***Stiles v. Commissioner*, 69 T.C. 510 (1978)**

Payments into a trust to secure a purchaser's obligations to a seller are deemed received by the seller when paid into the trust, unless subject to substantial restrictions that are definite, real, and not dependent on the seller's whim.

Summary

Fred Stiles sold his corporate stock back to the corporation, with a portion of the proceeds placed in a trust to secure against potential breaches of certain representations and warranties. The Tax Court held that because the trust funds were subject to substantial restrictions, Stiles did not constructively receive the entire sale price in the year of the sale. Therefore, he was entitled to report the gain from the stock redemption under the installment method of accounting per Section 453 of the Internal Revenue Code. The court also determined that he could not change to a cost recovery method after electing the installment method, as the installment method clearly reflected income.

Facts

Fred Stiles and Charles Rosen equally owned four companies. They entered into a settlement agreement due to disputes, wherein Stiles would sell his interest in the four companies back to those companies for $845,000. Approximately 75% ($635,000) of the redemption price was placed in trust to secure the companies against potential breaches by Stiles of certain representations and warranties regarding undisclosed liabilities and agreements. The trust agreement directed the trustee to invest the funds, accumulate income for Stiles, and distribute principal to him annually from 1973 to 1977, with the balance in 1978. The trust agreement outlined procedures for the redeeming corporations to file claims against the trust for breaches. Stiles was entitled to borrow from the trust to defray income tax liabilities with the redeeming corporations' consent.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Stiles' federal income taxes for 1972. Stiles petitioned the Tax Court, arguing that he was entitled to report the gain from the stock redemption under the installment method or, alternatively, use a cost recovery method of accounting. The Tax Court ruled in favor of Stiles, finding that he was entitled to use the installment method because the trust funds were subject to substantial restrictions.

Issue(s)

1. Whether the redemption of petitioner's corporate stock qualifies as an installment sale under Section 453.
2. Whether petitioners can change to a cost recovery method of accounting after electing to report under the installment method.

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Holding

1. Yes, because the funds placed in trust were subject to substantial restrictions, and therefore, Stiles did not constructively receive the entire redemption price in the year of the sale.
2. No, because Stiles failed to prove that the installment method did not clearly reflect his income, and the amount to be realized was ascertainable.

Court's Reasoning

The court reasoned that payments into a trust are generally deemed received by the seller unless subject to substantial restrictions. The restrictions in this case were substantial because the redeeming corporations could file claims against the trust for breaches of Stiles' representations and warranties. The trustee could then set aside funds to secure the corporations against the alleged breach. The court found the representations and warranties in paragraphs 22 and 23 of the redemption agreement to be substantial. The court distinguished this case from *Sproull v. Commissioner* and *Oden v. Commissioner*, where the trust funds were not subject to substantial conditions or limitations. The court stated, "In this case, petitioner does not enjoy an unqualified right to the trust funds. As we previously discussed, the trust funds were subject to any claims which might arise under paragraph 22 or 23 of the redemption agreement." The court also held that Stiles could not change to a cost recovery method because he failed to prove that the installment method did not clearly reflect his income and the amount to be realized was ascertainable.

Practical Implications

This case clarifies the circumstances under which funds placed in trust in connection with a sale will be considered constructively received by the seller. It emphasizes that the presence of substantial restrictions on the seller's access to those funds can allow the seller to report the gain under the installment method. The restrictions must be definite, real, and not dependent on the seller's whim. Attorneys structuring similar transactions should carefully document the restrictions imposed on the trust funds and ensure they are truly enforceable. This case is often cited when determining whether an escrow arrangement constitutes a substantial restriction for installment sales purposes, influencing tax planning and structuring of sales agreements.

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