Warrensburg Bd. & Paper Corp. v. Commissioner, 77 T. C. 1107 (1981)

A Subchapter S corporation must pay tax on certain capital gains unless it has been an electing small business corporation for at least three years or is a new corporation that has been in existence for less than four years and has made the election for all its taxable years.

Summary

Warrensburg Board & Paper Corp. elected Subchapter S status and experienced a fire that led to an involuntary conversion resulting in a long-term capital gain. The corporation argued that the tax under IRC Section 1378 should not apply because the gain stemmed from an involuntary conversion, not a manipulative election. However, the Tax Court held that the clear language of Section 1378 mandated taxation of the gain since the corporation did not meet the statutory exceptions. Additionally, the court upheld a negligence penalty due to the corporation's misrepresentation on its tax return regarding the duration of its Subchapter S election.

Facts

Warrensburg Board & Paper Corp. was incorporated on December 1, 1961, and elected Subchapter S status on June 27, 1974. On July 14, 1974, a fire partially destroyed its property, and the corporation received $216,225 from its insurer on January 27, 1975, resulting in a long-term capital gain of $151,235 for the taxable year ending June 30, 1975. The corporation reported no tax on this gain and misrepresented on its return that it had been a Subchapter S corporation for at least three years prior to the taxable year in question.

Procedural History

The Commissioner of Internal Revenue determined a deficiency and an addition to tax for negligence or intentional disregard of rules. Warrensburg Board & Paper Corp. petitioned the United States Tax Court. The court found for the respondent, holding that the corporation was subject to tax under Section 1378 and liable for the negligence penalty under Section 6653(a).

Issue(s)

1. Whether Warrensburg Board & Paper Corp. is subject to the tax imposed by IRC Section 1378 on a capital gain realized from an involuntary conversion.
2. Whether Warrensburg Board & Paper Corp. is liable for the addition to tax under IRC Section 6653(a) for negligence or intentional disregard of rules and regulations.

Holding

1. Yes, because the corporation's situation falls within Section 1378(a) and does not

meet any of the statutory exceptions under Section 1378(c).
2. Yes, because the corporation's misrepresentation on its return regarding the duration of its Subchapter S election indicates negligence or intentional disregard of the rules.

Court's Reasoning

The court applied the plain language of IRC Section 1378, which imposes a tax on Subchapter S corporations with certain capital gains unless specific exceptions are met. The court found no ambiguity in the statute and declined to consider the involuntary nature of the conversion as an exception. The court cited *George Van Camp & Sons Co. v. American Can Co.* to support its stance that clear statutory language does not require interpretation beyond its text. For the negligence penalty, the court reasoned that the corporation's misrepresentation on its tax return constituted negligence or intentional disregard of rules, referencing *Bunnel v. Commissioner* and other cases to affirm that the burden of proof lay with the petitioner to show the determination was erroneous.

Practical Implications

This decision reinforces the strict application of IRC Section 1378, indicating that Subchapter S corporations must adhere to the statutory exceptions to avoid taxation on capital gains, regardless of the circumstances leading to the gain. It underscores the importance of accurate reporting on tax returns, as misrepresentations can lead to negligence penalties. Practitioners should advise clients to carefully consider the timing and implications of Subchapter S elections, especially in light of potential capital gains. Subsequent cases, such as *Suburban Motors, Inc. v. Commissioner*, have followed this ruling, emphasizing the need for corporations to meet the Section 1378(c) exceptions to avoid taxation on capital gains.

