BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PALMER C. AND NORMA K. FORSELL)

Appearances:

For Appellants: John Roster and
Richard S. Calone,
Attorneys at Law

For Respondent: Jacqueline W. Martins
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Palmer C. and Norma K. Forsell against a proposed assessment of additional personal income tax in the amount of $6,568.10 for the year 1972.

The issue presented is whether appellants' transfer of stock to their son constituted a bona fide installment sale for tax purposes; entitling them to use the installment method of reporting their gain on the transaction.

Prior to Mr. Forsell's retirement in the spring of 1973, he and his wife (appellants) were residents of Stockton, California. In 1972,the year on appeal, appellants' only son, Garry P. Forsell, was twenty-one years of age and was attending the University of Pacific School of Pharmacy. Although he did not live with appellants, they paid most of his educational expenses and claimed him as a dependent on their 1972 tax returns. As of October 1, 1972, Garry had approximately $2, 000 in his individual savings and checking accounts and was the owner of common stocks valued at approximately $15,000, The stock had been given to him by appellants .

On October 5, 1972, appellants and Garry executed an "Installment Sales Contract" by which appellants transferred all their right, title, and interest in 1,916 shares of Bendix Corporation preferred stock to Garry for the sum of $131, 006. 50. Appellants' basis in that stock was $12, 816. 50. Under the terms of the contract, Garry agreed to pay appellants the total purchase price, plus interest at the rate of 5-1/2 percent per annum, principal and interest payable in monthly installments of $894.25, beginning November 1, 1972, and continuing until said principal and interest were paid in full. On October 5, 1972, Garry also executed two promissory installment notes in the amounts of $50, 000. 00 and $81, 006. 50, evidencing his obligation under the above mentioned contract.

In addition, a "Security Agreement" dated October 5, 1972, was executed by the parties to this transaction. By its terms, Garry granted to appellants a security interest in certain described collateral, to secure his performance of the obligations which he had assumed under the purported installment sale contract. The security agreement provided for substitution of collateral, with appellants' consent. The collateral described in the agreement consisted of shares in two mutual funds, Investment Company of America (5,019 shares) and E. W. Axe Co. , Inc. [Axe Houghton Stock Fund] (7,497 shares). The security agreement further provided that Garry would retain legal title to the collateral, but appellants had the right to take physical possession of that collateral at any time and to hold.it until Garry had fulfilled his obligations under the installment notes, at which time the collateral would be returned to him. In the event of Garry's default in payment of the notes, appellants were empowered to sell or otherwise dispose of the collateral to the extent necessary to secure payment of the obligation remaining at the time of default.

On or about November 13, 1972, Garry Forsell sold the 1,916 shares of Bendix preferred stock he had acquired from appellants for a total price of $130,105.36. On that same date he invested $130,007.75 of the proceeds of that sale in 5,019 shares of Investment Company f America and 7,497 shares of Axe Houghton Stock Fund. 1/ At the end of April, 1972, Garry graduated from pharmacy school and he has had continuous employment as a pharmacist since that time. Through the years he allegedly .has made all of the agreed installment payments to appellants.

In their 1972 California personal income tax return, appellants used the installment method of reporting their gain on the sale of the 1,916 shares of Bendix preferred stock to Garry. Respondent audited that return and recomputed appellants' taxable income for 1972, including therein the total gain realized upon Garry's November sale of the Bendix stock. The basis for that action was respondent's determination that, for tax purposes, there had been no bona fide installment sale of the stock by appellants to their son in October of 1972 and the gain realized on Garry's subsequent sale of that stock therefore constituted taxable income to appellants in 1972. Appellants protested the resulting proposed assessment, which was in due course affirmed by respondent. That action gave rise to this appeal.

1/ It is to be noted that these mutual fund shares purchased in November, 1972, are the precise ones described as collateral in the security agreement dated October 5, 1972. The explanation given for insertion of the mutual fund shares in the earlier-dated security agreement is "attorney delay" in preparing the documents memorializing the October 5, 1972, agreement of sale. Appellants contend that since Garry's purchase of the mutual fund shares had occurred by the time the formal documents of sale were completed, those purchased assets were incorporated as substituted collateral in the final draft of the security agreement.

