32 T.C. 723 (1959)

Gains from distributions and stock sales of a “collapsible corporation” are taxed as ordinary income rather than capital gains if the corporation was formed with the view of avoiding capital gains tax on property that would not be a capital asset in the hands of the shareholders.

Summary

The United States Tax Court addressed whether the gains realized by the Mintz brothers from distributions by Kingsway Developments, Inc., and the sale of their Kingsway stock, should be taxed as ordinary income under Section 117(m) of the 1939 Internal Revenue Code, which deals with “collapsible corporations.” Kingsway was formed to construct and own an apartment building project. The court found that Kingsway was a collapsible corporation and that the gains from distribution and sale were taxable as ordinary income because the gains were attributable to the project, which was not a capital asset. The court held that the requisite view to avoid capital gains tax existed, and the gains were not substantially realized before distribution.

Facts

Max, Louis, and Morris Mintz, along with Monroe Markowitz, acquired land to build an apartment house. They formed Kingsway Developments, Inc. Louis and Markowitz served as the primary sponsors, and Kingsway secured an FHA-insured mortgage. The Mintz brothers, along with Markowitz, were stockholders in Kingsway. Due to the excess of mortgage loan proceeds over construction costs, Kingsway distributed cash to shareholders and the Mintz brothers sold their Kingsway stock, resulting in gains. The IRS determined that the gains should be taxed as ordinary income, not capital gains.

Procedural History

The IRS determined deficiencies in the income taxes of Max, Louis, and Morris Mintz for the taxable year ending December 31, 1950, asserting that gains from distributions by Kingsway, and the subsequent stock sale, should be taxed as ordinary income. The Mintz brothers contested the IRS’s determination in the United States Tax Court.

Issue(s)

1. Whether Kingsway Developments, Inc. was a “collapsible corporation” under Section 117(m) of the 1939 Code?

2. Whether the gains realized by the petitioners from the cash distribution by Kingsway and the sale of Kingsway stock were taxable as ordinary income?

Holding

1. Yes, because Kingsway was formed with the intent to construct property and then distribute funds and sell stock before a substantial portion of the income from the property was realized.

2. Yes, because the gains were attributable to property that would not be a capital asset in the hands of the shareholders.

Court's Reasoning

The court applied Section 117(m) of the 1939 Code, defining a "collapsible corporation" as one formed with the view to avoid capital gains tax. The court found Kingsway was a collapsible corporation because the shareholders intended to distribute funds and sell stock before a substantial part of the income from the apartment project was realized. The court noted that the excess mortgage loan proceeds were a key factor in the distribution of funds. The court rejected the argument that the sale of stock was prompted by disputes with a co-owner, stating that friction had arisen before the project's completion. The court further held that the gains were attributable to the apartment project, a non-capital asset. The court also dismissed the argument that a substantial portion of the net income had been realized before the distribution and sale, as well as the argument that more than 70% of the gain was not attributable to construction.

Practical Implications

This case provides guidance to attorneys on identifying the characteristics of a collapsible corporation, which includes intent to convert ordinary income into capital gains by distributing funds before a substantial portion of the net income is realized. Tax attorneys and real estate developers must consider the timing of distributions and sales relative to income realization when structuring corporations. The case underscores the importance of the "view" or intent of the shareholders at the time of construction. This case may be cited in future cases involving collapsible corporations and real estate development, to determine what constitutes a collapsible corporation and when gains are taxable as ordinary income versus capital gains.