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Liquidation of a Subsidiary Held to be a "Disposition" by Tax Court

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Section 453(e) of the Code includes rules for taxing dispositions of property to related persons. If a person disposes of property to a related person, and before that related person pays the transferor for all payments with respect to that transfer, if the related transferee then in turn disposes of the property again, the amount realized with respect to that second disposition is treated as received at the time of the second disposition by the person making the first disposition. I.R.C. §453(e)(1). Stated more simply, notwithstanding

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installment treatment of the first disposition, when the second disposition is made, the transaction is effectively collapsed so that all gain must be recognized upon the second disposition.

The main limiting factor to this principle is contained in Section 453(e)(2), under which a two-year limit applies. The rule described above generally applies only if the date of the second disposition is no more than two years after the date of the first disposition. Here again, there are several

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exceptions. First, this two-year cutoff does not apply in the case of marketable securities.

Second, the running of the two-year period is suspended with respect to any property for any period during which the related person's risk of loss with respect to the property is substantially diminished in several enumerated respects. I.R.C. §453(e)(2)(B). These enumerated methods of reducing risk of loss include holding a put for the property or similar property, another person's right to acquire the property, a short sale, or any other transaction.

These provisions of the Code were recently highlighted in a Tax Court case of first impression. Despite the fact that Section 453(e) has been in the Code for some time, no case had yet considered precisely the question presented in *James M. Shelton v. Commissioner*, 105 T.C. No. 10 (1995). The facts arose out of the sale of a company and subsequent liquidation under Section 337 (as it existed prior to the Tax Reform Act of 1986).

Sale and Liquidation

James Shelton was the sole shareholder of JMS Liquidating Corp. JMS adopted a plan of complete liquidation under old Section 337 in June of 1980. JMS, in turn, had a 97% owned subsidiary, El Paso Sand Products, Inc., which in turn owned the stock of several other companies.

Pursuant to the Section 337 plan, in June of 1981 (before the running of the twelve-month period under Section 337), JMS sold all of its El Paso stock to a company wholly-owned by James Shelton's adult son and daughter, Wallington Corp. The purchase price was over $17 million, and the amount was payable under a twenty-year promissory note secured by the stock of El Paso. Although Wallington had been owned by Shelton's son and daughter since 1976, when the sale occurred in 1981, Wallington's stock was held by the son and daughter plus two trusts that had been created for the benefit of the daughter's children (i.e., James Shelton's grandchildren).

Pursuant to the Section 337 plan, JMS was liquidated in 1981, and the note from El Paso was distributed to Shelton's daughter. Wallington paid installments on the note in 1982 and 1983.

However, on March 31, 1983 (less than two years following the 1981 liquidation of JMS), Wallington and its subsidiaries (including El Paso), adopted a plan of liquidation under Section 337. On the day this plan of liquidation was adopted, El Paso sold most of its assets to an unrelated party (a subsidiary of General Dynamics). The purchase price was $35 million in cash plus the assumption of $4 million in liabilities.

One year later (in the Spring of 1994), El Paso and Wallington liquidated and distributed all other remaining assets to the Wallington shareholders in exchange for their outstanding stock. At this time, the Wallington shareholders (Shelton's daughter and the trusts), assumed substantially all of the liabilities of the corporations, including the note payable.

Installment Method and Dispositions?

Mr. Shelton reported the $16.4 million gain he had realized on the sale of his El Paso stock on the installment method. Furthermore, on his 1984 tax return, Shelton reported installment gain of $502,216, being the amount of the gain attributable to principal payments made on the note, multiplied by the gross profit ratio of 94.17%. The IRS disagreed, determining that Shelton should have recognized the remaining amount of the installment gain in 1984 on the liquidation of Wallington and El Paso.

IRS Arguments

The IRS arguments for acceleration of the installment gain were that:

- The sale of assets followed by liquidation of the underlying stock was a second disposition of the property by a related person under Section 453(e)(1);
- Shelton constructively received the balance due under the installment obligation when the stock was liquidated;
- Shelton received a payment on the installment obligation within the meaning of Temp. Reg. §15A.453-1(b)(3)(i) when the cash proceeds from the liquidation became the collateral for the installment obligation; and
- A deemed disposition occurred.

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In Tax Court, the taxpayer disagreed with all of these assertions. The first technical argument fell, according to Shelton, because the liquidation was not a "disposition," and because more than two years had passed between the original installment sale and the liquidation of El Paso. However, the Tax Court concluded that under the attribution rules of Section 318(a), Wallington was a related person with respect to Shelton.

Likewise, the court concluded that the liquidation of the El Paso stock did indeed trigger a disposition. For this conclusion under Section 453(e)(1), the court referred to the liquidation rules of Section 331, under which amounts distributed in a complete liquidation are treated as in full payment in exchange for the stock. Interestingly, the court noted that this particular question was a case of first impression, since the word "disposition" was nowhere defined for purposes of Section 453. The court found that treating a liquidation and distribution to a related party as a disposition comported with the language and legislative intent of Section 453(e), which was designed to prevent a related group from cashing out appreciation in stock on a current basis while deferring recognition of the gain.

Finally, the court also rejected the taxpayer's assertion that Section 453(e) did not apply because the liquidation did not occur within two years of the first disposition. The Tax Court agreed with the IRS that El Paso's sale of assets on March 31, 1983 caused the two-year period to be suspended. Nonetheless, the court did not uphold the IRS' determination that Shelton was liable for the substantial understatement addition to tax. Indeed, the Tax Court ruled that the IRS abused its discretion in refusing to waive the Section 6661 penalty. ■