H & M Auto Electric, Inc. v. Commissioner, 92 T. C. 1269 (1989)

Liabilities assumed by a shareholder in a corporate distribution must be allocated to specific assets to determine taxable gain under Section 311(c).

Summary

In H & M Auto Electric, Inc. v. Commissioner, the U. S. Tax Court ruled that when a corporation distributes assets in redemption of a shareholder's interest, liabilities assumed by the shareholder must be allocated to specific assets to determine taxable gain under Section 311(c). H & M Auto Electric, Inc. distributed a parcel of land and a note receivable to a shareholder in exchange for the assumption of secured and unsecured liabilities. The court held that secured liabilities should be allocated to the asset securing them, while unsecured liabilities should be allocated proportionally based on the fair market value of distributed assets. This ruling established the method for calculating gain when liabilities exceed the basis of distributed assets, affecting how similar cases are analyzed and reported for tax purposes.

Facts

H & M Auto Electric, Inc. distributed a parcel of land (Parcel #2) and a note receivable to Bette Horn in complete redemption of her 178 shares of stock. Bette Horn assumed a secured liability (Note #1) of $153,341, which was secured by Parcel #2 and another property, and an unsecured liability (Note #2) of $10,000. The fair market value of Parcel #2 was $202,000, with an adjusted basis of $37,486. The note receivable had a balance of $128,331. The Commissioner argued that the corporation should recognize gain because the liabilities exceeded the basis of the distributed assets.

Procedural History

The Commissioner determined a deficiency in H & M Auto Electric, Inc. 's 1983 Federal income tax, leading to a petition filed in the U. S. Tax Court. The case was fully stipulated, and the court addressed the issue of whether the corporation must recognize gain under Section 311(c) due to the distribution of assets.

Issue(s)

1. Whether the gain to be recognized under Section 311(c) should be computed by subtracting the aggregate of the corporation's bases in the property distributed from the aggregate of the liabilities assumed, or by subtracting the basis of each property distributed from the liability assumed in respect of each property.

Holding

1. No, because the court held that liabilities must be allocated to specific assets to

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determine taxable gain under Section 311(c). The secured liability (Note #1) was allocated to the asset securing it (Parcel #2), and the unsecured liability (Note #2) was allocated proportionally based on the fair market values of the distributed assets.

Court’s Reasoning

The court reasoned that Section 311(c) requires a matching of liabilities to assets to determine if a liability exceeds the basis of a distributed asset. The court disagreed with the taxpayer’s argument for an aggregate approach, instead adopting an asset-by-asset approach as suggested by the Commissioner, with modifications. The court allocated the secured liability to the asset it secured and the unsecured liability proportionally based on the fair market values of the assets distributed. The court also considered the joint and several liability of the co-makers on Note #1, adjusting the amount of liability assumed by Bette Horn accordingly. The court’s decision was influenced by the Treasury regulations and the statutory language of Section 311(c), contrasting it with Section 357(c), which explicitly uses an aggregate approach.

Practical Implications

This decision impacts how corporations and their tax advisors approach distributions involving the assumption of liabilities. It establishes that for tax purposes, liabilities must be allocated to specific assets to determine gain under Section 311(c). This ruling affects how similar cases are analyzed, requiring careful allocation of secured and unsecured liabilities. It also influences corporate tax planning, as companies must consider the tax implications of distributing assets with associated liabilities. The decision has been cited in subsequent cases dealing with the taxation of corporate distributions, reinforcing the asset-by-asset approach to liability allocation.

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