and liabilities. On July 1, 1967, he transferred all assets and liabilities of the business to Filmotheque, a newly activated corporation he wholly owned. At the time of transfer, the liabilities exceeded the assets, leaving Filmotheque insolvent. Rosen remained personally liable for the transferred liabilities. The transfer was intended to facilitate obtaining outside financing, but such efforts failed, and Rosen had to personally manage the business's debts.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Rosen for the taxable years 1965 and 1967, asserting that the transfer to Filmotheque resulted in a taxable gain under section 357(c). Rosen petitioned the U. S. Tax Court, arguing that the transfer was illusory and should be disregarded. The Tax Court upheld the Commissioner's determination of gain under section 357(c) and classified it as ordinary income under section 1245, denying Rosen's claim for a net operating loss carryback.

Issue(s)

1. Whether Rosen realized a taxable gain under section 357(c) when the liabilities assumed by Filmotheque exceeded the adjusted basis of the assets transferred, despite Rosen remaining personally liable for those liabilities?
2. Whether the gain realized under section 357(c) should be classified as ordinary income under section 1245?
3. Whether the realized gain negates the net operating loss for 1967, disallowing a carryback to the taxable year 1965?

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Holding

1. Yes, because section 357(c) applies when liabilities assumed exceed the adjusted basis of transferred assets, regardless of whether the transferor remains personally liable.
2. Yes, because the gain is allocable to the cinebox inventory, which is section 1245 property, and the recomputed basis exceeds the adjusted basis.
3. Yes, because the ordinary income realized under section 357(c) negates the net operating loss for 1967, thereby disallowing any carryback to 1965.

Court's Reasoning

The Tax Court applied section 357(c) to Rosen's transfer, finding that the liabilities assumed by Filmotheque exceeded the adjusted basis of the transferred assets by $147,315. 25. The court rejected Rosen's argument that the transfer was illusory, noting that Filmotheque was treated as a viable corporation for tax purposes. The court further reasoned that section 357(c) applies even if the transferor remains personally liable for the debts, as the statute does not require release from liability. The gain was allocated to the cinebox inventory, classified as section 1245 property, and treated as ordinary income because the recomputed basis exceeded the adjusted basis. The court upheld the Commissioner's determination, citing the legislative intent of section 357(c) to address situations where depreciation deductions are taken on assets purchased with borrowed funds, which are then repaid by the transferee corporation.

Practical Implications

This decision clarifies that section 357(c) applies to transfers where liabilities exceed the basis of transferred assets, even if the transferor remains personally liable. Practitioners must consider this when advising clients on transferring business assets to a corporation, especially in cases of insolvency or high debt. The ruling emphasizes the importance of accurately calculating the adjusted basis of assets transferred and the potential tax consequences of such transactions. It also highlights the need to assess the character of any gain realized under section 357(c), particularly when dealing with depreciable property under section 1245. Future cases involving similar transfers should be analyzed with this precedent in mind, considering both the tax implications and the potential for ordinary income classification.

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