TAX IMPACT OF A TRANSFER OF A BAD DEBT RESERVE TO A CONTROLLED CORPORATION: AN ANALYSIS OF *SCHUSTER* v. *COMMISSIONER*

Max Schuster operated a wholesale business in semi-precious stones in the form of a sole proprietorship. He employed the accrual method of accounting for items of income and expense, and utilized the reserve method of accounting for bad debts for federal income tax purposes.[1] On October 31, 1961, Schuster transferred the assets of his business, including its accounts receivable, to a corporation in a transaction which qualified as a tax-free exchange under section 351 of the Internal Revenue Code of 1954.[2] The Commissioner of Internal Revenue disallowed a deduction of $7,432.04 claimed as an addition to the proprietorship's bad debt reserve in 1961, and restored the $4,052.29 balance which remained in the bad debt reserve to gross income.[3] In a decision reviewed by the court, with two

1. INT. REV. CODE of 1954 § 166(c) permits a deduction for a reasonable addition to a reserve for bad debts.

2. INT. REV. CODE of 1954, § 351, the "nonrecognition" provision relating to such transactions, in pertinent part, states as follows:

> (a) *General Rule*—No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely in exchange for stocks or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation.

3. The Commissioner increased the petitioner's taxable income for 1961 by $11,484.33, a figure which coincides with the balance in the proprietorship's reserve for bad debts on October 31, 1961, when the assets were transferred to the corporation. 50 T.C. 98, 99. The entries to the bad debt reserve account in 1961 are reflected in the following computation:

Balance at 1/1/61, per books	$12,237.51
Add: Bad Debt Recoveries in 1961	66.86
	$12,304.37
Less: Worthless accounts written off at 10/31/61	6,984.15
	$ 5,320.22
Add: Addition to Reserve at 10/31/61	7,432.04
Balance per books at 10/31/61	$12,752.26
Less: Disallowance of addition to reserve, per Revenue Agent's Report for 1960	1,267.93
Balance at 10/31/61, as adjusted	$11,484.33

dissenting opinions,[4] the Tax Court held for the Commissioner: Proper accounting principles require the restoration of a reserve for bad debts to income when events render the reserve no longer necessary. *Schuster v. Commissioner*, 50 T.C. 98 (1968).

A provision of the Internal Revenue Code dealing with the nontaxable transfer of property to a controlled corporation has been part of the statutory scheme since 1921.[5] The current provision, section 351, "contemplate[s] as a general principle that unrecognized gain or loss will be taken into account by the transferee corporation when it disposes of the property received."[6] This approach reflects the congressional policy of facilitating business readjustments.[7]

In order to avoid gain or loss recognition in a section 351 transfer:[8]

> (1) One or more persons must transfer "property"[9] to a corporation; (2) the transfer must be "solely in exchange for stock or securities in such corporation;"[10] (3) the transferor(s)

---

4. *Id.* at 98. One of the dissents relies upon the arguments expressed in Estate of Schmidt v. Commissioner, 355 F.2d 111 (9th Cir. 1966) *rev'g* Estate of Schmidt v. Commissioner, 42 T.C. 1130 (1964).

5. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 3.01, at 65 (2d ed. 1966). There was no statutory provision for nonrecognition prior to the Revenue Act of 1921. Riebesehl, *Tax-Free Incorporation under Section 351*, 46 TAXES 360 (1968).

6. B. BITTKER & J. EUSTICE, *supra* note 5, § 3.17, at 112.

7. *Id.* § 3.01, at 65.

8. *Id.* § 3.02, at 69.

9. There is no statutory definition of this term, *but see* Borini, *Problems Upon Incorporation of the Family Business*, N.Y.U. 25TH INST. ON FED. TAX, 229, 232 (1967):

> [I]ntangible property will qualify for a nontaxable transfer to the corporation. The term "property" includes tangibles such as real estate and machinery and intangibles such as cash, and patent rights.

B. BITTKER & J. EUSTICE, *supra* note 5, § 3.02, at 69 do not consider the absence of a definition of "property" as used in section 351 to be "troublesome."

