Greene v. Commissioner, 70 T. C. 534 (1978)

Rents from properties intended for demolition, but temporarily rented out, constitute passive investment income under IRC § 1372(e)(5) and can terminate a corporation's subchapter S election.

Summary

In Greene v. Commissioner, the U. S. Tax Court held that rental income from properties intended for demolition to make way for a motel project was passive investment income under IRC § 1372(e)(5). The corporation, which had elected subchapter S status, received over $3,000 in rents and interest in 1972, constituting more than 20% of its gross receipts. The court rejected the taxpayers' argument that these rents should be considered proceeds from demolition, affirming that such income was indeed passive and led to the termination of the corporation's subchapter S election.

Facts

S. Ward White Motor Inn, Inc. was formed to construct and operate a motel in Danville, Illinois. The corporation purchased land with existing residential dwellings, intending to demolish them for the motel project. However, the occupants were allowed to remain until construction necessitated their removal. In 1972, the corporation reported $13,347. 42 in gross rents from these dwellings and $747. 11 in interest income from certificates of deposit. These amounts constituted the corporation's entire gross receipts for that year.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' federal income taxes, asserting that the corporation's subchapter S election was terminated due to passive investment income exceeding 20% of gross receipts in 1972. The petitioners contested this, arguing that the rents should be treated as proceeds from demolition. The case was heard by the U. S. Tax Court, which granted partial summary judgment in favor of the Commissioner.

Issue(s)

1. Whether the rental income received by the corporation from properties intended for demolition constitutes "proceeds from demolition" under IRC § 165 and thus should not be considered in calculating passive investment income under IRC § 1372(e)(5).

Holding

1. No, because the rents did not constitute "proceeds from demolition" but rather were passive investment income under IRC § 1372(e)(5), leading to the termination

© 2025 SCOTUSreports.com. All rights reserved.

of the corporation’s subchapter S election.

Court’s Reasoning

The court reasoned that the rents received from the temporarily occupied dwellings did not fit the concept of “proceeds from demolition” as outlined in Treas. Reg. § 1. 165-3(a)(1). The regulation addresses the allocation of basis between land and buildings when purchased with the intent to demolish, but does not extend to income derived from using the buildings before demolition. The court emphasized that such income and related expenses are separate from the basis adjustment intended by the regulation. Furthermore, the court rejected the petitioners’ argument that the corporation’s intent to demolish should alter the characterization of the rental income, citing Osborne v. Commissioner for support. The court also noted that even if the rents were considered proceeds from demolition, they would still be included in gross receipts under IRC § 1372(e)(5), and thus passive investment income.

Practical Implications

This decision clarifies that rental income from properties intended for future demolition cannot be offset against the cost basis of the land as “proceeds from demolition. ” For corporations with subchapter S status, any rental or interest income must be carefully monitored to ensure it does not exceed the 20% threshold of gross receipts, as it could lead to the termination of the election. This ruling affects real estate development projects where properties are acquired for redevelopment, as temporary rental income must be treated as passive investment income. Subsequent cases have applied this principle to similar situations, emphasizing the need for corporations to plan their income streams to maintain subchapter S status.

© 2025 SCOTUSreports.com. All rights reserved.