28 T.C. 246 (1957)

A corporation formed to construct property, with the intent to distribute funds to shareholders or have them sell stock before realizing substantial income from the property, is a collapsible corporation, and gains from stock transactions are treated as ordinary income.

Summary

In 1950, Raymond Burge and his associates formed Park Terrace, Inc., to build and operate apartment buildings. The corporation obtained a loan exceeding construction costs. After construction, the corporation redeemed its class B stock, distributing cash to Burge. A few months later, Burge sold his class A stock. The IRS determined that Park Terrace, Inc., was a "collapsible corporation" under Section 117(m) of the Internal Revenue Code of 1939, and treated Burge's gains from both the stock redemption and sale as ordinary income, not capital gains. The Tax Court agreed, finding that the corporation was formed with a view to these stock transactions before realizing substantial income from the apartments. The court emphasized that the distribution of excess loan proceeds, even in cash, triggered the collapsible corporation rules, making Burge's gains taxable as ordinary income.

Facts

Raymond Burge, along with Lawson Lester, Jr., and W.B. Pollard, formed Park Terrace, Inc., to build apartments for colored occupancy. They obtained an FHA-insured loan for $1,632,000, exceeding the actual construction costs. The corporation issued class A and class B stock. Burge, Lester, and Pollard each received class B stock. After the apartments were built and before substantial rental income was realized, Park Terrace, Inc., redeemed all of its outstanding class B stock for cash. Subsequently, Burge sold his class A common stock. The IRS determined that Park Terrace, Inc., was a collapsible corporation and reclassified Burge's gains on the redemption and sale of stock from long-term capital gains to ordinary income.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Raymond G. Burge's income taxes for 1950 and 1951. Burge challenged these determinations in the United States Tax Court. The Tax Court agreed with the IRS and upheld the assessment of taxes as ordinary income.

Issue(s)

1. Whether Park Terrace, Inc., was a "collapsible corporation" under Section 117(m) of the 1939 Internal Revenue Code.
2. Whether the gain realized by Burge from the redemption of his class B stock was subject to treatment as ordinary income under Section 117(m).

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3. Whether the gain realized by Burge from the sale of his class A stock was subject to treatment as ordinary income under Section 117(m).

Holding

1. Yes, because the corporation was formed with a view to the sale or exchange of stock or distribution to its shareholders prior to the realization by the corporation of a substantial part of the net income to be derived from such property, and with a view to the realization by the shareholders of gain attributable to such property.
2. Yes, because the distribution of cash in redemption of the stock was a distribution made before substantial income was realized, and the gain was attributable to the apartment construction.
3. Yes, because the corporation was collapsible, and the sale of stock was therefore subject to ordinary income tax treatment.

Court's Reasoning

The court analyzed whether Park Terrace, Inc., met the definition of a "collapsible corporation" under Section 117(m) of the 1939 Internal Revenue Code. The statute defines a collapsible corporation as one formed or availed of principally for the construction of property with a view to the sale or exchange of stock by its shareholders or a distribution to its shareholders before the corporation realizes a substantial part of the income from the property, and with a view to shareholder gain. The court found that Park Terrace, Inc., was formed with the requisite "view" based on the timing of the redemption of the class B stock and sale of the class A stock, both occurring before substantial rental income had been realized. The court rejected the petitioner's argument that Section 117(m) only applied to temporary corporations or distributions of property, holding that the statute explicitly covered both sales and exchanges of stock and distributions and made no distinction between distributions of cash and property. The Court emphasized, "[i]f Congress has made a choice of language which fairly brings a given situation within a statute, it is unimportant that the particular application may not have been contemplated by the legislators."

Practical Implications

This case provides guidance on what constitutes a "collapsible corporation" under the tax code. It clarifies that corporations formed to construct property, even those that continue to operate the property after stock transactions, can be collapsible if the intent is to allow shareholders to realize gains from the property before substantial income is realized by the corporation. It also indicates that distributions of cash, not just property, are covered under Section 117(m). Therefore, tax advisors should closely examine the intent of the principals in forming the corporation, the timing of stock transactions relative to income realization, and the nature of distributions when advising clients involved in real estate development or other

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construction projects. This decision impacts tax planning by establishing that early distributions of excess loan proceeds, even in cash, trigger the collapsible corporation rules. Later cases would need to determine when a “substantial part” of the income has been realized, but this case makes clear that Congress intended to capture these types of transactions to prevent tax avoidance.

Meta Description

The Burge case clarifies the definition of a “collapsible corporation,” and the applicability of Section 117(m) to stock redemptions and sales before the corporation realizes substantial income, resulting in gains taxed as ordinary income.

Tags

Burge v. Commissioner, Tax Court, 1957, Collapsible Corporation, Section 117(m), Stock Redemption, Ordinary Income

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