T.C. Memo. 1963-204

A corporation is not considered ‘collapsible’ under Section 117(m) of the 1939 Internal Revenue Code if it has already realized a ‘substantial part’ of the net income expected from its property before the sale of its stock, and ‘substantial part’ is determined by comparing the income realized before the sale to the total expected income.

Summary

In *Zongker v. Commissioner*, the Tax Court addressed whether the sale of stock in Park City Development Company, Inc. resulted in ordinary income under the collapsible corporation rules of the 1939 Internal Revenue Code. The petitioners, the Zongkers, sold their stock in a corporation that developed real estate. The IRS argued the corporation was ‘collapsible’ because it was formed to develop property with a view to selling stock before realizing substantial income, thus converting ordinary income into capital gain. The Tax Court held that because the corporation had already realized a ‘substantial part’ (over 34%) of the net income expected from the development project prior to the stock sale, it did not meet the definition of a collapsible corporation. The court focused on the proportion of income realized before the sale versus the total expected income, finding the presale realization to be ‘substantial’. This decision clarified the ‘substantial part’ test for collapsible corporations under the 1939 Code.

Facts

Petitioners E.J. and Charleen Zongker owned a one-half interest in Park City Development Company, Inc., formed in 1952 to develop a real estate subdivision. The corporation acquired land and began developing it into residential and commercial lots in 1953. By November 16, 1953, the corporation had sold 200 residential lots out of 474, realizing a gross profit of approximately $60,118 and a net profit of about $13,000. On November 16, 1953, the Zongkers sold their stock in the corporation. As part of the stock sale, they received an option to purchase a one-half interest in a 16-acre commercial tract at book value. They exercised this option and later sold their interest in the commercial tract. The corporation reported significant accrued officer salaries as deductions, which were unpaid at the time of the stock sale due to lack of funds. After the stock sale, the purchasers loaned funds to the corporation to pay these salaries, and the corporation was later dissolved.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners’ income tax for 1953 and 1955, arguing that the gain from the sale of stock was taxable as ordinary income because the corporation was collapsible. The petitioners contested this determination in the Tax Court.

Issue(s)

1. Whether Park City Development Company, Inc. was a ‘collapsible corporation’ within the meaning of Section 117(m) of the 1939 Internal Revenue Code, such that the gain from the sale of stock should be taxed as ordinary income rather than capital gain.

2. What was the fair market value of the one-half interest in the 16-acre commercial tract of land transferred to petitioners as part of the stock sale consideration?

3. Whether petitioners are liable for additions to tax under Section 294(d)(1)(A) and Section 294(d)(2) of the 1939 Code, and Section 6651(a) of the 1954 Code for failure to timely file estimated tax declarations and income tax returns.

Holding

1. No, because Park City Development Company, Inc. had realized a ‘substantial part’ of the net income to be derived from the property before the sale of stock, and thus did not meet the definition of a collapsible corporation.

2. The fair market value of the 16-acre commercial tract on November 16, 1953, was $35,000.

3. Yes, petitioners are liable for additions to tax because they did file a declaration of estimated tax for 1953, albeit belatedly, and failed to timely file their 1955 income tax return.

Court’s Reasoning

Collapsible Corporation Issue: The court relied on prior cases like *Rose Sidney, 30 T.C. 1155 (1958), aff’d, 273 F.2d 928 (2d Cir. 1960)*, and *James B. Kelley, 32 T.C. 135 (1959), aff’d, 293 F.2d 904 (5th Cir. 1961)*, which interpreted ‘substantial part’ in Section 117(m) as relating to the income already realized at the time of sale compared to the total expected income. The court calculated that the corporation had already realized over 34% of the total expected net income. The court stated, **“No case is cited, and we find none, where more than 20 percent of total net profits has been held insubstantial.”** Therefore, the court concluded that Park City Development Company, Inc. was not a collapsible corporation.

Valuation Issue: The court found the Commissioner’s valuation of $60,000 for the 16-acre commercial tract to be excessive. It noted the property was undeveloped, unproductive, and had no foreseeable income-producing potential at the time of the stock sale. The court considered subsequent events and appraisals, ultimately determining a fair market value of $35,000.

Additions to Tax Issue: The court rejected petitioners’ reliance on *Commissioner v. Acker, 361 U.S. 87 (1959)*. The court distinguished *Acker* because in that case, no declaration of estimated tax was filed. Here, petitioners did file a declaration, albeit late. The court followed *Rose S. Harkins, 33 T.C. 365 (1959)*, holding that penalties for underestimation and failure to file timely could both apply when a late declaration was filed.

Practical Implications

Zongker v. Commissioner provides practical guidance on the 'substantial part' test for determining whether a corporation is collapsible under the 1939 Code, offering insights still relevant for understanding similar provisions in current tax law. It emphasizes a quantitative approach, comparing the net income realized by the corporation before a stock sale to the total net income expected from the property. The case suggests that realizing more than 20% of the expected net income is likely to be considered 'substantial,' thus preventing collapsible corporation status. For legal professionals and businesses involved in real estate development, this case highlights the importance of timing stock sales in relation to income realization to manage tax classifications and avoid ordinary income treatment on stock sales. It also illustrates the Tax Court's approach to valuing undeveloped real estate, considering its income-producing potential and market conditions at the relevant time. Finally, it serves as a reminder of the penalties associated with underpayment of estimated taxes, even when a declaration is filed late.