The general rule is that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis of the property. (Rev. & Tax. Code, § 18031, subd. (a).) Such gain is generally included in the taxpayer's computation of taxable income according to his normal accounting method. (Rev. & Tax. Code, § 17561, subd. (a).) Thus, a cash basis taxpayer would normally report his entire gain from a sale of property in the year in which the sale occurred. In certain circumstances, however, the installment method of accounting may be utilized to report such gain. Section 17578 of the Revenue and Taxation Code provides generally that, at the election of the taxpayer, income from the sale of personal property for a price exceeding $1,000 may be reported on the installment method if, in the year of sale, the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price. This provisipn is substantially similar to section 453(b) of the Internal Revenue Code of 1954.

The purpose of section 17578, and its federal counterpart, is to provide relief for the taxpayer by matching the timing of the payment of tax to the receipt of the sales price. (Commissioner v. South Texas Lumber Co., 333 U.S. 496, 503 [92 L. Ed. 831] (1948).) As a relief measure, the installment sale provisions are to be narrowly construed (Cappel House Furnishing Co. v. United States, 244 F. 2d 525, 529 (6th Cir. 1957)), and taxpayers have been denied the benefits of the installment method of reporting whenever the transfer in question is found not to have been a true installment sale. (See, e. g., Griffiths v. Helvering, 308 U.S. 355 [84 L. Ed. 319] (1939) and Everett Pozzi, 49 T. C. 119 (1967); see also Rev. Rul. 73-157, 1973-1 Cum. Bull. 213 and Rev. Rul. 73-536, 1973-2 Cum. Bull. 158.) In this regard, transactions purporting to be installment sales between family members or other closely related parties are given special scrutiny by the taxing authorities. (See, e.g., Philip W. Wrenn, 67 T. C. 576 (1976) and William D. Pityo, 70 T.C. 225 (1978).)

Appellants dispute respondent's disallowance of their use of the installment method of reporting, contending that their transfer of Bendix preferred stock to Carry clearly qualified as an installment sale, under the express language of section 17578 of the Revenue and Taxation Code. They claim they had valid business and personal purposes for structuring the transfer as they did. In that, regard they argue that, with appellant Mr. Forsell's approaching retirement, they needed to increase the return on his investments; in addition, their son stood to realize a profit from the transaction.

Appellants believe they find support for their position in the United States District Court's decision in Nye v. United States, 407 F. Supp. 1345 (M. D. N. C. 1975). The taxpayers therein were husband and wife who were both active and financially successful professionals, he a lawyer and she a medical doctor. Roth had sizeable separate estates. Mrs. Nye owned, as her separate property, certain stock which had appreciated greatly in value. Her husband was principal financier of a construction project and he needed $100,000 in cash by June **1969,** in order to meet an obligation under a construction financing agreement. Although Mr. Nye clearly had ample personal resources to make that payment, he instead purchased a block of his wife's greatly appreciated stock in February of 1969, with the intention of selling it in order to obtain the required cash. Mrs. Nye's transfer of stock to her husband was structured as an installment sale, at four percent interest, and it met all of the technical requirements of section 453 of the Internal Revenue Code of 1954. It was undisputed that Mr. Nye paid the full market value for his wife's stock and made all the agreed payments of principal and interest. Approximately five months after the purported installment sale, Mr. Nye sold most of the stock he had acquired from his wife for $100,381.72. For federal income tax purposes the Nyes used the installment method of reporting Mrs. Nye's gain on the transaction. The use of that method was disallowed by the Internal Revenue Service on the ground that there was no bona fide installment sale, as Mr. Nye was merely acting as his wife's agent in the transaction.