10. The problems involved in qualifying "stock or securities" under section 351 are discussed in Riebesehl, *supra* note 5, at 363. *See* INT. REV. CODE of 1954 § 351(b) which provides for gain recognition up to the amount of the non-qualifying property ("boot") received:

> Receipt of Property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—
>
> (1) gain (if any) to such recipient shall be recognized, but not in excess of—
>
> (A) the amount of money received, plus
>
> (B) the fair market value of such other property received; and
>
> (2) no loss to such recipient shall be recognized.

must be "in control"[11] of the corporation "immediately after the exchange."[12]

Since Max Schuster's transfer qualified under this provision, he generally would not have recognized a gain or loss on the exchange, the transferee corporation would assume the transferor's basis for the property received,[13] and the transferor's basis for the stock or securities received would be the same as his basis for the property transferred.[14] Although the court in *Schuster* determined that the transfer of assets met the requirements of section 351, the court concluded that to the extent the transferor realized a *tax benefit* by previously taking a deduction for anticipated bad debt losses which he will never, as a *proprietorship*, sustain, he must now restore that amount to gross income.[15]

Before discussing the "recapture" of previously taken deductions (i.e., treating part or all of the gain or benefit derived therefrom as ordinary income), an examination of selected tax accounting concepts is desirable.

It is important to note that Max Schuster was an "accrual-basis" taxpayer. The theory underlying the accrual method of accounting is that items of income and expense should be recognized in the accounting period during which the income is earned and the expense incurred.[16]

Thus, the accrual technique requires that items of income be reported in the period in which the right to the receipt occurs, and that the deductions be reflected in the period in which the obligation to the creditor arises.[17] Generally the receipt and payment is irrelevant in the determination of net income for a particular period.[18]

---

11. INT. REV. CODE of 1954, § 368(c):

"[C]ontrol" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

12. *See* Rev. Rul. 54-96, 1954-1 CUM. BULL. 111, which holds that an exchange will not qualify under section 351 if, after the exchange, as part of a "prearranged integrated plan," the transferors lose control of the corporation.

13. INT. REV. CODE of 1954, § 362(a).

14. INT. REV. CODE of 1954, § 358(a).

15. 50 T.C. at 102.

16. *See* J. CHOMMIE, THE LAW OF FEDERAL INCOME TAXATION § 74, at 166 (1968).

17. *Id.*

18. *Id.*

A concept attendant to the accrual method is the recognition of losses from accounts receivable. "Receivables" are claims which will be settled sometime in the future by the receipt of money.[19] Since some of the accounts receivable invariably prove uncollectible, it is desirable to anticipate the difference between total receivables and estimated collectible receivables by use of a separate account, alternately referred to as an "Allowance for Bad Debts,"[20] "Estimate of Uncollectible Accounts," or "Reserve for Bad Debts."[21] A reduction in owner's equity is recognized by debiting a bad debt expense account and a reduction in assets is recognized by crediting the Allowance for Bad Debts Account, an "asset offset" account.[22] Thus, the loss relates to the period of sale, and the asset arising from that sale is stated at its estimated realizable amount because the Allowance for Bad Debts Account is reported on the balance sheet as a subtraction from accounts receivable.[23] Subsequently, when a particular account is identified as worthless, a charge is made to the allowance account and the receivable account is credited.[24] Total assets are unchanged and expenses are unaffected since an asset account is reduced (credited) and an asset offset account is reduced (debited). If the method of anticipation of loss from uncollectible receivables is reasonable and consistent, it is acceptable for income tax purposes.[25]

The justification for the restoration of Schuster's bad debt reserve to income involves an application of the tax benefit rule.[26] Under this concept, income which is attributable to the recovery of bad debts previously deducted "is specifically excluded from taxable income by the Code to the extent that the original deduction . . . did not reduce income tax for any taxable year."[27] Conversely, the regulations require the "recapture" of

19. *See* W. KARRENBROCK & H. SIMMONS, INTERMEDIATE ACCOUNTING 137 (2d ed. 1954).

20. *Id.* at 141.

21. *See* Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporation.* 40 TAXES 995, 998, n.16 (1962).

22. W. KARRENBROCK & H. SIMMONS *supra* note 19, at 141.

23. *Id.* at 153-54.

24. *Id.* at 144-45.

