***Rechner v. Commissioner*, 30 T.C. 186 (1958)**

The sale of stock in a corporation formed for the construction of property, where the sale occurs before the corporation realizes substantial income from the property, and with the intention of avoiding ordinary income tax, will be treated as ordinary income under the collapsible corporation provisions of the Internal Revenue Code, even if the sale is to a related entity.

Summary

The Rechner case addressed whether the sale of stock in two construction corporations (Vicksburg and Concord) to a third corporation (East Side), all controlled by the same individuals (Rechner and Swan), should be taxed as ordinary income or capital gains. The Commissioner argued the corporations were "collapsible corporations" under the 1939 Internal Revenue Code, designed to convert ordinary income into capital gains. The court agreed, finding that the corporations were formed principally for construction, that the stock sales occurred before the corporations realized substantial income from their projects, and that the shareholders intended to realize gains attributable to the projects. The court rejected the petitioners' arguments that the sale to a related entity should be treated differently and that post-construction motives for the sale should be considered. The court's decision affirmed the Commissioner's determination, holding that the gains were taxable as ordinary income, as Congress intended to prevent the use of collapsible corporations to avoid ordinary income tax rates. The court highlighted that the critical factor was the intent to realize gains prior to the corporation's realization of substantial income from the projects.

Facts

- Carl B. Rechner and Howard W. Swan (along with their wives), formed three corporations (East Side, Vicksburg, Concord) to build and operate rental housing projects under the National Housing Act.
- East Side completed its project first; Vicksburg and Concord constructed similar apartment buildings shortly thereafter.
- Rechner and Swan owned most of the common stock in all three corporations.
- Before Vicksburg and Concord realized substantial income from the projects, Rechner and Swan decided to sell their stock in these two corporations to East Side.
- The Federal Housing Administration (FHA) approved the sale, contingent on the cancellation of a builder's fee owed to Rechner and Swan by East Side.
- Rechner and Swan transferred their Vicksburg and Concord stock to East Side.
- Rechner and Swan reported long-term capital gains from the sale on their 1952 tax returns.
- The Commissioner determined that the gain should be taxed as ordinary income because Vicksburg and Concord were collapsible corporations.

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Procedural History

The Commissioner of Internal Revenue determined deficiencies in the taxpayers' income tax and additions to tax, arguing that the gains from the stock sales should have been taxed as ordinary income and not as capital gains. The taxpayers challenged this determination in the United States Tax Court.

Issue(s)

1. Whether the gain realized by Rechner and Swan on the transfer of stock in Vicksburg and Concord to East Side is taxable as ordinary income from the sale or exchange of stock in a collapsible corporation under section 117 (m) of the Internal Revenue Code of 1939.
2. The correct amount of the addition to the tax under section 294 (d) (1) (A) for failure to file a declaration of estimated tax. This issue was dependent on the resolution of the first issue.

Holding

1. Yes, the gain realized is taxable as ordinary income because Vicksburg and Concord are collapsible corporations.
2. The court's determination on the first issue is determinative of the second.

Court's Reasoning

The court applied Section 117(m) of the 1939 Internal Revenue Code, which addressed collapsible corporations. A key provision, 117(m)(2), defines a collapsible corporation as one formed or availed of principally for the construction of property with the view to (i) the sale or exchange of stock by its shareholders before the corporation realizes a substantial part of the net income from the property and (ii) the realization by such shareholders of gain attributable to such property. The court found that the facts of the case clearly fell within the scope of the statute.

The court referenced Burge v. Commissioner, where the shareholders sold their stock after construction was substantially completed. The court emphasized that the statute does not require the sale to be to an outside interest, and the intention of Congress was to prevent the conversion of ordinary income into capital gains through this device. The court stated, "[W]e think we are bound to follow the language of the statute and not restrict the meaning of the words employed merely because the committee reports refer to the basic type of transaction which gave rise to the legislation."

The court rejected the taxpayers' arguments that the sale to a related entity should be treated differently, stating that Congress's concern was with the overall attempt to convert ordinary income into capital gains. The court also considered whether the reasons for the sale of the stock were based on post-construction factors, but found the reasons for sale were attributable to circumstances that could have been

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reasonably anticipated at the time of construction, thus within the scope of the statute.

Practical Implications

- This case provides guidance on what constitutes a collapsible corporation and clarifies that sales to related parties fall within the scope of the collapsible corporation rules.
- Attorneys should carefully analyze the timing of stock sales relative to income realization by the corporation and the intent of the shareholders.
- The decision highlights the importance of the “view” or intention of the shareholders at the time of construction or when availing the corporation for the sale or exchange of its stock. If the shareholder had the view to sell the stock before a substantial amount of income was realized by the corporation, the ordinary income treatment would be likely.
- This case illustrates how courts interpret tax laws based on the language of the statute, legislative history, and the broader policy considerations of preventing tax avoidance schemes.
- Later cases dealing with collapsible corporations often cite this case to underscore the application of the collapsible corporation rules, even when sales occur within a related group of corporations.

Meta Description

Rechner v. Commissioner clarified the application of collapsible corporation rules, particularly when stock sales occur within a controlled group, reinforcing the focus on shareholder intent and the timing of stock sales relative to corporate income.

Tags

Rechner, Collapsible Corporation, Tax Court, 1958, Section 117(m), Ordinary Income, Stock Sale

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