The federal district court in Nye searched for an appropriate standard to apply in testing thealidity of the purported installment sale between Mr. and Mrs. Nye. It found that standard in Rushing v. Commissioner, 441 F. 2d 593 (5th Cir. 1971), a case involving the tax consequences of an installment sale of stock in a wholly owned corporation to an irrevocable family trust, and a subsequent liquidation of the corporation. The Rushing court stated, in pertinent part:

> . . . a taxpayer may, if he chooses, reap the tax advantages of the installment sales provision if he actually carries through an installment sale, even though this method was used at his insistence and was designed for the purpose of minimizing his tax. [Citations omitted.] On the other hand, a taxpayer certainly may not receive the benefits of the installment sales provisions if, through his machinations, he achieves in reality the same result as if he had immediately collected the full sales price, . . . As we understand the test, in order to receive the installment sale benefits the seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom. (Emphasis added.) (441 F. 2d at 598.)

Applying this-test in Nye, the court concluded that after the installment sale of stock to her husband, Mrs. Nye retained no effective benefit or control over the proceeds of the subsequent sale of that stock by Mr. Nye. The court seemed impressed by the economic independence of the spouses, finding them to be separate and very healthy economic entities who had entered into a bona fide installment sale contract. It rejected the notion that the mere fact that the buyer and seller were married should deprive Mrs. Nye of the benefits of reporting her gain on the transaction by the installment method.

Respondent concedes that the manner in which appellants herein transferred their Bendix preferred stock met all of the statutory requirements for an installment sale. Despite such formal compliance, however, respondent contends that, for tax purposes, the transaction was not a bona fide installment sale because it lacked economic substance-and had no purpose other than tax avoidance. In support of its position, respondent relies primarily on the United States Tax Court's decision in

Philip W. Wrenn, supra, 67 T. C. **576 (1976).** That case involved a transfer of common stock by Mr. Wrenn to his wife in what purported to be an installment sale. Pursuant to the terms of the contract which they executed, Mrs. Wrenn was to make monthly payments of principal and interest to her husband for a period of fifteen years, and was to provide him with security for payment of the agreed price ($250,000) by' purchasing mutual fund shares in an amount equal to the purchase price of his stock. Immediately after Mr. Wrenn's transfer of the stock to his wife, she sold the entire block on the open market and purchased 'mutual fund shares worth $250, 000.

The tax court held that the Wrenns were not entitled to use the installment method of reporting Mr. Wrenn's gain on the transfer of stock to his wife because they had failed to establish that the transaction was a bona fide installment sale for tax purposes. In reaching this conclusion the Wrenn court 'observed that in order for an interspousal transfer of this type to be deemed bona fide, it must be shown that the transaction had economic substance and. that there was some substantive purpose other than tax avoidance underlying its structure as an installment sale. The court noted that Mrs. Wrenn obviously did not buy her husband's stock for its intrinsic value, because she immediately resold it. Nor was she in need of funds for any independent business or personal purpose, being herself a successful businesswoman of substantial means. Conceding that there may be factual situations in which an installment sale between spouses has substance and validity, as in Nye, the court remained unconvinced that Mrs. Wrenn had any bona fide. reason for entering into the stock transfer other than to assist her husband in his scheme of tax avoidance. Respondent contends that the transaction involved in the instant case similarly lacked economic substance, and that Garry was merely a conduit or straw man through which his parents accomplished a sale of their Bendix stock for cash and a purchase of mutual funds with the proceeds.

This appeal presents a case of first impression to our board. In order to put the Nye and Wrenn decisions into perspective, and in an effort to ascertainthe limitations on the availability of the installment method of reporting gain on intrafamily transfers, we believe it will be helpful to review a series of more recent United States Tax Court decisions, some of which are presently under appeal.

The validity of installment sales by taxpayers to family trusts has been upheld in William D. Pityo, supra, 70 T.C. 225 (1978); Clair E. Roberts, 71 T. C. 311 (1978), on appeal (USCA, 9th Cir. , April 27, 1979); and James H. Weaver, Jr., 71 T.C. 443 (1978), on appeal (USCA, 6th Cir., June 22, 1979): In all of these cases the taxpayers created irrevocable trusts for the benefit of family members; they then sold stock to the trusts on the installment basis. In Pityo and Weaver the trustee was a bank, and in Roberts the co-trustees were the taxpayer's brother and his accountant, both of whom were found by the court to have acted independently of the taxpayer. In no case did the trustee give the taxpayer-transferor any security for payment of the purchase price. In each case the tax court determined that the existence of a viable and independent trust met the Rushing test because, by creating the irrevocable trust, the taxpayer had relinquished control over the stock transferred to the trust. As a result, the taxpayer did not actually or constructively receive or derive economic benefit, from the proceeds of the trustee's subsequent sale of the stock, and he was therefore entitled to use the installment method of reporting his gain on the transfer of stock to the trust.

