Day v. Commissioner, 46 T. C. 81 (1966)

The term ‘substantial part’ in the context of a collapsible corporation refers to the taxable income already realized by the corporation, not the income yet to be realized.

Summary

In Day v. Commissioner, the Tax Court addressed whether Day Enterprises, Inc. was a collapsible corporation under Section 341 of the Internal Revenue Code upon its liquidation in 1963. The court focused on the definition of ‘substantial part’ of taxable income in relation to the Glenview project, which had realized 56% of its income before liquidation. The Tax Court held that the corporation was not collapsible because it had already realized a substantial part of the taxable income, adhering to prior precedents. This decision emphasized the importance of the income already realized rather than what remained unrealized in determining collapsibility.

Facts

George W. Day and Muriel E. Day, residents of Saratoga, California, filed a joint Federal income tax return for 1963. Day Enterprises, Inc. , solely owned by George W. Day, was incorporated in 1957 and engaged in real estate development. The corporation was liquidated on May 29, 1963, distributing all its assets to Day. At the time of liquidation, Day Enterprises had completed or partially completed three projects: Westview, Aloha, and Glenview. The Glenview project had realized 56% of its taxable income prior to liquidation. The Days reported the liquidation proceeds as long-term capital gain, but the IRS argued it should be taxed as ordinary income due to the corporation being collapsible under Section 341.

Procedural History

The Tax Court case arose after the IRS determined a deficiency in the Days’ 1963 income tax due to the treatment of the liquidation proceeds as ordinary income. The Days contested this determination, leading to the case being heard by the Tax Court to determine if Day Enterprises was a collapsible corporation at the time of its liquidation.

Issue(s)

1. Whether Day Enterprises, Inc. was a collapsible corporation under Section 341(b) of the Internal Revenue Code at the time of its liquidation in 1963?

Holding

1. No, because Day Enterprises had realized a substantial part of the taxable income from the Glenview project prior to its liquidation, which was 56% of the total income

to be derived from that project.

Court’s Reasoning

The Tax Court’s decision hinged on the interpretation of ‘substantial part’ in Section 341(b). The court relied on prior cases, such as James B. Kelley and Commissioner v. Zongker, which established that ‘substantial part’ refers to the income already realized by the corporation, not the income yet to be realized. The court emphasized that at the time of liquidation, Day Enterprises had realized 56% of the taxable income from the Glenview project, which was deemed substantial. The court rejected the IRS’s argument that the remaining 44% of unrealized income should be considered, as this interpretation was consistently rejected in prior cases. The court noted that this interpretation was more in line with the statute’s language and was supported by other courts in similar cases.

Practical Implications

This decision clarifies the criteria for determining whether a corporation is collapsible under Section 341, focusing on the income already realized rather than what remains unrealized. Practically, this means taxpayers can plan their corporate liquidations to ensure that a substantial part of the taxable income has been realized before distributing assets, potentially avoiding ordinary income treatment. This ruling also guides tax professionals in advising clients on structuring their business transactions to minimize tax liabilities. The decision reinforces the importance of statutory language over assumed legislative intent, impacting how similar tax provisions are interpreted in future cases.

