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## Collapsible Corporations - Section 341 of the Internal Revenue Code of 1954

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COLLAPSIBLE CORPORATIONS —  
Section 341 of the Internal Revenue Code of 1954

*by*

*Donald J. Malouf\* and David G. McLane\*\**

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##### I. PREFACE

THE higher the tax rates, the stronger the incentive to exploit terms of the taxing statute as a means of avoiding the high rates. The collapsible corporation, a device for converting ordinary income into capital gains, became common because of the high tax rates imposed during World War II. Initially, it was most commonly used in the motion-picture industry, but it was soon found useful in other fields, such as the construction industry.

In the typical case, a person who anticipated earning a large amount of income through the manufacture, production, or purchase of property, organized a corporation and caused it to carry on the activity. After the expiration of more than six months and before the corporation realized the ordinary income which was the fruit of its efforts, the stockholder either sold his stock or liquidated his corporation. He thus obtained as a long-term capital gain what would otherwise have been taxed as ordinary income.

To close this loophole, the "collapsible corporation" provisions were enacted into the federal tax laws in 1950.<sup>1</sup> Probably the only provisions of the code more complex than the original collapsible section are the amendments to that section. The newest addition, subsection (f) enacted in 1964, is certainly consistent with this proposition.

The purpose of this Article is to present a comprehensive examination of the collapsible rules. A secondary purpose involves (to use

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<sup>1</sup> Section 117(m), the original collapsible corporation provision, was added to the Internal Revenue Code of 1939 by the Revenue Act of 1950. The section was amended by the Revenue Act of 1951.

the words of the statute) a "view to" planning one's way around, through, or out of the hazardous area created by section 341.<sup>2</sup>

## II. TREATMENT OF COLLAPSIBLE STOCK

The Internal Revenue Code imposes ordinary income treatment for the following transactions involving "collapsible corporations:"<sup>3</sup> (1) the sale or exchange of its stock;<sup>4</sup> (2) a distribution in partial or complete liquidation;<sup>5</sup> or (3) a distribution, gain from which would otherwise be treated as gain from the sale or exchange of its stock.<sup>6</sup> If the shareholder has held his stock six months or less, the gain is treated as a short term capital gain.<sup>7</sup> If the stock has been held for more than six months, the gain is treated as though arising from the sale of property which is not a capital asset.<sup>8</sup>

## III. DEFINITION OF "COLLAPSIBLE CORPORATION"

The code defines a "collapsible corporation" as one which is formed or availed of principally for the manufacture, construction, or production of property, for the purchase of "section 341 assets," or for the holding of stock in a corporation so formed or availed of, with a view to the following objectives:

- (1) The sale or exchange of stock by its shareholders [whether in liquidation or otherwise], or a distribution to its shareholders, before [the corporation realizes] . . . a "substantial part" of the taxable income to be derived from such property,<sup>9</sup> and
- (2) The realization by such shareholders of gain attributable to such property.<sup>10</sup>

Two aspects of this definition are particularly interesting. The first is the subjective feature; the often-litigated and usually-perplex-

<sup>2</sup> The original § 117(m) was re-enacted without substantial change as § 341 of the Internal Revenue Code of 1954, and was amended by the Technical Amendments Act of 1958, by the Revenue Act of 1962, and by Pub. L. Mo. 88-484.

<sup>3</sup> INT. REV. CODE OF 1954, § 341.

<sup>4</sup> INT. REV. CODE OF 1954, § 341(a)(1). See *Elliott v. United States*, 205 F. Supp. 384 (D. Ore. 1962) (transfer between promoters, per prearranged plan not a "sale").

<sup>5</sup> INT. REV. CODE OF 1954, § 341(a)(2). Whether any stock was surrendered is immaterial. *Jesse Hartman*, 34 T.C. 1085 (1960).

<sup>6</sup> INT. REV. CODE OF 1954, §§ 341(a)(3), 301(c)(3)(A). And see *Arthur Pomponio*, 33 T.C. 1072 (1960) (decided under the 1939 Code).

<sup>7</sup> INT. REV. CODE OF 1954, §§ 1221, 1222(1).

<sup>8</sup> INT. REV. CODE OF 1954, § 341(a).

<sup>9</sup> INT. REV. CODE OF 1954, § 341(b)(1)(A).

<sup>10</sup> INT. REV. CODE OF 1954, § 341(b)(1)(B).

ing test of intent<sup>11</sup> forms the basis of the section's application. The second is the use of words that are pregnant with litigation potential.