25. INT. REV. CODE of 1954, § 166(c) allows a deduction for a reasonable addition to a reserve for bad debts.

26. INT. REV. CODE of 1954, § 111; Treas. Reg. § 1.111-1 (1956).

27. MONTGOMERY'S FEDERAL TAXES 1.35 (39th ed. 1964).

all items previously deducted to the extent a tax benefit is realized.[28] An application of this principle is expressed in Revenue Ruling 62-128 where the Commissioner ruled that a sole proprietor transferring his business under section 351 was required to restore his bad debt reserve to ordinary income, to the extent that additions to the reserve had been deducted in prior years with a tax benefit.[29]

The fairness and logic of restoring the bad debt reserve to income obviously depends upon the type of transaction involved. Since an account receivable may be considered "property,"[30] it is questionable whether the tax benefit principle is equitably applied when assets are transferred to a new corporation and there is no interruption in business activity and the transferor's ownership interest continues. If there is no economic recovery of income attributable to bad debts, the justification for restoring the reserve to income is no longer apparent.

Although the taxability of an accrual basis taxpayer is the primary concern of this note, similar issues arise when the taxpayer reflects his income by the cash receipts and disbursements method,[31] also an acceptable accounting practice for income tax purposes.[32] Under this procedure, most items of

---

28. Treas. Reg. § 1.111-1 (1956).

29. Rev. Rul. 62-128, 1962-2 CUM. BULL. 139, provides as follows:

> A taxpayer, engaged in a business as a sole proprietor, transferred all of the assets of his business, subject to its liabilities, to a corporation controlled by the transferor in a nontaxable exchange under the provisions of section 351 of the Internal Revenue Code of 1954. Prior to the transfer, the business had, on its books of account, a reserve for bad debts which had been accumulated by additions for which the taxpayer had derived full tax benefits in prior taxable years. *Held*, under these circumstances the reserve for bad debts is not transferable to any other entity. Accordingly, the reserve for bad debts represents ordinary income to the taxpayer for the taxable year during which the transfer of the accounts receivable was made, since, during such time, his need for the reserve ceased. *See Geyer, Cornell & Newell, Inc. v. Commissioner*, 6 T.C. 96, acquiescence, C.B. 1946-1, 2; Rev. Rul. 57-482, C.B. 1957-2, 49; and *C. Standlee Martin, Inc. v. Riddell*, 56-2, U.S.T.C. 9989, 51 A.F.T.R. 1376. Under similar circumstances, a partnership must likewise include such reserve for bad debts in its final return as ordinary income. However, to the extent that the additions to the reserve for bad debts in prior years may not have resulted in tax benefits, they need not be included in the transferor's gross income. *See M. & E. Corporation v. Commissioner*, 7 T.C. 1276, acquiescence, C.B. 1947-1, 3.

30. Borini, *supra* note 9, at 260; Dauber, *Accounts Receivable in Section 351 Transfers*, 52 A.B.A.J. 92 (1966).

31. H. FINNEY & H. MILLER, PRINCIPLES OF ACCOUNTING 62 (6th ed. 1963).

32. Treas. Reg. § 1.446-1(c)(1) (1961).

revenue and expense are reported in the period in which the collection or disbursement occurs.[33] The cash basis taxpayer does not generally recognize a loss for bad debts since there is no recognition of income until the cash is received.[34] Since section 351 provides for the tax-free transfer of property for the stock of a controlled corporation, the provision seems to permit a tax-free transfer of accounts receivable which arose from commercial activity before the transfer, although no income has yet been recognized by the transferor relative to those accounts. Because of the assignment of income principle (the transferor has earned the income but not recognized it because it is uncollected, and now he is transferring this unrecognized income to another taxpayer) it has been held that the income when collected by the corporation is taxable to the transferor.[35] It has also been held that the transfer is the taxable event.[36] This view suggests that taxability is not based on assignment of income principles, but upon some concept of realization, i.e., the taxpayer has derived "measurable gain [albeit nonpecuniary] from his exercise of dominion over the receivable."[37] On the other hand, the Tax Court and the Seventh Circuit have held that a cash basis taxpayer may transfer accounts receivable to a controlled corporation without a tax impact at the time of transfer, and that the accounts become income to the corporation when collected.[38]

---

33. H. FINNEY & H. MILLER, *supra* note 31.

34. W. KARRENBROCK & H. SIMMONS, *supra* note 19, at 67. However, for tax purposes it is possible for the taxpayer to utilize a combination of the accrual and cash accounting methods. Thus, sales and purchases may be reported on an accrual basis, while the remaining income and expense items are measured on a cash basis. Note that Treas. Reg. § 1.446-1(c)(1)(iv)(a) (1961) permits a combination of accounting methods to be used provided such combination clearly reflects income and is consistently used. However, if inventory is maintained, the accrual method of accounting must be used with regard to purchases and sales. Treas Reg. § 1.446-1(c)(2) (1961).

