30 T.C. 969 (1958)

A corporation can be considered a "collapsible corporation" if it's formed or used to construct property with the intent to distribute funds to shareholders before realizing substantial income from the property, thus converting what would be capital gains into ordinary income for tax purposes.

Summary

The August case involved shareholders who owned all the stock in a corporation that built apartment houses. The corporation received construction loans exceeding construction costs, creating surplus funds. After construction was complete, the corporation distributed these surplus funds to the shareholders by redeeming a portion of their stock. The IRS argued that the corporation was a "collapsible corporation" under Section 117(m) of the Internal Revenue Code of 1939, meaning the shareholders' gain from the stock redemption should be taxed as ordinary income, not capital gains. The Tax Court agreed, holding that the corporation was formed and availed of for construction with the intent to distribute the surplus funds, triggering the "collapsible corporation" rules, and that more than 70% of the gain realized by the petitioners was attributable to the constructed property, negating the application of the 70% rule exemption.

Facts

The petitioners were siblings who owned all the stock of the Camden Housing Corporation. Camden constructed apartment houses (Washington Park Apartments) financed by loans insured by the Federal Housing Administration (FHA). The construction loans exceeded construction costs, resulting in surplus funds. After construction was complete, the corporation distributed $205,000 to the shareholders in redemption of half their stock. The petitioners then used these funds to finance another project. The IRS determined that the corporation was a collapsible corporation.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax for the taxable year 1950, arguing that the gains realized from the redemption of their stock in Camden were taxable as ordinary income. The petitioners challenged the deficiencies in the United States Tax Court. The Tax Court ruled in favor of the Commissioner.

Issue(s)

1. Whether Camden Housing Corporation was a "collapsible corporation" under Section 117(m)(2)(A) of the 1939 Internal Revenue Code?

2. If so, whether more than 70% of the petitioners' gain from the stock redemption

was attributable to the constructed property, as per Section 117(m)(3)(B)?

Holding

1. Yes, because Camden was availed of for the construction of property with a view to the distribution of funds to its shareholders before realizing substantial income from that property.

2. Yes, because more than 70% of the petitioners' gain was attributable to the construction of the apartment houses.

Court's Reasoning

The Court focused on whether the corporation was formed or availed of with the intent to distribute funds to shareholders before earning substantial income from the constructed property, as defined in Section 117(m)(2)(A). The Court found that the shareholders' plan from the outset was to utilize any surplus mortgage funds as working capital for other enterprises, which was a key factor. The Court referenced the regulations, specifically that "if the distribution is attributable solely to circumstances which arose after the construction" the corporation will not be considered a collapsible corporation, unless those circumstances could have been anticipated at the time of construction. The court determined that the intent and circumstances surrounding the distribution of surplus funds, while not determinable until after the completion of construction, were anticipated as a recognized possibility from the outset. The Court also addressed the 70% limitation in Section 117(m)(3)(B), stating that all of the gain realized by the petitioners on the partial liquidation was attributable to the constructed property. The Court referenced the *Burge* case, where the gain realized by the shareholders was "gain attributable to the property constructed" and held in line with the logic from *Glickman v. Commissioner*.

Practical Implications

This case highlights the importance of considering the tax implications of construction projects, especially those involving government-insured loans. It emphasizes that the IRS will scrutinize distributions of surplus funds from construction projects to determine if they are attempts to convert ordinary income into capital gains through the use of a "collapsible corporation." The case also indicates that a corporation can be considered "collapsible" even if the shareholders didn't have a specific plan for distribution at the construction's start, as long as the possibility of such a distribution was reasonably anticipated. This case is still relevant today, and serves as precedent for other similar cases. Corporate and tax attorneys need to carefully structure transactions and maintain documentation to avoid unintended tax consequences.