Benedek v. Commissioner, 37 T. C. 68 (1961)

Gain from distributions in a collapsible corporation is attributable to construction costs when derived from surplus mortgage funds, not leasehold values.

Summary

In Benedek v. Commissioner, the Tax Court determined that distributions from the Farragut corporations, which were formed to construct apartment buildings, were taxable as ordinary income under the collapsible corporation rules of the Internal Revenue Code of 1939. The court found that the distributions were derived from surplus mortgage funds obtained due to the construction of the apartments, not from the value of the leaseholds. The case emphasizes that gains in collapsible corporations are attributed to the property constructed when the distributions are funded by construction-related mortgage proceeds, even if leaseholds have independent value.

Facts

Newstrand Realty Corp. purchased land from New York Water Service Corp. and leased it to the Farragut corporations, which were formed by the same shareholders to construct apartment buildings. The Farragut corporations secured FHA-insured mortgage loans based on the construction costs of the apartments, which exceeded those costs. Distributions totaling $3,158,000 were made to shareholders in 1949, 1950, and 1951. The IRS assessed deficiencies, arguing the distributions should be taxed as ordinary income under the collapsible corporation rules, while the shareholders claimed the gains were attributable to the leasehold interests.

Procedural History

The IRS determined deficiencies in the petitioners' income tax, leading to the case being brought before the Tax Court. The court reviewed the case to determine whether the distributions were taxable as ordinary income under section 117(m) of the Internal Revenue Code of 1939.

Issue(s)

1. Whether the Farragut corporations were collapsible corporations under section 117(m) of the Internal Revenue Code of 1939.
2. Whether more than 70 percent of the gain recognized by the petitioners on the distributions was attributable to property constructed by the corporations under section 117(m)(3)(B).

Holding

1. Yes, because the Farragut corporations fit the definition of collapsible corporations, as they were formed to construct property with a view to distributing

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gains before realizing substantial income from the property.
2. Yes, because the distributions were derived from surplus mortgage funds obtained due to the construction of the apartments, not from the leasehold values.

Court's Reasoning

The court applied the collapsible corporation rules of section 117(m), which aim to prevent shareholders from converting ordinary income into capital gains through the sale or distribution of stock in a corporation formed primarily for construction or production. The court found that the Farragut corporations met the statutory definition of collapsible corporations, as they were formed to construct apartment buildings and distribute gains before realizing substantial income from the property. The court then focused on the attribution of gains under section 117(m)(3)(B), which excludes gains from collapsible corporation treatment if less than 70 percent of the gain is attributable to constructed property. The court determined that the distributions were funded by surplus mortgage funds obtained due to the construction of the apartments, not from the value of the leaseholds. The court cited cases like Elizabeth M. August and Glickman v. Commissioner, which held that gains from distributions funded by construction-related mortgage proceeds are attributable to the constructed property. The court rejected the petitioners' argument that the gains were attributable to the leasehold values, as there was no evidence that the leasehold values enabled the distributions.

Practical Implications

This decision clarifies that gains from distributions in collapsible corporations are attributable to the property constructed when the distributions are funded by construction-related mortgage proceeds, even if leaseholds have independent value. Tax practitioners should carefully analyze the source of distributions in collapsible corporations to determine whether they are attributable to construction costs or other assets. The case also highlights the importance of proving the fair market value of constructed property in relation to mortgage loans when arguing for the exclusion of gains from collapsible corporation treatment. Later cases have applied this ruling to similar situations involving FHA-insured mortgage loans and collapsible corporations.

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