Lustgarten v. Commissioner, 71 T. C. 303 (1978)

A taxpayer cannot use the installment method of reporting income if they retain control over the proceeds of the sale, even when selling to family members.

Summary

Paul Lustgarten sold stock to his son under an installment contract that required the son to sell the stock and invest the proceeds in specific securities placed in escrow. The Tax Court held that Lustgarten was not entitled to use the installment method because he effectively controlled the sale proceeds, thus constructively receiving them. This case underscores the importance of ensuring true independence of the buyer in family transactions to avoid constructive receipt and loss of installment sale benefits.

Facts

Paul Lustgarten sold 42,000 shares of Cooper Laboratories, Inc. stock to his son, Bruce, on November 15, 1971, for $1,017,590. 69 under an installment contract. The contract required Bruce to execute a promissory note and an escrow agreement. Per the agreements, Bruce was to immediately sell the Cooper stock, use the entire proceeds to buy Sigma Investment Shares, Inc. stock, and deposit the Sigma stock into an escrow account. The escrow agreement stipulated that monthly payments to Lustgarten would come from the Sigma stock's income or, if necessary, its liquidation. Bruce's personal net worth was insufficient to purchase the Cooper stock independently.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to Lustgarten on July 23, 1976, disallowing the use of the installment method for reporting the sale's gain. Lustgarten petitioned the Tax Court, which held that he was not entitled to use the installment method due to his control over the sale's proceeds.

Issue(s)

1. Whether Lustgarten is entitled to report the gain from the sale of Cooper Laboratories, Inc. stock on the installment basis under section 453 of the Internal Revenue Code.

Holding

1. No, because Lustgarten retained control over the proceeds of the sale, resulting in constructive receipt of the full sale price in the year of the sale, thus disqualifying him from using the installment method.

Court's Reasoning

The Tax Court applied the principles established in *Rushing v. Commissioner* and *Pozzi v. Commissioner*. The court found that the escrow agreement and the requirement for Bruce to sell the stock and reinvest the proceeds evidenced Lustgarten's control over the sale's proceeds. The court noted that the transaction was structured so that Lustgarten effectively used his son as an agent to sell the stock and reinvest the proceeds, retaining the economic benefit. The court emphasized that Bruce did not have the financial capability to independently purchase the stock, further supporting the finding of control by Lustgarten. The court stated, "The substance of the transaction *is as if* petitioner had sold the Cooper stock, purchased the Sigma stock, then placed the latter in trust for the benefit of Elaine while retaining an income interest. " This control over the sale's proceeds led to the conclusion of constructive receipt, disqualifying Lustgarten from using section 453.

Practical Implications

This decision emphasizes the scrutiny applied to installment sales between family members. It highlights that taxpayers must ensure that the buyer has true independence and control over the sale's proceeds to qualify for installment reporting. Practitioners should advise clients to avoid structures where the seller retains economic benefit or control over the sale's proceeds, as such arrangements can lead to constructive receipt and immediate tax liability. This case has influenced subsequent cases involving family transactions and the use of escrow accounts, reinforcing the importance of substance over form in tax planning.