35. Brown v. Commissioner, 115 F.2d 337 (2d Cir. 1940) (claim for legal fees); Davidson v. Commissioner, 43 B.T.A. 576 (1941) (insurance commissions); Weinberg v. Commissioner, 44 T.C. 233 (1965) (growing crops).

36. Commissioner v. Fender Sales, Inc., 338 F.2d 924 (9th Cir. 1964).

37. *See* Dauber, *supra* note 30, at 93.

38. *See* Briggs v. Commissioner, 15 CCH Tax Ct. Mem. 440 (1956). In this case a "Welcome Wagon" business was operated in the form of a sole proprietorship. Commercial products were advertised by bestowing gifts on newcomers to an area. "Welcome Wagon" derived its income by charging the commercial sponsors for the hostess visits. Upon incorporation, the business retained the cash method of accounting. Uncollected receivables of $200,000.00 were transferred to the new corporation. The Commissioner argued that the uncollected fees represented services which had been

The court in *Schuster* initially observed that the transfer of the proprietorship assets qualified under section 351 and that the bad debt reserve was reasonable in amount.[39] The reserve, however, was treated as ordinary income since (1) the proprietorship will never sustain a bad debt loss, the reserve is no longer necessary, and (2) proper accounting principles require that the reserve be included in gross income.[40] The *Schuster* court therefore viewed the application of section 351 as subordinate to the tax benefit rule with respect to the bad debt reserve. Moreover, the Tax Court observed that there is no statutory provision permitting a carryover of a bad debt reserve from the transferor to the transferee corporation in a transaction which is governed by section 351.[41] Whether the newly formed corporation has a similar need for the reserve is irrelevant.[42]

The argument in *Schuster* that the transfer vitiates the need for the bad debt reserve[43] has been utilized by the Internal Revenue Service in analogous cases. For example, this principle has been extended to cases involving a section 337 sale and liquidation of a corporation.[44] Under this provision, no gain or loss is generally attributed to the liquidating corporation due to a sale or exchange of its property within twelve months after the plan to liquidate is adopted.[45] On occasion the liquidating corporation has been required to recognize the bad debt reserve as income upon a sale or transfer of its accounts receivables.[46]

---

performed. The court, however, observed that the business in reality was a continuous operation, and held that the accounts became income to the corporation when collected. *See also* P.A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718 (7th Cir. 1940) where the court held that the transferee corporation assumes previously untaxed receivables at a basis of zero, and that ordinary income will be recognized when the receivables are collected. *See also*, Brown v. Commissioner, 115 F.2d 337 (2d Cir. 1940) (claim for legal fees); *and* Kniffin v. Commissioner, 39 T.C. 553 (1962) *acquiesced in*, 1965-1 CUM. BULL. 5 (1965) (a tax free exchange under section 351 did not permit immediate taxability).

39. 50 T.C. at 99.

40. *Id.* at 100-01.

41. *Id.* at 102.

42. *Id.*

43. 50 T.C. at 100.

44. West Seattle Nat'l Bank v. Commissioner, 33 T.C. 341 (1959), *aff'd* 288 F.2d 47 (9th Cir. 1961). Rev. Rul. 57-482, 1957-2 CUM. BULL. 49.

45. INT. REV. CODE of 1954 § 337.

46. West Seattle Nat'l Bank v. Commissioner, 33 T.C. 341; Citizens Fed. Sav. & Loan Ass'n v. United States, 290 F.2d 932 (Ct. Cl. 1961); Ina Handelman, 36 T.C. 560 (1961). *But see* B. BITTKER & J. EUSTICE, *supra* note 5, § 9.65 at 403, n.93:

If the receivables are sold for less than face, there is authority both for and

A section 337 sale and liquidation, however, should be distinguished from the section 351 transfer. In the former transaction, the business entity is dissolved, while in the latter case the holder of the reserve continues business operations, although in an altered form.[47] In the case of dissolution, there is no longer a reason to accord nonrecognition, while in a section 351 transfer the business "continues to experience the risk of a bad debt loss."[48] The argument that a continuity of business and ownership interest is adequate justification for not restoring the reserve to income has been upheld in comparable transactions. For instance, a section 332 liquidation of a subsidiary corporation into a parent corporation[49] has not resulted in the restoration of the amount of the bad debt reserve into income on the premise that the enterprise continues to do business.[50] Likewise, in the case of a statutory merger under section 368 (a)(1)(A), the recognition of the amount of the reserve as income is considered inappropriate since there is a continuity of business and ownership interest.[51] It seems reasonable to conclude, therefore, that a change of business organization from an unincorporated entity to a corporate entity under section 351 should have no effect on the tax treatment of the reserve account.

