T.C. Memo. 1960-173

Gains from the sale of stock in a corporation formed to construct an apartment building with an FHA-insured mortgage, where distributions were made based on excess mortgage proceeds over construction costs, are taxable as ordinary income under collapsible corporation rules, even if disputes arise post-construction.

Summary

Petitioners sought capital gains treatment on profits from cash distributions and the sale of stock in Kingsway Developments, Inc., a corporation formed to build an apartment complex under the National Housing Act. The IRS argued that these gains were ordinary income under the collapsible corporation provisions of Section 117(m) of the 1939 Internal Revenue Code. The Tax Court agreed with the IRS, holding that Kingsway was a collapsible corporation because the distributions and stock sale occurred before a substantial part of the income from the project was realized, and the gains were attributable to the constructed property. The court rejected the taxpayers' arguments regarding post-construction motive, substantial income realization, and the source of the gain.

Facts

Kingsway Developments, Inc. was formed to construct and operate an apartment complex under Section 608 of the National Housing Act. The project was financed with an FHA-insured mortgage. Mortgage proceeds exceeded construction costs, creating excess cash anticipated from the project's inception. Prior to project completion, disagreements arose between the petitioners and another shareholder, Markowitz. Petitioners received cash distributions from Kingsway and subsequently sold their stock, realizing gains. The IRS determined these gains were ordinary income under collapsible corporation rules.

Procedural History

The case was heard in the Tax Court of the United States. The Commissioner of Internal Revenue assessed deficiencies against the petitioners, arguing for ordinary income treatment. The petitioners contested this assessment, claiming capital gains treatment.

Issue(s)

1. Whether the gains realized by petitioners from cash distributions and the sale of Kingsway stock are taxable as ordinary income under Section 117(m) of the Internal Revenue Code of 1939 as gains from a collapsible corporation?

2. Whether the distribution and sale of stock occurred prior to the realization of a substantial part of the net income to be derived from the constructed property?

3. Whether more than 70 percent of the gain was attributable to the property constructed?

Holding

1. Yes, the gains are taxable as ordinary income because Kingsway was a collapsible corporation, and the transactions fell within the scope of Section 117(m).

2. Yes, the distribution and sale occurred prior to the realization of a substantial part of the net income because the mortgage premium, included in Kingsway's initial net income, is not considered "net income to be derived from such property" for collapsible corporation purposes, and without it, there was a net loss.

3. Yes, more than 70 percent of the gain was attributable to the constructed property because the increase in land value was directly related to its use in the FHA-insured housing project, and the excess mortgage proceeds were a direct result of the construction.

Court's Reasoning

The court reasoned that the "view" to collapse the corporation existed during construction, as the possibility of excess mortgage proceeds and distributions was recognized from the outset. The court cited Regulation 111, Section 29.117-11(b), stating the "view" exists if distribution is contemplated as a "recognized possibility" attributable to circumstances reasonably anticipated during construction. The court emphasized that "construction" is technically defined to mean all construction required to perform the contract completely, extending beyond mere physical completion to include "finaling out" the mortgage. Regarding substantial income realization, the court followed precedent (*Rose Sidney*) that mortgage premiums are not considered "net income to be derived from such property" for collapsible corporation analysis. Excluding the premium, Kingsway had a net loss at the time of distribution and sale. The court also found that the gain was primarily attributable to the constructed property, rejecting the argument that pre-construction land value increases should be excluded. The court noted the distribution amount closely matched the excess mortgage proceeds, indicating the gain was intrinsically linked to the constructed property and financing.

Practical Implications

This case clarifies the application of collapsible corporation rules to real estate development projects financed with FHA-insured mortgages, particularly those generating excess mortgage proceeds. It underscores that the "view" to collapse can be established by recognizing the possibility of distributions from excess funds even if not a certainty. It highlights that