33 T.C. 1072 (1960)

Cash distributions from a corporation engaged in building multiple-unit apartments, in excess of the shareholder's stock basis, are taxable as ordinary income, not capital gains, if the corporation is deemed "collapsible" under I.R.C. § 117(m).

Summary

The U.S. Tax Court determined that cash distributions received by Arthur and Teresa Pomponio from two real estate corporations were taxable as ordinary income rather than long-term capital gains. The Pomponios, experienced in real estate, owned stock in corporations that built multiple-unit apartments. The court found that the distributions exceeded the reported dividends and the cost basis of the stock. The court applied I.R.C. § 117(m), which addresses collapsible corporations, to classify the income as ordinary, rejecting the Pomponios' arguments that the corporations were not collapsible and that the distributions should be treated as capital gains. The court cited prior rulings to support its decision and highlighted the importance of "net income" rather than gross income in determining whether a corporation is collapsible.

Facts

Arthur Pomponio, an experienced builder and real estate developer, and his wife, Teresa, filed joint income tax returns. Pomponio was a stockholder and officer in Donna Lee Corporation and Greenbrier Apartments, Inc., both formed to construct and operate multiple-unit apartments. Both corporations obtained FHA-insured mortgage loans. During the tax years 1950, 1951, and 1952, Pomponio received cash distributions from these corporations that exceeded the amounts reported as dividends and his cost basis in the stock. These distributions included amounts from the corporations that were in excess of the cost basis of the stock. The Commissioner of Internal Revenue determined that the distributions should be taxed as ordinary income under I.R.C. § 117(m).

Procedural History

The Commissioner determined deficiencies in the Pomponios' income tax for 1950, 1951, and 1952, classifying distributions from the corporations as ordinary income. The Pomponios contested this, arguing for capital gains treatment. The case was brought before the U.S. Tax Court.

Issue(s)

1. Whether the cash distributions received by Arthur Pomponio from Donna Lee Corporation and Greenbrier Apartments, Inc., are taxable as ordinary income under I.R.C. § 117(m).
2. Whether Donna Lee Corporation and Greenbrier Apartments, Inc., were "collapsible corporations" under I.R.C. § 117(m)(2)(A)(i).

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Holding

1. Yes, because the distributions were from corporations meeting the criteria for collapsible corporations.
2. Yes, because neither corporation had realized a substantial part of the net income from its properties prior to the distributions.

Court’s Reasoning

The court addressed the Pomponios’ argument that I.R.C. § 117(m) did not apply to cash distributions, only to sales or exchanges of stock. The court cited *Burge* and *Glickman*, where the court had already rejected this argument. The court emphasized the meaning of “collapsible corporation” and the intent of the statute. The court also addressed the issue of whether the corporations were collapsible. The Pomponios argued that the corporations had realized a substantial part of the income prior to the distributions. The court found that, in determining “substantial part,” it had to consider net income, not gross income, and neither corporation realized a substantial portion of net income. The court noted that depreciation and interest costs had to be considered to determine the net income, and the Pomponios had not demonstrated that a substantial portion of net income had been realized. The court also rejected the argument that the distributions were in the nature of a return of capital, and that the Commissioner had been taxing such distributions as capital gains. The court held that the Commissioner was not bound by a past, mistaken application of the law.

Practical Implications

This case is significant for its interpretation of I.R.C. § 117(m) regarding collapsible corporations and distributions to shareholders. Legal practitioners should note that distributions from corporations that meet the definition of a “collapsible corporation” are subject to tax at ordinary income rates. This case emphasizes that the critical factor is the realization of net income, not gross income. This analysis is vital in the context of real estate development and construction. It underscores the importance of examining the net income derived from a project when determining whether a corporation meets the definition of a collapsible corporation. The decision is also notable for its stance on the Commissioner’s authority. The case clarifies that even if the IRS has previously treated similar transactions differently, it is not bound by past errors and can correct its approach to comply with the law.

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