Maher v. Commissioner, 55 T. C. 441 (1970)

The assumption of a shareholder's debt by a corporation can be treated as a taxable dividend to the shareholder in the year of assumption, to the extent of the corporation's earnings and profits.

Summary

Ray Maher purchased all stock in four related corporations, securing the purchase with promissory notes held in escrow. Maher then assigned his interest in one corporation's stock to another corporation, Selectivend, which assumed his notes. The court held that this transaction constituted a stock redemption under IRC § 304(a)(1), treated as a taxable dividend under § 301(a) in 1963 when the debt was assumed, not when payments were made. The court also ruled that Maher was liable as a transferee for the corporation's unpaid taxes and that Selectivend could deduct interest payments on the assumed notes.

Facts

Ray Maher entered into an agreement on April 26, 1963, to buy all stock in four corporations (Selectivend, Surevend, Selvend, and Selvex) for $500,000. The payment included $250,000 in cash and two $125,000 promissory notes, with the stock held in escrow as collateral. On December 31, 1963, Maher assigned his interest in Selvex stock to Selectivend in exchange for Selectivend's assumption of his liability on the notes. Maher remained secondarily liable. Selectivend made payments on the notes from 1965 to 1967, and deducted the interest. Selectivend dissolved in 1967, transferring its assets to Maher.

Procedural History

The Commissioner determined deficiencies in Maher's federal income tax for 1963-1967, asserting that Selectivend's assumption of Maher's liability constituted a taxable dividend. Maher petitioned the U. S. Tax Court, which consolidated the cases. The court found for the Commissioner on the dividend issue, holding that the assumption was taxable in 1963. It also ruled that Maher was liable as a transferee for Selectivend's 1964 and 1965 taxes and that Selectivend could deduct interest payments on the notes.

Issue(s)

1. Whether Selectivend's assumption of Maher's promissory notes in 1963 constituted a taxable dividend to him under IRC §§ 301(a) and 304(a)(1)?
2. Whether Maher is liable as a transferee for Selectivend's unpaid taxes for 1964 and 1965 under IRC § 6901?
3. Whether Selectivend is entitled to interest deductions for payments on Maher's promissory notes under IRC § 163?

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Holding

1. Yes, because the transaction was a stock redemption under § 304(a)(1) that did not qualify as an exchange under § 302(b)(1), thus taxable as a dividend under § 301(a) in 1963 when the debt was assumed.
2. Yes, because Maher agreed to the extension of time for assessment and received a timely notice of deficiency as transferee.
3. Yes, because Selectivend was using the borrowed funds in its business, making the interest payments deductible under § 163.

Court's Reasoning

The court applied IRC § 304(a)(1), treating the transaction as a redemption of stock by a related corporation, which did not qualify as an exchange under § 302(b)(1) because it did not meaningfully reduce Maher's interest in the corporation. The court rejected Maher's argument that he sold a "contract to purchase stock," finding he was the equitable owner of the stock. The assumption of liability was treated as "property" received by Maher, taxable as a dividend under § 301(a) in the year of assumption (1963), not when payments were made. The court cited precedents treating assumption of liability as money received for tax purposes. On the transferee liability, the court held that a notice of deficiency to the transferor was unnecessary when futile, and Maher's agreement to extend the assessment period was valid. For the interest deductions, the court found Selectivend was using the funds, so the payments were deductible business expenses.

Practical Implications

This decision clarifies that a corporation's assumption of a shareholder's debt can trigger immediate dividend tax consequences, even if the shareholder remains secondarily liable. Practitioners must advise clients of potential tax liabilities when structuring such transactions. The ruling also affirms that transferee liability can be enforced without a notice of deficiency to the dissolved transferor, emphasizing the need for careful planning when assets are transferred from a dissolving corporation. Finally, it confirms that a corporation assuming debt can still deduct interest payments as business expenses, impacting how related-party financing is structured and reported.

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