Proposed Regs on Installment Obligations and Liquidation

by Robert W. Wood • San Francisco

As part of the recent spate of proposed regulation offerings, the IRS has released proposed regulations covering a shareholder's use of the installment method to report gain on installment obligations that are distributed in complete liquidation of a corporation. (See Reg. REG-209332-80.) The proposed regulations under Section 453 state that a shareholder who does not elect out of the installment method will treat payments on a qualifying installment obligation received in a corporate liquidation as consideration for the stock. If an installment obligation is received by a shareholder from a liquidating non-publicly traded corporation, and the obligation arose from a sale by the corporation of stock or securities that are traded on an established securities market, then the obligation will generally be a qualifying one. The big exception to this rule applies where the liquidating corporation was formed or used to avoid the limitations on installment reporting through the use of a related party. (See Prop. Reg. §1.453-11(c)(5).) The IRS is requesting comments on this particular exception.

More Than One Year

Where a shareholder receives liquidating distributions in more than one year, and a qualifying installment obligation is included in those distributions, there is a basis issue that must be addressed. In this case, the shareholder must reallocate his basis among all property received (or to be received) in all years on completion of the liquidation. This may be a reason for shareholders who are in a control position to prefer a quick and orderly liquidation that does not

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span several taxable years.

Of course, in some cases, it is not possible to make all distributions within one taxable year. Indeed, liquidation timing has become less important over the last ten years. Back in the halcyon days of pre-1986 Act Section 337, the twelve-month liquidation was sacrosanct. With this Code provision now long gone, the only express timing limitation contained in the Code's liquidation provisions concerns parent-subsidiary liquidations under Section 332. Even there, there is no great significance where the liquidation goes on for up to four years.

Section 453(e) was added to the Code to restrict dispositions of property to related persons. Section 453(e) was highlighted in *James M. Shelton v. Commissioner*, 105 T.C. 114 (1995), a case of first impression. *Shelton* involved a sale of a company and subsequent liquidation under old Section 337. As the sole shareholder of his corporation, Shelton adopted a complete liquidation plan under old Section 337 in June of 1980. The company had a 97%-owned subsidiary, which in turn owned the stock of several other companies. Under the 337 plan, in June of 1981 (before the running of the twelve-month liquidation period), the parent corporation sold all of its subsidiary stock to a company wholly-owned by Shelton's adult son and daughter. The purchase price was over $17 million, with the amount payable under a twenty-year promissory note secured by the stock of the subsidiary.

Under the 337 plan, the parent was liquidated in 1981, and the note from the subsidiary was distributed to Shelton's daughter. The son/daughter holding company paid installments on the note in 1982 and 1983. Then, in 1983 (within two years of the 1981 liquidation of the parent), the holding company and its subsidiaries adopted a 337 plan. On the same day, the assets were sold. One year later, the companies were liquidated, distributing all remaining assets to the son and daughter in exchange for their outstanding stock.

Shelton reported $16.4 million in gain on the sale of his stock on the installment method. The IRS disagreed, determining that Shelton should have recognized the remaining amount of the installment gain in 1984 on the liquidation of the other two companies. The basic question was whether there had been a disposition of the installment obligation. Since the word "disposition" was not defined, the court examined the question, finding that treating a liquidation and distribution to a related party as a "disposition" comported with the language and legislative intent of Section 453(e).

That subsection, according to the court, was designed to prevent a related group from cashing out appreciation in stock on a current basis, while at the same time deferring recognition of the gain. The court specifically rejected Shelton's argument that Section 453(e) did not apply. The Tax Court found that the subsequent sale of assets (which did occur within the two-year window) caused this two-year period to be suspended. The only good news for Shelton concerned penalties. Although the court determined there was acceleration on the installment obligation, the court did not sustain the Commissioner's views about the substantial understatement addition to tax. The Tax Court ruled that the IRS had abused its discretion in refusing to waive the Section 6661 penalty. ■

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