32 T.C. 104 (1959)

The gain from the redemption of stock in a "collapsible corporation" is taxed as ordinary income rather than capital gains, if the corporation was formed to construct property with the intent of shareholders realizing gains before the corporation recognizes substantial income from the property.

Summary

In this case, the Tax Court considered whether the redemptions of stock in two corporations, Bragg Investment Co. and Bragg Development Co., resulted in ordinary income or capital gains for the shareholders, Bryan and McNairy. The court found that the corporations were "collapsible corporations" under Section 117(m) of the Internal Revenue Code of 1939 because they were formed to construct rental properties with the intent to distribute gains to shareholders through stock redemptions before realizing substantial income from those properties. Additionally, the court addressed several other tax issues, including the deductibility of certain taxes and the penalties for failure to file estimated tax declarations. This case clarifies the application of collapsible corporation rules in the context of real estate development and the importance of the intent of the shareholders.

Facts

Bryan and McNairy, along with others, formed two corporations, Bragg Investment Co. and Bragg Development Co., to construct military housing projects. The corporations issued class B common stock to an architect, who immediately endorsed the shares to Bryan, McNairy, and Weaver. After the projects were completed and the FHA loans finalized, the corporations redeemed the class B stock. The taxpayers reported the gains from the redemptions as capital gains. The IRS argued the corporations were "collapsible" and taxed the redemptions as ordinary income. The court also addressed whether certain taxes were deductible and if the taxpayers were liable for failure to file estimated tax.

Procedural History

The IRS determined deficiencies against the taxpayers. The taxpayers contested these deficiencies in the Tax Court. The Tax Court consolidated several cases involving Bryan and McNairy. The Tax Court considered the various issues raised by the IRS. The Tax Court ruled in favor of the IRS on key issues, including the collapsible corporation designation and the tax consequences of redemptions, as well as the penalties for failure to file estimated taxes.

Issue(s)

1. Whether Bragg Investment and Bragg Development were "collapsible corporations" under Section 117(m) of the Internal Revenue Code of 1939.
2. Whether the gain from the redemption of the class B stock was taxable as

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ordinary income or capital gains.
3. Whether the partnership Fayetteville Building Company could deduct certain taxes paid in connection with construction.
4. Whether the taxpayers were liable for penalties for failure to timely file declarations of estimated tax.

Holding

1. Yes, the corporations were "collapsible corporations."
2. Yes, the gain from the stock redemption was taxable as ordinary income.
3. The Fayetteville Building Company could deduct federal social security and unemployment taxes, and North Carolina unemployment taxes, but not North Carolina sales taxes.
4. Yes, the taxpayers were liable for penalties for failure to timely file declarations of estimated tax.

Court's Reasoning

The court applied Section 117(m), which defines a "collapsible corporation" as one formed or availed of principally for the construction of property with the intent of shareholders realizing gain through stock transactions before the corporation realizes substantial income from that property. The court found that the issuance of stock to the architect, followed by its immediate reassignment to the shareholders, coupled with the subsequent stock redemptions soon after project completion, demonstrated this intent. The court emphasized that the corporations were formed for the purpose of constructing the housing projects, that the stock redemptions occurred before the corporations realized substantial income from the rentals, and that the shareholders received gains attributable to the constructed property. The court held that the redemptions were attributable to the constructed property, regardless of whether they were paid from construction loans or rental income. The court also ruled on various other issues, determining the deductibility of different taxes by the partnerships and finding the taxpayers liable for penalties related to estimated tax filings because they relied on an accountant who did not provide proper advice on the relevant deadlines. "A view to the redemption of the class B stock is sufficient to require classification of the corporations as collapsible."

Practical Implications

This case has significant implications for real estate developers and investors. It reinforces the importance of understanding the "collapsible corporation" rules under the Internal Revenue Code. It highlights that forming a corporation to construct property, with a plan to distribute gains to shareholders through stock redemptions before the corporation realizes substantial rental income, can trigger ordinary income tax treatment on the gains. When structuring real estate investments, tax advisors must consider the timing of distributions to shareholders and the corporation's income recognition. Specifically, the case underscores the

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need to carefully document shareholder intent and to structure transactions to avoid the application of the collapsible corporation rules. Furthermore, the court's ruling underscores the taxpayer's responsibility to understand and meet tax filing requirements, and the limitations of relying on professional advice.

Meta Description

The Tax Court held that gains from stock redemptions in real estate corporations were ordinary income because the corporations were collapsible, emphasizing the shareholder intent and the timing of income recognition.

Tags

Bryan v. Commissioner, Tax Court, 1959, Collapsible Corporation, Stock Redemption, Real Estate, Section 117(m)

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