34 T.C. 86 (1960)

A corporation is deemed "collapsible" under Section 117(m) of the Internal Revenue Code if it is formed to build property with the intent to distribute assets to shareholders before realizing a substantial portion of the income from the property, thereby converting what would normally be ordinary income into capital gains for the shareholders.

Summary

The Tax Court held that a construction corporation was a "collapsible corporation" because it distributed its assets, including real estate, to its sole shareholder before realizing a substantial portion of the income from those assets. The shareholder then sold the assets, attempting to classify the profit as capital gains. The court determined that the shareholder's gain from the liquidation of the corporation was taxable as ordinary income, not capital gain, because the corporation was designed to avoid taxes at the corporate level by distributing the assets before the realization of substantial income from their sale. The decision focused on whether the corporation had realized a "substantial part" of its income from the properties prior to the liquidation.

Facts

G.A. Heft owned all the stock of Gulf Construction Corporation, which built houses on 53 lots. Prior to liquidating the corporation, the corporation sold 16 houses and received rent on the properties, realizing a profit and rental income. The corporation then voted to liquidate. Heft was appointed liquidator and received 26 houses. The remaining 11 houses were sold after the liquidation. Heft sold the houses he received. The Commissioner of Internal Revenue determined that the gain from the liquidation should be taxed as ordinary income due to the collapsible corporation provisions of Section 117(m) of the Internal Revenue Code.

Procedural History

The case began when the Commissioner of Internal Revenue determined a deficiency in the Hefts' income tax, asserting that the gain from the liquidation of Gulf Construction Corporation was taxable as ordinary income rather than capital gain. The Hefts challenged the deficiency in the United States Tax Court. The Tax Court's decision is the subject of this case brief.

Issue(s)

1. Whether Gulf Construction Corporation was a "collapsible corporation" under Section 117(m) of the Internal Revenue Code.

2. Whether the corporation realized a "substantial part" of the net income from its property prior to distribution, thus impacting the characterization of the

shareholders' gains.

Holding

1. Yes, the corporation was a collapsible corporation because it was formed to construct property and distribute it to shareholders prior to realizing a substantial part of the net income to be derived from it.

2. No, the corporation had not realized a substantial part of the net income.

Court's Reasoning

The court applied Section 117(m) of the Internal Revenue Code, which defines a "collapsible corporation" and determines the tax treatment of gains from such corporations. The court focused on whether the corporation had realized a "substantial part" of the net income to be derived from the properties before the distribution. The court determined that less than 12.86 percent of the income from sales and less than 17.07 percent of the income from both sales and rentals had been realized by the corporation. The court stated, "Gulf Corporation was formed or availed of principally for the construction of property with a view to a distribution to its sole stockholder, prior to the realization by the corporation… of a substantial part of the net income to be derived from the 53 Sheryl Park properties and the realization by its sole stockholder of gain attributable to those properties." Therefore, the gain was not eligible for capital gains treatment. No dissenting opinions were presented.

Practical Implications

This case is critical for understanding how to classify income from corporate liquidations, especially where built properties are involved. The case emphasizes that the intent behind a corporation's formation and the timing of asset distributions in relation to income realization are key to determining the tax treatment of shareholders' gains. This case warns against attempting to convert ordinary income into capital gains through liquidation and asset sales, specifically in instances where a corporation has been created to build property before distributing it to its shareholders. Subsequent courts follow this approach, reinforcing the

