Shelton v. Commissioner, 105 T. C. 114 (1995)

Installment sale gain may be accelerated when a related party disposes of the property within two years, even if the risk of loss is substantially diminished by an intervening transaction.

Summary

James M. Shelton sold stock of El Paso Sand Products, Inc. (EPSP) to Wallington Corporation, a related party, on an installment basis. Within two years, EPSP sold its assets and was liquidated, leading the Commissioner to argue that Shelton should recognize the remaining installment gain. The Tax Court held that the liquidation of EPSP was a second disposition by a related party, and that the two-year period under Section 453(e)(2) was tolled due to the asset sale and liquidation plan, requiring Shelton to recognize the gain. However, the court found that Shelton reasonably relied on professional advice and thus was not liable for an addition to tax.

Facts

James M. Shelton owned all the stock of JMS Liquidating Corporation (JMS), which sold its 97% ownership in EPSP to Wallington Corporation on June 22, 1981, for a 20-year promissory note. Wallington's shareholders were Shelton's daughter and trusts for his grandchildren. On March 31, 1983, EPSP sold most of its assets to Material Service Corporation for cash and assumed liabilities. On the same day, EPSP and Wallington adopted plans of liquidation. On March 15, 1984, EPSP and Wallington liquidated, distributing their assets to the shareholders, who assumed the note's liability. Shelton reported the EPSP stock sale on the installment method but did not report additional gain from the liquidation.

Procedural History

The Commissioner determined a deficiency in Shelton's 1984 income tax and an addition to tax for substantial understatement, asserting that the liquidation of EPSP required Shelton to recognize the remaining installment gain. Shelton petitioned the Tax Court, which found for the Commissioner on the deficiency but for Shelton on the addition to tax, holding that he reasonably relied on professional advice.

Issue(s)

1. Whether the liquidation of EPSP constituted a second disposition of the property by a related party under Section 453(e)(1)?
2. Whether the two-year period under Section 453(e)(2) was tolled by the sale of EPSP's assets and the adoption of the plan of liquidation?
3. Whether Shelton is liable for the addition to tax under Section 6661 for substantial understatement of income tax?

Holding

1. Yes, because the liquidation of EPSP by Wallington, a related party, was considered a disposition under Section 453(e)(1), as it resulted in cash and other property flowing into the related group.
2. Yes, because the sale of EPSP's assets and the adoption of the liquidation plan substantially diminished Wallington's risk of loss, tolling the two-year period under Section 453(e)(2).
3. No, because Shelton reasonably relied on the advice of his tax adviser, and the Commissioner abused her discretion in not waiving the addition to tax.

Court's Reasoning

The court interpreted Section 453(e) as aimed at preventing related parties from realizing appreciation in property without current tax recognition. The court found that the liquidation of EPSP was a disposition under Section 453(e)(1) because it resulted in cash and property flowing into the related group. Regarding the two-year period under Section 453(e)(2), the court held it was tolled from March 31, 1983, when EPSP sold its assets and adopted a plan of liquidation, as these actions substantially diminished Wallington's risk of loss in the EPSP stock. The court also considered the legislative history, which targeted situations like those in Rushing v. Commissioner, where installment treatment was allowed despite related-party liquidations. For the addition to tax, the court found that Shelton's reliance on professional advice was reasonable, given the novel issue presented, and thus the Commissioner abused her discretion in not waiving the penalty.

Practical Implications

This decision clarifies that the sale of assets by a related party followed by a liquidation can trigger accelerated recognition of installment sale gain, even if the liquidation occurs more than two years after the initial sale, provided the related party's risk of loss was substantially diminished within that period. Taxpayers engaging in installment sales to related parties must be cautious about subsequent transactions that could diminish the related party's risk, as these may lead to immediate tax consequences. The ruling also underscores the importance of relying on professional advice in complex tax situations, as such reliance can be a defense against penalties for substantial understatements. Subsequent cases have cited Shelton for its interpretation of related-party dispositions and the tolling of the two-year period under Section 453(e)(2).