***Rappaport v. Commissioner*, 36 T.C. 117 (1961)**

Losses claimed by a sole stockholder from transactions with his wholly owned corporation will be disallowed if the transactions lack an arm's-length relationship and lack economic substance.

Summary

The case concerns a taxpayer, Rappaport, who was both a building contractor and the sole stockholder of two corporations. He contracted with his corporations to build housing projects. His costs exceeded the contract prices, and he sought to deduct these excess costs as business losses. The Tax Court disallowed the deductions, finding that Rappaport's transactions with his wholly owned corporations lacked an arm's-length relationship. The court reasoned that Rappaport's actions primarily benefited himself as the stockholder through increased stock value rather than the corporations, and the transactions lacked economic substance. The court emphasized the need for special scrutiny when a sole stockholder deals with a wholly owned corporation and determined that the excess costs were capital contributions.

Facts

Rappaport, a building contractor, was the sole stockholder of two corporations, Frederick Courts, Inc., and Parkwood, Inc., formed to develop rental housing. He contracted with each corporation to construct housing projects, but his costs exceeded the contract prices. He voluntarily supplied materials of a higher grade than required in the contracts. Although the contracts were amended, Rappaport still incurred unreimbursed costs. Rappaport sought to deduct these unreimbursed costs as business losses under Section 23(e) of the Internal Revenue Code of 1939.

Procedural History

The Commissioner of Internal Revenue disallowed Rappaport's claimed loss deductions. Rappaport petitioned the Tax Court to challenge the Commissioner's determination.

Issue(s)

Whether the taxpayer is entitled to deduct as losses, under Section 23 (e) of the Internal Revenue Code of 1939, the unreimbursed costs incurred in construction contracts with his wholly-owned corporations.

Holding

No, because the transactions lacked arm's-length relationships and were essentially capital contributions rather than true business losses.

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Court’s Reasoning

The court focused on the lack of an arm’s-length relationship between Rappaport and his corporations. It emphasized that transactions between a sole stockholder and their wholly owned corporation warrant special scrutiny. The court found that Rappaport’s actions, such as providing higher-quality materials, primarily benefited him as the stockholder and were not driven by a profit motive for the corporations. The court cited *Higgins v. Smith*, which disallowed a loss on a sale to a wholly-owned corporation. The court referenced *Crown Cork International Corporation*, which stated that transactions should be disregarded if the individual existence of the two entities is an unsupported fiction or if the transaction itself is without a true purpose except that of tax avoidance. The court determined that Rappaport controlled the corporations and could have adjusted the contract prices further, making the excess costs capital contributions that increased his stock basis, not deductible losses.

The court referenced the following quote from *Higgins v. Smith*: “Indeed this domination and control is so obvious in a wholly owned corporation as to require a peremptory instruction [to a jury] that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity.”

Practical Implications

This case highlights the importance of maintaining an arm’s-length relationship in transactions between related parties, especially a sole stockholder and their wholly-owned corporation. Legal professionals should advise clients to document transactions with related entities thoroughly and demonstrate that they were conducted at fair market value and for legitimate business purposes. Failure to do so could result in the disallowance of claimed losses and may trigger scrutiny from the IRS. When dealing with sole proprietorships, closely held corporations, and/or transactions between them, an attorney should advise the client that substance over form should be considered. Tax planning in these situations should prioritize economic reality, not just tax minimization. Courts may recharacterize the transactions, as they did here, treating them as contributions to capital rather than deductible business losses. This case is still relevant, as evidenced by citations, and provides a strong basis for the IRS to challenge similar transactions lacking economic substance and conducted without a true arm’s-length relationship.

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