On the same date as his decision in the Roberts case, Judge Samuel B. Sterrett of the United States Tax Court issued his opinion in Paul G. Lustgarten, 71 T.C. 303 (1978), on appeal (USCA, 5th Cir. , April 30, 1979), holding that the taxpayer therein was not entitled to use the installment reporting method because he had failed to meet the Rushing test. Mr. Lustgarten "sold" common stock valued at over $1,000,000 to his son, Bruce, under an installment sale contract. The contract required Bruce to execute a promissory note and to purchase specified mutual fund shares in an amount equal to the purchase price as security for his payment of that price. The mutual fund shares were to be placed in an escrow account at a financial institution and monthly installment payments to Mr. Lustgarten were to be made out of escrow proceeds. Within two weeks after execution of the purported installment sale agreement, Bruce sold the stock he had acquired from his father and, using the entire proceeds, purchased the required mutual fund shares and placed them in escrow.

Judge Sterrett agreed with the Commissioner that Mr. Lustgarten was not entitled to use the installment method of reporting his gain on the transaction because, by his use of his son as an agent and his beneficial use of an escrow account, he had retained control over the proceeds of his son's sale of the common stock and had therefore constructively received the entire purchase price in the year of sale. The court pointed out that the substance of the transaction was as if Mr. Lustgarten himself had sold the common stock and purchased the mutual fund shares. The court also observed that Bruce did not have sufficient funds of his own to purchase either his father's stock or the mutual fund shares. He therefore was forced by the terms of the agreement to sell the common stock and purchase the shares in the mutual funds, which would produce the income necessary for him to make the payments to his father.

In attacking the validity of installment sales to related parties, the Internal Revenue Service has used a variety of legal theories, including substance over form, step transaction, assignment of income, and constructive receipt. After thorough review of the existing case law, we conclude that whatever legal theory is applied, the ultimate determination is whether the purported installment sale has economic substance and reality. In making that determination, questions which must be asked are whether the taxpayer-seller has truly parted with control, whether the intermediate party (the buyer) has independent significance or is merely a conduit, and whether the seller, in reality, has achieved the same result as if he had immediately collected the full sale price,

With these thoughts in mind, we turn to the case at hand. In late 1972 appellant Mr. Forsell was approaching retirement and he wanted to enhance his retirement income by increasing the return on his investments. Although his Bendix preferred stock had appreciated greatly in value since he began acquiring it in 1948, it produced a relatively low rate of return. In 1972 "blue-chip" mutual funds presented a much more attractive annual rate of return, plus a growth potential. Had appellant Mr. Forsell instructed his broker to sell the Bendix preferred stock on the open market for cash and to invest the entire proceeds from that sale in mutual funds, appellants would have realized a substantial capital gain and incurred significant tax liability in the year of sale.

Unlike the husband-purchaser in the Nye case, Garry was not at the time of the transaction a separate economic entity with an independent purpose for entering into the installment sale arrangement.

We conclude that appellants have failed to meet the Rushing test and the standards established in later cases. After the transaction was completed, appellants directly or indirectly retained control of the proceeds of Garry's sale of the Bendix preferred stock, through their close relationship with their son and their rights under the security agreement. Respondent's inclusion in appellants' taxable income for 1972 of the gain realized upon that later sale must therefore be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Palmer C. and Norma K. Forsell against a proposed assessment of additional personal income tax in the amount of $6,568.10 for the year 1972, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of February, 19~~79~~, by the State Board of Equalization.
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______________________, Chairman

______________________, Member

______________________, Member

______________________, Member

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