The conflict of judicial authority on this issue is illustrated in the *Estate of Schmidt v. Commissioner*[52] where the Ninth Circuit held that a sole proprietor was *not* required to include his

---

against taking the bad debt reserve into income; J.E. Hawes Corp., 44 T.C. 705 (1965) (taxable); Mountain States Mixed Feed Co. v. United States, 245 F. Supp. 369, 16 AFTR 2d 5460 (D. Colo. 1965) (contra); see Schmidt's Estate v. Commissioner [*infra* note 52].

In James M. Pierce Corp. v. Commissioner, 326 F.2d 67, 13 AFTR 2d 358 (8th Cir. 1964), the court relied on the *West Seattle Bank* case to require a publisher to take deferred subscription income into account on liquidating, but permitted this to be offset by a deduction on the theory that the taxpayer had paid the buyer to take over the liabilities attributable to the reserve in the form of a reduced sales price for the assets.

47. Citizens Fed. Sav. & Loan Ass'n of Cleveland v. United States, 290 F.2d 932 (Ct. Cl. 1961).

48. *Id.*

49. *See* Calavo Inc. v. Commissioner, 304 F.2d 650 (9th Cir. 1962).

50. *Id.*

51. *See* MONTGOMERY, *supra* note 27, at 5.48.

52. 355 F.2d 111 (9th Cir. 1966) *rev'g* Estate of Schmidt v. Commissioner, 42 T.C. 1130 (1964). *See also* Rowe v. United States, 69-1 T.C. ¶ 9162 (1969), a district court decision which has also rejected the reasoning behind Rev. Rul. 62-128 and followed the Ninth Circuit. A similar result was reached in another recent district court, Birmingham v. United States, 68-2 T.C. ¶ 9513 (1968).

bad debt reserve account in income for the taxable year in which he transferred his business to a controlled corporation.[53] The *Schmidt* court asserted that the Commissioner had ignored the economic realities of the transaction since the actual amount of accounts receivable could only be reflected after an appropriate deduction for the reserve account.[54] The court observed:

> It is quite true that the taxpayer no longer "needed" the reserve, but it is certainly not true, in any economic sense, that he has recovered its value. What he has recovered, in relation to the receivables, is pieces of paper—stock certificates—representing their net value, not their gross value.[55]

A second ground for the *Schuster* holding was the court's conclusion that the termination of the reserve account at the time of transfer was consistent with proper accounting practice.[56] It is questionable, however, whether it is an acceptable accounting practice to have the transferor recognize the reserve account as ordinary income when, in fact, no gain has been realized in the economic sense. Restoration of the reserve into income completely distorts the annual income concept since deductions properly computed in past accounting periods will be collectively reflected in gross income for the current year.[57] Moreover, this distortion is compounded since the transferee corporation may also utilize a similar deduction in a taxable year unrelated to the time in which the loss has occurred.[58] For example, suppose the transferor treats the reserve account as ordinary income when the corporation is organized under section 351 in order to offset an ordinary loss. The transferee corporation's basis for the receivables would be equal to that of the transferor,[59] undiminished by the reserve; the corporation would be permitted to take a deduction from ordinary income when it later established a reserve.[60] The transfer of an ordinary loss to a taxpayer who has not recognized the income represented by the receivables constitutes a distortion of net income and is contrary

53. 355 F.2d 111.
54. *Id.* at 112.
55. *Id.* at 113.
56. 50 T.C. at 101.
57. F. Hickman, *Incorporation and Capitalization*, 40 TAXES 974, 978 (1962).
58. *Id.*
59. INT. REV. CODE of 1954, § 358.
60. 50 T.C. at 102.

to the purpose of the reserve method of accounting for bad debts. By contrast, if the reserve account in *Schuster* represented an unreasonable estimate of uncollectibles,[61] restoration of that account to income would seem to be justified.

