Braunstein v. Commissioner, 30 T.C. 1131 (1958)

Gains from distributions and sales of stock in a corporation formed to construct and own an apartment complex are taxable as ordinary income, not capital gains, if the corporation is deemed "collapsible" under the Internal Revenue Code.

Summary

The case concerns whether gains from cash distributions and the sale of stock in Kingsway Developments, Inc., a corporation formed to build an apartment complex, should be taxed as ordinary income or capital gains. The IRS determined that Kingsway was a "collapsible corporation," thus triggering ordinary income tax treatment for the taxpayers. The Tax Court agreed with the IRS, finding that the taxpayers' gains were attributable to the construction of the apartment project and that the corporation was formed with the requisite view to collapse before realizing substantial income. The court rejected several arguments by the taxpayers regarding the timing of the distributions, the definition of construction, and the calculation of income derived from the property.

Facts

Petitioners (Braunstein et al.) formed Kingsway to construct and own an apartment house development. The project received financing under the National Housing Act. Cash distributions were made to shareholders before the project was fully completed. The taxpayers later sold their stock in Kingsway, realizing substantial gains. The IRS contended that Kingsway was a "collapsible corporation," and therefore the gains were taxable as ordinary income under Section 117(m) of the Internal Revenue Code of 1939.

Procedural History

The Commissioner of Internal Revenue determined that the gains from the distributions and stock sales were taxable as ordinary income. The taxpayers contested this decision in the U.S. Tax Court. The Tax Court ruled in favor of the Commissioner.

Issue(s)

1. Whether the taxpayers' gains were subject to ordinary income tax under Section 117(m) of the Internal Revenue Code of 1939, due to Kingsway being a "collapsible corporation."
2. Whether the distributions and sales took place before the realization of a substantial portion of the net income to be derived from the property.
3. Whether more than 70 percent of the gain was attributable to the property constructed.

Holding

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1. Yes, because Kingsway was a collapsible corporation, the gains were subject to ordinary income tax.
2. No, the distributions and sales did not occur after the realization of a substantial part of the net income.
3. No, more than 70% of the gain was attributable to the property constructed.

Court's Reasoning

The court found that Kingsway met the definition of a collapsible corporation under the statute because the distributions and stock sales occurred before Kingsway realized substantial income from the apartment project. The court rejected the taxpayers' arguments based on a "post-construction motive" because the "view" to collapse existed before the project was completed. The court also determined that the project was not fully completed before the events that triggered the tax liability.

The court reasoned that the distribution of excess mortgage proceeds was a key factor. The court stated that the regulations defined the required "view" as existing if the sale of stock or the distribution to shareholders is contemplated "unconditionally, conditionally, or as a recognized possibility" and, further, that the view exists during construction if the sale or distribution is attributable to "circumstances which reasonably could be anticipated at the time of such * * * construction."

The court further held that net income should not include the mortgage premium and that early years of apartment operation should not be used to determine the substantiality of income. Regarding the allocation of gain to the property constructed, the court found that the increase in land value attributable to its use in the apartment project was part of the profit relating to the property. The court emphasized that the distribution of funds closely matched the excess mortgage proceeds, strongly indicating the source of the gain. The court cited previous cases to support its conclusions.

Practical Implications

This case reinforces the importance of understanding the "collapsible corporation" rules and the implications for real estate development ventures. It clarifies that a "view" to collapse can exist even if the specific timing is not entirely fixed and emphasizes the importance of the construction phase. The case serves as a warning to taxpayers and their advisors to carefully plan the timing of distributions and sales in relation to the completion of a project and the realization of income. It highlights that the source of gains is scrutinized to determine the proper tax treatment, especially when excess mortgage proceeds are involved.

The decision has practical implications for: (1) Tax planning: Developers must understand how distributions and sales affect tax liability; (2) Business structuring: The form of entity (corporation, LLC, etc.) is important. (3) Legal analysis: Attorneys

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must evaluate the timing and source of gains in their cases, and analyze the net income expectation. The court cited multiple other cases which should also be evaluated.

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