28 T.C. 795 (1957)

A corporation formed or availed of principally for the construction of property, with a view to its shareholders realizing gain before the corporation recognizes substantial income from that property, is considered a "collapsible corporation," and the shareholders' gain is taxed as ordinary income rather than capital gain.

Summary

The case involves a dispute over whether the gain realized by J.D. and Kathryn Abbott and Carl M. and Mary E. Wolfe from the liquidation of Leland Corporation should be taxed as ordinary income or capital gain. The Internal Revenue Service (IRS) asserted that Leland was a "collapsible corporation" under Section 117(m) of the Internal Revenue Code of 1939, meaning it was formed for the construction of property with the intent to allow shareholders to realize gain before the corporation recognized substantial income. The Tax Court agreed with the IRS, finding that Leland's activities, including land subdivision, street and utility installation, and securing F.H.A. commitments, constituted construction, and the corporation was availed of to avoid ordinary income tax. The court held that the petitioners' gain from the liquidation was taxable as ordinary income, and also upheld additions to tax for the Wolfes due to failure to file a declaration of estimated tax.

Facts

Leland Corporation was formed to buy and develop real estate for single-family homes. Leland purchased several tracts of land. The corporation contracted for the installation of streets, curbs, and sewers. Abbott's corporation secured F.H.A. site approval for building apartments and engineered the layout and plans. Abbott acquired a 75% interest in Leland. Leland contracted with the township to complete the necessary improvements, including streets and sewers, in exchange for the recording of development plans. Leland shareholders voted to dissolve and distribute the assets to the shareholders. Petitioners, after receiving the land, sold it. The IRS determined that Leland was a collapsible corporation and reclassified the petitioners' gains from long-term capital gains to ordinary income.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in income tax and additions to tax against petitioners. The petitioners challenged the determination in the United States Tax Court. The Tax Court consolidated the cases for trial and rendered a decision in favor of the Commissioner, finding Leland Corporation to be collapsible under Section 117(m) of the Internal Revenue Code of 1939.

Issue(s)

1. Whether Leland Corporation was a "collapsible corporation" under Section 117(m) of the Internal Revenue Code of 1939.

2. Whether the gain realized by petitioners on the liquidation of Leland should be taxed as ordinary income or capital gains.

3. Whether additions to tax were properly imposed on the Wolfes for failure to file a declaration of estimated tax and underestimation of tax.

Holding

1. Yes, Leland Corporation was a collapsible corporation because it engaged in construction with a view to shareholder gain before substantial income realization by the corporation.

2. Yes, the gain realized by the petitioners was properly taxable as ordinary income.

3. Yes, the additions to tax were properly imposed on the Wolfes.

Court's Reasoning

The court focused on whether Leland was formed or availed of principally for the "construction" of property under Section 117(m). The court defined "construction" broadly, including land subdivision, street and utility installation, and securing F.H.A. commitments. The court found that Leland's activities, even if some work occurred after the land was distributed to the shareholders, constituted construction. The court reasoned that the corporation was "availed of" for tax avoidance purposes, as the liquidation allowed shareholders to realize gains that would have otherwise been taxed as ordinary income to the corporation. The Court noted, "all of the provisions in question would be meaningless. If it were otherwise, and if individuals could thus project the acts which would take place after distribution and dissolution as though the corporation was in no sense a participant…" The court rejected the petitioners' argument that they were not engaged in construction, stating that the securing of F.H.A. commitments, subdivision, and street improvement was part of the construction of property. The Court also upheld the additions to tax against the Wolfes, finding that the failure to file a declaration of estimated tax was not due to reasonable cause. The Court found that the gain should be treated as ordinary income, and the gain was attributable to the property constructed.

Practical Implications

This case has significant implications for real estate developers and other businesses that undertake construction projects through corporations. It clarifies the definition of "collapsible corporation" and the broad scope of activities considered "construction."

1. **Tax Planning:** Attorneys must advise clients that if a corporation is formed or availed of primarily to construct property, and there is a plan to distribute the property or sell stock before the corporation recognizes a substantial amount of

income from the property, the shareholders' gains will likely be treated as ordinary income. This case highlights the importance of careful tax planning to avoid collapsible corporation status, including delaying liquidation or sale until the corporation has recognized substantial income.

2. **"With a View To" Requirement:** The court's emphasis on the "with a view to" requirement underscores the need for careful analysis of the corporation's intent and the timing of events. If the liquidation or stock sale is not planned from the outset of the project, the collapsible corporation rules may not apply. However, the court found in Abbott that although there was an intention to liquidate the corporation by prior stockholders, there was a change in the control of the corporation, and the change in control constituted an intention by Abbott to liquidate the corporation. Therefore, even though there was no direct evidence that the corporation was formed with the specific intent to be collapsible, the fact that the corporation was availed of to create this result triggered the rules. Evidence of the shareholder's intent will be considered.

3. **Construction Activities:** Attorneys should advise clients that a wide range of activities can constitute "construction," not just the physical building itself. Preparing land for construction, including securing financing and making improvements, can be sufficient.

4. **Ordinary vs. Capital Gain:** The case underscores the potentially significant tax consequences of mischaracterizing the nature of income. Proper classification is critical.

5. **Substantial Income:** This case demonstrates how to assess whether a substantial part of income has been realized. The more income realized, the more likely the rules do not apply.