The court in *Schuster* also suggests that the lack of statutory authority precludes the carryover of a bad debt reserve.[62] In analogous situations, however, and without specific statutory authority, the regulations provide that "no gain or loss shall result under section 453(d) in the case of a disposition of an installment obligation" in a section 351 transfer.[63]

It can also be argued that the existence of statutory authority providing for the recapture of depreciation expense[64] precludes the recapture of depreciation and other deductions based upon tax benefit principles. Thus the recapture of income when there is a section 351 transfer of sections 1245 and 1250 property[65] is precluded unless "boot"[66] is received.

A criticism of the Internal Revenue Service's position is its "shocking indifference to the underlying policy of section 351 of permitting tax-free incorporation of going businesses."[67] While sound reasons exist for regulating areas of potential abuse such

61. Reallocation of income is justifiable "where there is a substantial distortion of annual income—a bulging or a bunching of income or deductions—arising out of the arbitrary timing of a transaction . . . " F. Hickman, *supra* note 57, at 980.

62. 50 T.C. at 102.

63. Treas. Reg. § 1.453-9 (c) (2) (1963).

64. INT. REV. CODE of 1954, § 1245(b)(3) and § 1250(d)(3).

65. *Id.*

66. Benjamin, Jr., *Problems in Transition from Sole Proprietorship or Partnership to Corporation*, N.Y.U. 26TH INST. OF FED. TAX 791, 801 (1968) states that:

> Any item that is not included in the phrase "stock or securities" will be treated as boot, with gain (but not loss) recognized to the extent of the lesser of (i) its fair market value or (ii) any gain realized on the exchange under Section 1001. Any such boot will be ordinary income even in the case of an incorporation involving capital and Section 1231 assets held by the predecessor unincorporated business for more than six months, to the extent that Section 1239, Section 1245, or Section 1250 applies to the gain recognized on incorporation. (Footnotes omitted).

67. Arent, *supra* note 21, at 998. The writer further observes that:

> The ruling [Rev. Rul. 62-128] not only does violence to the policy of Section 351 by creating obstacles to easy incorporation, but it also accomplishes the very opposite of what cases like Central Cuba Sugar Company [v. Commissioner, 198 F.2d 214 (2d Cir. 1962), cert. den., 344 U.S. 874] and Rooney [v. United States, 305 F.2d 681 (9th Cir. 1962)] set out to do when they insisted that Section 351 could not be used to screen a gross distortion of income among related taxpayers. *Id.* [Italics omitted].

as unrealistic transactions[68] (which the Commissioner concedes was not the case in *Schuster*),[69] there may be less justification for taxing a legitimate business exchange. On the other hand, the same commentators who have criticized Rev. Rul. 62-128 on the ground that it ignored the nonrecognition policy of section 351 may have failed to consider the fact that specific statutory authority is sometimes subordinate to other principles such as the doctrine of assignment of income and the tax benefit rules.[70] Instead, a more appropriate inquiry is whether the tax benefit rule was properly applied in *Schuster*. If, as this commentary suggests, it was not, questions then arise as to the proper application of section 351 and the appropriateness of restoring a reserve to income when there has been no economic gain.

The practical impact of the *Schuster* decision is to render the transfer of assets in a section 351 exchange a partially taxable event if tax benefit principles, as construed in *Schuster*, are to be consistently applied. The accrual basis taxpayer will have to recognize the bad debt reserve as income; the cash basis taxpayer will have to recognize as income pre-incorporation expenses which have been deducted where the expenditure was incurred for an asset or benefit not yet consumed when the new corporation is formed (e.g., stationery and other supplies, short-term insurance policies, real estate taxes, prepaid interest).[71] Such an extension would undermine the basic philosophy of section 351, which is to allow the incorporation of unincorporated businesses without a tax consequence.

EDWARD J. PULASKI, JR.

68. *See* note 61 *supra*.

69. 50 T.C. at 99.

70. B. BITTKER & J. EUSTICE, *supra* note 5, § 3.17 at 112.

71. *See* Rev. Rul. 69-117, 1969 INT. REV. BULL. No. 11, at 12, which states that the basis of items of inventory which are transferred by two sole proprietorships (utilizing the cash method) to a controlled corporation under section 351 is zero where the cost of those items was previously deducted. The implication of this ruling is that no income is realized by the transferor.