32 T.C. 104 (1959)

Gains from the redemption of stock in a collapsible corporation are taxed as ordinary income, not capital gains, when the corporation is formed or availed of to construct property with a view to shareholder gain before the corporation realizes substantial income from the property.

Summary

In *Bryan v. Commissioner*, the Tax Court addressed whether gains from the redemption of Class B stock in two corporations were taxable as ordinary income under the collapsible corporation rules. The corporations were formed to construct housing for military personnel under the Wherry Act. The court held that the corporations were collapsible because they were formed with a view to distribute gains to shareholders (through stock redemption) before realizing a substantial portion of the income from the constructed properties. Therefore, the gains from stock redemption were deemed ordinary income, not capital gains, under Section 117(m) of the 1939 Internal Revenue Code.

Facts

Petitioners Bryan and McNairy were shareholders in two corporations, Bragg Investment Co. and Bragg Development Co., formed to construct military housing under the Wherry Act. The corporations issued Class B common stock to an architect as a fee, which was immediately reissued to the petitioners and another individual. The corporations secured FHA-insured loans exceeding construction costs. Shortly after construction completion and before substantial rental income was realized, the corporations redeemed the Class B stock from the petitioners. The Commissioner determined that the gains from these redemptions were ordinary income under the collapsible corporation provisions.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax for the years 1951, 1952, and 1953, asserting that gains from stock redemptions were ordinary income. The petitioners contested this determination in the United States Tax Court.

Issue(s)

1. Whether Bragg Investment Co. and Bragg Development Co. were collapsible corporations within the meaning of Section 117(m) of the Internal Revenue Code of 1939.
2. Whether the gain derived by the petitioners from the redemption of their Class B common stock should be treated as ordinary income or capital gain.

Holding

1. Yes, Bragg Investment Co. and Bragg Development Co. were collapsible corporations because they were formed principally for the construction of property with a view to shareholder gain before substantial corporate income realization.
2. Yes, the gain derived by the petitioners from the redemption of their Class B common stock is considered ordinary income because the corporations were collapsible.

Court's Reasoning

The Tax Court reasoned that the corporations were formed with the view to redeem the Class B stock shortly after completion of construction and before realizing a substantial part of the net income from the rental properties. The court noted the issuance and immediate redemption of Class B stock, the excess of FHA loans over construction costs, and the timing of the stock redemption shortly after project completion as evidence of this view. The court rejected the petitioners' argument that the Wherry Act restrictions and government ownership of the land distinguished this case from typical collapsible corporation scenarios. The court emphasized that the statute's broad language targets the abuse of converting ordinary income into capital gains through temporary corporations, regardless of whether the corporation sells the property or remains in existence. The court stated, "A careful consideration of the facts…leaves us in no doubt that these two corporations constituted collapsible corporations within the meaning of section 117(m)(2)." The court concluded that the gains were attributable to the constructed property and taxable as ordinary income under Section 117(m).

Practical Implications

Bryan v. Commissioner clarifies the application of the collapsible corporation rules to Wherry Act corporations and reinforces the broad scope of Section 117(m). It demonstrates that even in situations with government-regulated housing and restrictions on property disposition, the collapsible corporation rules can apply if the intent is to realize shareholder-level gain before substantial corporate income realization. This case highlights the importance of considering the timing of distributions and stock redemptions in relation to the corporation's income generation from constructed property. Legal professionals should analyze similar cases by focusing on the intent behind corporate formation and actions, particularly regarding distributions and stock sales or exchanges occurring before the corporation has realized a substantial portion of the income to be derived from the constructed property. This case remains relevant for understanding the nuances of collapsible corporation rules and their application in various contexts beyond traditional real estate development.

