20 T.C. 56 (1953)

Amounts received for the use of corporate property by a partnership comprised of shareholders owning 25% or more of the corporation's stock constitutes personal holding company income, even if the sublease is to the partnership rather than individual shareholders.

Summary

O. Falk's Department Store, Inc. and Franklin Polk Corporation challenged the Commissioner's determination that they were personal holding companies in 1945, subject to surtax and penalties for failing to file required returns. The Tax Court held that both corporations met the definition of a personal holding company because over 80% of their income was derived from rent, and more than 50% of the stock was owned by a small group of individuals. However, the Court found the failure to file was due to reasonable cause, as the corporations relied on professional advice, and thus, no penalties were assessed.

Facts

Franklin Polk Corporation (P) owned real estate leased to O. Falk's Department Store, Inc. (F). F subleased the property to a partnership formed by David Falk, Annie Falk Mandel, and Frank Mandel, who also held a majority of F's stock. The partnership operated a department store on the property and paid rent to F. F's primary income consisted of rent received from the partnership. Franklin Polk Corporation's income primarily consisted of rent from O. Falk's Department Store, Inc.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in personal holding company surtax and additions to tax for failure to file personal holding company returns against both O. Falk's Department Store, Inc. and Franklin Polk Corporation for the tax year 1945. The taxpayers petitioned the Tax Court, contesting the Commissioner's determination. The Commissioner conceded no tax or penalty was due for 1946.

Issue(s)

1. Whether O. Falk's Department Store, Inc. and Franklin Polk Corporation were personal holding companies during the calendar year 1945 and subject to the personal holding company surtax under the Internal Revenue Code.

2. Whether O. Falk's Department Store, Inc. and Franklin Polk Corporation are subject to the 25% addition to tax for failure to file personal holding company tax returns for the taxable year 1945.

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Holding

1. Yes, because both corporations met the definition of a personal holding company under the Internal Revenue Code, as their income was primarily derived from rent, and over 50% of their stock was owned by five or fewer individuals.

2. No, because the failure to file personal holding company tax returns was due to reasonable cause and not willful neglect, as the corporations relied on the advice of a qualified certified public accountant.

Court’s Reasoning

The court determined that both corporations’ income qualified as personal holding company income under Section 502(f) of the Internal Revenue Code, which includes “amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 per centum or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property.” The court relied on Section 503(a)(1) stating that stock owned by a corporation shall be considered as being owned proportionately by its shareholders. The court rejected the argument that leasing to a partnership insulates individual stockholders. Citing *Western Transmission Co.*, 18 T.C. 818. The court also found that reliance on a qualified tax expert constituted reasonable cause for failing to file the returns, precluding penalties.

Practical Implications

This case clarifies that a corporation cannot avoid personal holding company status by leasing property to a partnership comprised of its shareholders. The stock ownership rules apply even when the property is used by a partnership. This reinforces the principle that tax law looks to the substance of a transaction over its form. The case also reaffirms the "reasonable cause" exception to failure-to-file penalties when taxpayers rely in good faith on the advice of qualified professionals, even if that advice turns out to be incorrect. This decision underscores the importance of seeking and documenting professional tax advice.

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