54 T.C. 680 (1970)

Payments offset against a taxpayer's debt to the purchaser in the year of sale are considered 'payments' received in the year of sale for the purposes of the installment method of accounting, even if the formal offset occurs after the close of the taxable year.

Summary

John H. Rickey sold stock in two corporations to Hyatt Corporation. The sale agreement stipulated that Hyatt would offset debts Rickey owed to the corporations (and thus to Hyatt after the acquisition) against the purchase price payments. Although the formal offset of a substantial portion of the payment was scheduled for January of the following year, the Tax Court held that this amount was constructively received in the year of sale because the debt offset was predetermined and the taxpayer never had control over those funds. As a result, payments in the year of sale exceeded 30% of the selling price, disqualifying Rickey from using the installment method of reporting gain. The court also denied ordinary loss treatment under Section 1244 for separate stock, finding the written plan requirement was not met.

Facts

Petitioner John H. Rickey owned all stock of Rickey Enterprises and 50% of Rickey's Studio Inn Hotel. In 1962, Rickey negotiated to sell these stocks to Hyatt. The sale contract, executed March 31, 1962 and closed April 2, 1962, set a purchase price and payment terms. A key term involved offsetting debts Rickey and related companies owed to Enterprises and Studio Inn against the purchase price. An audit revealed Rickey owed a substantial net amount. While 29% of the purchase price was structured for payment in 1962 (cash at closing and within 30 days post-audit), a larger portion was nominally due January 2, 1963. However, due to the offset, a significant portion of the January 1963 payment was effectively cancelled against Rickey's debt. Rickey sought to report the gain on the installment method.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Rickey's income tax for 1962 and 1964, disallowing installment sale treatment and ordinary loss deductions. Rickey petitioned the Tax Court. The Tax Court addressed two issues: the propriety of installment method reporting and the eligibility for ordinary loss treatment under Section 1244. The Tax Court ruled against Rickey on both issues.

Issue(s)

1. Whether payments received in the year of sale, including amounts offset against the seller's debt to the buyer, exceeded 30 percent of the selling price, thereby precluding installment method reporting under Section 453.

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2. Whether the taxpayer was entitled to ordinary loss treatment under Section 1244 on the worthlessness of stock in Rick's Swiss Chalet, Inc.

Holding

1. No, because the payment due January 2, 1963, was effectively received in 1962 due to the offset agreement, causing total payments in the year of sale to exceed 30% of the selling price.
2. No, because the stock was not issued pursuant to a written plan that met the requirements of Section 1244, specifically regarding the offering period.

Court's Reasoning

Installment Method: The court emphasized substance over form. It found that the deferral of the January 2, 1963 payment was a mere formality to circumvent the 30% rule. The offset mechanism ensured Rickey would never actually receive the January payment in cash; it was immediately applied to reduce his debt to Hyatt. The court quoted *Commissioner v. Court Holding Co.*, stating, "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." The court likened the situation to cases where taxpayers received constructive payments via debt cancellation or prearranged offsets in the year of sale, citing *James Hammond* and *United States v. Ingalls*. The court concluded that the $193,541.48 offset was effectively received in 1962.

Section 1244 Loss: The court found that the corporate minutes and stock permit did not constitute a qualifying written plan under Section 1244. The resolution lacked any indication of awareness of Section 1244 or intent to offer its tax advantages. Furthermore, the plan did not specify a period, ending within two years, for offering the stock. While the permit had a termination date, it was renewable, failing to establish a definitive two-year limit from the plan's adoption. The court cited *Godart v. Commissioner*, emphasizing the need for "some substantially contemporary objective evidence that the plan was adopted with § 1244 in view." Such evidence was absent.

Practical Implications

Rickey v. Commissioner serves as a crucial reminder that the IRS and courts scrutinize the substance of transactions, especially in tax planning. For installment sales, structuring payments to fall just under the 30% threshold in the year of sale is insufficient if other aspects of the transaction indicate constructive receipt of additional payments. Debt offsets, especially prearranged ones, are treated as actual payments in the year of sale. Legal professionals must advise clients that complex payment schemes designed solely to manipulate tax outcomes are vulnerable to being recharacterized based on economic reality. For Section 1244 stock, meticulous documentation of a written plan, explicitly referencing Section 1244 and

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adhering strictly to the regulatory requirements regarding offering periods, is essential to ensure ordinary loss treatment for stock losses. This case reinforces the importance of clear, contemporaneous evidence of intent to comply with Section 1244 when establishing a plan to issue small business stock.

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