29 T.C. 959 (1958)

In a tax deficiency case involving a collapsible corporation under section 117(m) of the 1939 Internal Revenue Code, the burden of proof rests on the taxpayer to demonstrate that the corporation does not meet the criteria for classification as a collapsible corporation, when the IRS's initial determination is based on ordinary income tax rates.

Summary

Arthur and Henrietta Sorin challenged the IRS's determination that a $50,000 distribution Henrietta received from Garden Hills, Inc. was taxable as ordinary income under section 117(m) of the 1939 Internal Revenue Code, which deals with collapsible corporations. The Sorins contended the income should be treated as capital gains. The Tax Court held that because the IRS's initial deficiency notice broadly asserted taxability at ordinary income rates, the Sorins bore the burden of proving that the corporation was not collapsible. They failed to present sufficient evidence to meet this burden, and the court therefore upheld the IRS's assessment.

Facts

Arthur and Murray Sorin were executives in an air-conditioning firm. In 1948, Murray purchased land in Forest Hills, New York. They decided to construct apartments on the land through Garden Hills, Inc., a corporation formed in 1949. Murray and Arthur caused the stock of Garden Hills, Inc. to be issued in the names of their wives, Henrietta and Patricia. The corporation obtained FHA-insured financing to construct a rental housing project. Garden Hills, Inc. leased the land from Murray. In 1950, Garden Hills, Inc. distributed $100,000 in cash to its common stockholders, with Henrietta receiving $50,000. The IRS determined this distribution was fully taxable as ordinary income under section 117(m) of the 1939 Internal Revenue Code. The Sorins reported the distribution as a capital gain and contested the IRS's determination.

Procedural History

The IRS determined a tax deficiency against Arthur and Henrietta Sorin for the 1950 tax year, based on the reclassification of a distribution from Garden Hills, Inc. from capital gains to ordinary income, under the collapsible corporation rules. The Sorins petitioned the Tax Court to contest the deficiency. The Tax Court heard the case and issued a decision.

Issue(s)

1. Whether the IRS, when issuing a deficiency notice, needs to specifically cite the section of the Internal Revenue Code (e.g., Section 117(m)) as a basis for assessing the deficiency?

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2. Whether the petitioners successfully proved that the distribution from the corporation was not subject to ordinary income tax rates as a collapsible corporation.

Holding

1. No, because the deficiency notice specified “ordinary income tax rates,” it did not limit the IRS from applying Section 117(m).

2. No, because the taxpayers did not meet their burden of proof that the corporation was not a collapsible corporation.

Court’s Reasoning

The Tax Court determined that the deficiency notice, which stated that the distribution was taxable at ordinary income tax rates, was broad enough to encompass the application of section 117(m). The Court distinguished the case from situations where the IRS specifically cites a section of the code in the deficiency notice and then later attempts to rely on a different, undisclosed ground. In the present case, the Court held that, as the deficiency notice was general, the burden was on the taxpayers to demonstrate that their situation was not covered by the Code section. The Court reasoned that the taxpayers failed to prove that the corporation was not formed or availed of principally for the construction of property with a view to a distribution to shareholders before realization of substantial income.

The Court found that the taxpayers did not present sufficient evidence to show that the corporation did not meet the definition of a collapsible corporation, and therefore, upheld the IRS’s assessment.

Practical Implications

This case emphasizes the importance of the initial IRS notice of deficiency. If the IRS’s initial determination is broad and does not specify a particular legal theory, the taxpayer bears the burden of proof to show the IRS’s position is incorrect. Therefore, attorneys must carefully evaluate the facts to see if they have the burden of proof. The case also underscores the importance of presenting sufficient evidence to rebut the IRS’s arguments. Attorneys must anticipate the IRS’s potential arguments and gather the necessary evidence to counter them, especially when dealing with potentially complex areas of tax law like collapsible corporations. Subsequent cases will likely follow the reasoning here that a general notice of deficiency puts the burden of proof on the taxpayer, and that detailed evidence is needed to overcome that burden.

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