32 T.C. 782 (1959)

A corporation is considered “collapsible” under Section 117(m) of the Internal Revenue Code of 1939 if it is formed or availed of principally for the construction of property with a view to shareholder gain before the corporation realizes substantial income from the property.

Summary

The case involves a tax dispute where the Commissioner of Internal Revenue determined that gains from stock redemptions by C.D. Spangler were taxable as ordinary income, rather than capital gains. The court addressed whether two corporations, Double Oaks and Newland Road, were “collapsible corporations” under Section 117(m) of the Internal Revenue Code of 1939. This determination hinged on whether the corporations were formed primarily to construct properties with a view to shareholder gain through stock redemptions before the corporation realized substantial net income from the projects. The Tax Court held for the Commissioner, concluding the corporations were collapsible because the redemptions occurred before substantial income realization, thereby classifying the gains as ordinary income.

Facts

C.D. Spangler was the principal shareholder of Construction Company, which built rental housing projects. Spangler sponsored two housing projects, Double Oaks and Newland Road, each structured with two classes of common stock. Class B stock was issued to architects and others involved in the construction. Spangler later purchased this class B stock. Double Oaks and Newland Road obtained FHA-insured loans for construction. Prior to substantial income generation, Spangler redeemed portions of his class B stock in both corporations. The corporations had significant net operating losses during the relevant periods, and the redemptions occurred soon after the construction was completed. Spangler reported gains from the redemptions as long-term capital gains. The Commissioner determined these gains were ordinary income under Section 117(m) of the Internal Revenue Code of 1939.

Procedural History

The Commissioner issued a notice of deficiency, asserting that the gains from the stock redemptions should be taxed as ordinary income under section 22(a). The Commissioner later amended his answer, specifically citing Section 117(m) as the basis for this determination. The petitioners challenged this assessment in the United States Tax Court. The Tax Court upheld the Commissioner’s determination, concluding that the corporations were “collapsible” under Section 117(m), thereby classifying the gains as ordinary income.

Issue(s)

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1. Whether the corporations, Double Oaks Apartments, Inc., and Newland Road Apartments, Inc., were "collapsible corporations" under Section 117(m) of the Internal Revenue Code of 1939?

2. Whether the Commissioner's reliance on Section 117(m) shifted the burden of proof to the petitioners?

Holding

1. Yes, because the corporations were formed primarily to construct properties with a view to shareholder gain before realizing substantial income.

2. No, because the Commissioner's reliance on Section 117(m) was permissible under his initial deficiency notice.

Court's Reasoning

The court first addressed the procedural issue of the burden of proof. The court clarified that the Commissioner's amended answer, invoking Section 117(m), did not introduce new matter, thereby avoiding the burden of proof shifting to him. The court overruled a prior decision, *Thomas Wilson*, to maintain that the Commissioner could assert Section 117(m) as a reason for his deficiency determination, even if not explicitly stated in the initial notice. The court then focused on whether the corporations met the definition of a "collapsible corporation." The court found that they were formed "principally for the construction of properties with a view to the sale or exchange of the class B stock…prior to the realization by the corporations of substantial parts of the net income to be derived from the properties." The court noted that the redemptions occurred shortly after construction, before the corporations generated significant rental income, and that the amount of the FHA-insured loans far exceeded the construction costs. Thus, the court concluded the redemptions were a means for Spangler to realize gain, triggering Section 117(m). The court also rejected Spangler's argument that more than 70% of the gain was attributable to rentals, noting that the distributions could have been made from the excess of the loans over construction costs.

Practical Implications

This case highlights the importance of carefully structuring real estate projects to avoid the "collapsible corporation" provisions. Tax advisors and attorneys should scrutinize the timing of stock redemptions relative to income generation. If distributions to shareholders occur before the corporation has realized a significant portion of its net income, the IRS is more likely to classify the corporation as collapsible. The decision clarifies that the government can change its legal basis for asserting a tax deficiency as long as it's within the scope of the original notice, which affects the burden of proof. Finally, this case illustrates that funding redemptions from the proceeds of a loan does not prevent the IRS from asserting

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Section 117(m), particularly when the loans exceed the construction costs.

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