Rose Sidney, et al., v. Commissioner of Internal Revenue, 30 T.C. 1155 (1958)

A corporation formed to construct property with a view to distributing profits to shareholders before realizing substantial income from the property is considered a collapsible corporation, and distributions are taxed as ordinary income.

Summary

The United States Tax Court considered whether distributions made by two corporations to their shareholders were taxable as ordinary income or capital gains. The corporations were formed to construct housing projects, financed by F.H.A.-insured loans. The construction costs were less than the loan amounts, and the corporations distributed the excess funds to shareholders before realizing substantial net income from the projects. The court held that the corporations were "collapsible corporations" under Section 117(m) of the Internal Revenue Code of 1939, meaning the distributions were taxable as ordinary income, not capital gains. The court found the intention to distribute the excess funds existed during construction. The case underscores the importance of the timing of distributions and the intention of the corporation when evaluating collapsible corporation status.

Facts

Taxpayers organized two corporations, Kew Terrace, Inc. and Kew Terrace #2 Corp., to construct two housing projects. The projects were financed with F.H.A.-insured loans. Construction costs were less than the loan amounts. In January and February 1950, and again in August 1951, the corporations made distributions to their shareholders using the excess funds, before the projects generated substantial income. The corporations then filed their Federal income tax returns on a fiscal year basis. The Commissioner determined deficiencies, asserting that the distributions should be taxed as ordinary income under section 117(m) of the Internal Revenue Code of 1939. The taxpayers contested this, arguing the distributions were capital gains.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the taxpayers' income tax. The taxpayers filed petitions with the United States Tax Court challenging the Commissioner's determination. The Tax Court consolidated the cases for trial and decision. The Tax Court reviewed the facts, arguments, and relevant law and issued its opinion, siding with the Commissioner and ruling that the distributions were taxable as ordinary income.

Issue(s)

1. Whether the distributions made by the corporations to the shareholders were taxable as ordinary income or capital gains under Section 117(m) of the

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Internal Revenue Code of 1939.
2. Whether the respondent has the burden of proof in these cases.

Holding

1. Yes, the distributions were taxable as ordinary income because the corporations were considered “collapsible corporations.”
2. No, the respondent does not have the burden of proof.

Court's Reasoning

The court addressed two main issues. First, the court examined whether the corporations met the definition of a “collapsible corporation” under section 117(m). The statute defines a collapsible corporation as one formed with a view to the distribution of assets to shareholders before the corporation realizes a substantial part of the income. The court determined that the corporations were formed and availed of principally for the construction of the housing projects. “The amount of the distributions in dispute is attributable to the excess mortgage proceeds and the mortgage premium.” The court rejected the taxpayers’ arguments. The court focused on the timing of the distributions relative to the realization of income, which, along with the intent of the corporations, classified them as collapsible. The court also noted that the intention to distribute the excess funds existed during construction. Second, the court held that the taxpayers, not the Commissioner, bore the burden of proof regarding the applicability of section 117(m). The court cited a prior case, Leland D. Payne, to support this conclusion.

Practical Implications

This case is crucial for understanding the tax implications of corporate distributions, especially in real estate development. It highlights that when a corporation is formed or availed of for construction of property, distributions of funds to shareholders before the realization of substantial income could trigger the “collapsible corporation” provisions. This impacts the tax rate the shareholders will pay on the distributions, changing from a lower capital gains rate to a higher ordinary income tax rate. Therefore, it is vital to properly time and structure corporate distributions and to document the intent behind these distributions. Attorneys and tax advisors must consider this ruling when advising clients on how to structure their businesses and distribute profits to minimize tax liabilities. Furthermore, taxpayers must be ready to prove the timing of events and the corporations’ intentions to avoid the negative consequences of this ruling. The court’s rejection of the taxpayers’ arguments shows that the intention behind the distributions, as well as the timing, are paramount.

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