Payne v. Commissioner, 30 T.C. 1054 (1958)

A corporation formed or availed of principally for the construction of property with a view to the distribution of gain to its shareholders before realizing substantial income from the property can be classified as a collapsible corporation, and the gains from stock redemptions are taxed as ordinary income rather than capital gains.

Summary

The case involved taxpayers who formed multiple corporations to develop rental housing projects, structuring the corporations' capitalization to allow for the redemption of second preferred common stock after construction. The taxpayers argued that gains realized from the stock redemptions should be treated as capital gains. The Tax Court, however, held that the corporations were "collapsible" under I.R.C. § 117(m) because they were formed with a view to the distribution of gain to shareholders before the realization of substantial income by the corporations from their projects. Therefore, the gains were taxed as ordinary income. The court emphasized the taxpayers' intent, the corporations' structure, and the timing of the distributions in determining the tax treatment.

Facts

Leland Payne, J.T. Jenkins, and R.B. Walden, along with their spouses, were involved in promoting and constructing rental-housing projects under the Federal Housing Administration (F.H.A.) program. They formed six corporations (Highland Place corporations) and, in a separate venture, two more corporations (Big Spring corporations). Each corporation's capital structure included second preferred common stock, redeemable after construction, designed to allow the investors to recoup their land investment through distributions. The total loan proceeds exceeded construction costs. The corporations redeemed the second preferred common stock, distributing excess funds to the shareholders. The Commissioner of Internal Revenue determined that the gains from these stock redemptions were taxable as ordinary income, rather than capital gains. The Tax Court addressed whether the corporations were "collapsible" under I.R.C. § 117(m).

Procedural History

The Commissioner of Internal Revenue determined deficiencies in income tax and additions to tax for the tax year 1950. Taxpayers contested the determinations, leading to the consolidation of the cases before the Tax Court. The Tax Court upheld the Commissioner's determination, concluding the corporations were collapsible.

Issue(s)

1. Whether the gains realized by the taxpayers on the redemption of their second preferred common stock were taxable as gain from the sale or exchange of capital

assets.

2. Whether the gains were taxable as gain from distributions by collapsible corporations under section 117(m) of the Internal Revenue Code of 1939.

3. Whether the gains were taxable as compensation for personal services and for the supplying of building materials at cost under section 22(a) of the Internal Revenue Code of 1939.

4. Whether additions to tax should be assessed for the failure of taxpayers J.T. and Myrtle Jenkins and R.B. and Marcelle Walden to file a declaration of estimated tax.

Holding

1. No, because the corporations were collapsible.

2. Yes, because the corporations were formed or availed of principally for construction with a view to the distribution of gain to the shareholders before the realization of substantial net income from the property.

3. No, because the court found no evidence to support this position.

4. Yes, because there was no showing of reasonable cause for failure to file the declaration.

Court's Reasoning

The court focused on whether the corporations were "collapsible" corporations as defined by I.R.C. § 117(m). The court cited the definition of a collapsible corporation as one formed or availed of principally for the construction of property with a view to the shareholders' realizing gain through distributions before the corporation realizes substantial income. The court found that the taxpayers had the requisite intent to distribute the excess funds through stock redemption, as evidenced by the corporations' capital structure and the actual distribution of funds. The court rejected the taxpayers' argument that the statute required a pre-construction intent, stating that the intent could develop anytime during construction. The court also ruled that the taxpayers' activities in subdividing land, installing utilities, and securing financing were part of the "construction" process, which contributed to the gain. The court noted that the distributions were "attributable to circumstances present at the time of the * * * construction" and no "compelling facts to the contrary" have been shown to negate the presumption that all eight of these corporations were formed or availed of with the requisite view.

The court also rejected the argument that the Highland Place corporations had realized a substantial part of the net income prior to the redemption, and therefore, the exception to Section 117(m) should apply. Finally, the court rejected arguments that the gain was not primarily attributable to construction, pointing out the taxpayers’ contributions included the construction of the infrastructure.

The Court also found that the Commissioner’s notices of deficiency were sufficient. Furthermore, since the taxpayers’ failure to file declarations of estimated tax was not due to reasonable cause, they were liable for the additions to tax.

Practical Implications

This case is a key precedent for understanding collapsible corporations, which are often used in real estate development. It emphasizes that: (1) The form and timing of the corporation are central to the inquiry, (2) Taxpayers should be aware that the intent to distribute gains can be formed at any point during construction, not just before construction; and (3) Activities such as land preparation can constitute “construction.” Counsel must carefully advise clients on the tax implications of corporate structures and stock redemptions, especially in real estate or other projects where the intent is to realize gains before the corporation realizes a substantial amount of income. Practitioners should be aware of how courts will interpret the term “construction” and evaluate the timing of distributions and when that timing implicates collapsible corporation rules. This case is a caution to clients, when planning their business structures, of the potential tax consequences when attempting to recoup their investments.

Meta Description

The Tax Court’s ruling in Payne established that gains from stock redemption in a corporation formed to develop real estate were taxable as ordinary income because it was formed as a collapsible corporation under I.R.C. § 117(m).

Tags

Payne v. Commissioner, Tax Court, 1958, Collapsible Corporation, Stock Redemption, Real Estate Development, Ordinary Income