32 T.C. 1144 (1959)

A corporation is considered "collapsible" under Section 117(m) of the 1939 Internal Revenue Code if it is formed to construct property, and the shareholders sell their stock before the corporation realizes a substantial portion of the income from that property, with the intention of converting ordinary income into capital gains.

Summary

The United States Tax Court addressed whether gains from the sale of stock in two corporations, North and Stanton, Inc., and Hancock Court Apartments, Inc., were taxable as ordinary income or capital gains. The IRS argued the corporations were "collapsible" under Section 117(m) of the 1939 Internal Revenue Code because the stockholders sold their shares before the corporations realized substantial income from the construction of apartment buildings. The Court agreed with the Commissioner. It held that both corporations met the definition of collapsible corporations, as they were formed to construct property, and the shareholders sold their stock before substantial income was realized. The Court rejected the taxpayers' arguments regarding shareholder disputes as the primary reason for the sales, and that the level of construction activity was not sufficient to trigger the collapsible corporation rules.

Facts

The petitioners, Ellsworth J. Sterner, Helen W. Sterner, David Levy, Jennie Levy, Barney Pivnick, Rose Pivnick, Joseph Feldman, and Sarah Feldman, formed Tudor Court, Inc. to construct an apartment building. Disagreements arose between Pivnick and Feldman. Subsequently, the petitioners formed two new corporations, North and Stanton, Inc., and Hancock Court Apartments, Inc., to construct additional apartment buildings. The petitioners owned 25% of the stock in each of the two corporations. The shareholders of North and Stanton, Inc. agreed to sell their stock before construction was complete. Hancock Court had undertaken some preliminary steps toward construction, including land acquisition and applying for mortgage insurance but was not yet under construction. They also agreed to sell their Hancock Court stock contingent on the issuance of a mortgage commitment by the Federal Housing Administration (FHA). The IRS contended that the corporations were "collapsible" as defined by Section 117(m) of the Internal Revenue Code of 1939, and thus, gains from stock sales should be treated as ordinary income.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes for the year 1950. The petitioners challenged the IRS's determination, and the case was brought before the United States Tax Court. The Tax Court consolidated the cases for trial and decision. The Tax Court agreed with the Commissioner.

Issue(s)

1. Whether North and Stanton, Inc., and Hancock Court Apartments, Inc., were “collapsible corporations” within the meaning of Section 117(m) of the 1939 Internal Revenue Code.

2. If the corporations were collapsible, whether the gains realized by the petitioners on the sale of their stock should be treated as ordinary income, or capital gains.

Holding

1. Yes, North and Stanton, Inc., and Hancock Court Apartments, Inc., were collapsible corporations because they were formed with the primary purpose of constructing property, and the sale of stock occurred before the realization of substantial income from the project.

2. Yes, the gains realized by the petitioners on the sale of their stock were attributable to property which is not a capital asset, and thus should be treated as ordinary income, as the corporations met the definition of collapsible corporations.

Court’s Reasoning

The Court focused on whether the corporations met the definition of a