#### A. "Formed Or Availed Of"

A corporation must be "formed or availed of" for one of the purposes previously mentioned before the collapsible rules can apply. Even if the corporation is "formed" for one of the proscribed purposes, however, if the event whereby the corporation is "availed of" fails to occur, the ordinary-income results should likewise not occur. For example, two individuals form a corporation to manufacture certain items, with intent to liquidate the corporation before it realizes a substantial part of the income from the sale of the manufactured property. The stockholders subsequently change their intent, however, and they retain their stock until after the corporation realizes a substantial part of the income from the manufactured items. Thereafter, they liquidate the corporation. If the disjunctive "or" is taken literally, the corporation, having been "formed" for the proscribed purpose, remains collapsible even though never having been "availed of" for that purpose. This strict interpretation imposes a result which is harsher than the purpose of the statute requires. It has even been rejected by the Internal Revenue Service.<sup>12</sup> The key event, therefore, apparently is not the "formation" of the corporation but, instead, the "availing of" the corporation.

#### B. "Principally"

To which words in the statutory definition of a collapsible corporation is the word "principally" meant to apply? A reasonable argument could be made that "principally" applies only to the phrase "with a view to." Drawing, by analogy, from the interpretation of similar language elsewhere in the code,<sup>13</sup> one could then argue that more than fifty per cent of the intent in "forming" or "availing of" the corporation would have to be the "view to" collapsing it.

The Internal Revenue Service, as might be expected, takes a different position. The service interprets "principally" as measuring not

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<sup>11</sup> Although the matter of intent is a question of the subjective state of a person's mind, the courts have relied on objective facts to determine this intent. Thus, for example, in *Jack D. Saltzman*, 22 CCH Tax Ct. Mem. 336 (1963), the court said: "If petitioner's conclusion as to his intent were required to be accepted in accordance with his statement, disposition of the question here involved could be made on the basis of this testimony of petitioner. However, the requisite view is a subjective state of mind which must be determined through assessing the objective facts." See also *Treas. Reg. § 1.341-5(b)* (1955).

<sup>12</sup> *Rev. Rul. 58-241, 1958-1 CUM. BULL. 179.*

<sup>13</sup> E.g., *INT. REV. CODE OF 1954, § 269* ("principal purpose"); *INT. REV. CODE OF 1954, § 1231(b)* ("primarily"). Cf. *Malat v. Riddell*, 383 U.S. 569 (1966) ("primarily"), *on remand*, 18 Am. Fed. Tax R.2d 5015 (S.D. Cal. May 6, 1966).

the intended action by the shareholders but, instead, the listed activities of the corporation, *i.e.*, (1) the manufacture, construction, or production of property; (2) the purchase of "section 341 assets"; or (3) the holding of stock in a corporation so formed or availed of.

The difference between the two positions on what "principally" refers to is very important. The Commissioner can usually prove with relative ease that the principal intention in the use of the corporation was, for example, manufacturing. His job is made much harder if he must prove that the principal intent was to collapse the corporation. To date, the Commissioner has been uniformly successful in his interpretation found in the regulations.<sup>14</sup>

### C. "Manufacture, Construction, Or Production"

For purposes of the statutory definition, a corporation is regarded as having manufactured, constructed, or produced property if it engages in any of these activities "to any extent."<sup>15</sup> The corporation is also regarded as having manufactured, constructed, produced, or purchased property if it receives such property and takes the transferor's basis therein in a nontaxable exchange,<sup>16</sup> or if it receives property in a nontaxable exchange in substitution for property which the corporation manufactured, constructed, produced, or purchased.<sup>17</sup>

Since many of the cases have involved real estate corporations, the courts have had to consider what "construction" is in that context. The revenue service has taken the seemingly extreme position that merely rezoning for a shopping center constitutes construction.<sup>18</sup> If additional steps are taken, the Tax Court will apparently find that construction has taken place. Thus, for example, in *J. D. Abbott*<sup>19</sup> the Tax Court held that the arrangement for F.H.A. financing, the obtaining of the approval of the plan by the township, and the agreement to construct streets and sewers were "construction" for this purpose. The court pointed to the words "to any extent"<sup>20</sup> in the

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<sup>14</sup> *E.g.*, *Farber v. Commissioner*, 312 F.2d 729 (2d Cir. 1963); *Mintz v. Commissioner*, 284 F.2d 554 (2d Cir. 1960), *affirming* 32 T.C. 723 (1959); *Weil v. Commissioner*, 252 F.2d 805 (2d Cir. 1958), *affirming* 28 T.C. 809 (1957); *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958); *R.A. Bryan*, 32 T.C. 104 (1959), *acq.*, 1959-2 CUM. BULL. 4, *aff'd in part and remanded on another issue*, 281 F.2d 238 (4th Cir. 1960), *cert. denied*, 364 U.S. 931 (1961).

<sup>15</sup> INT. REV. CODE OF 1954, § 341(b)(2)(A).

<sup>16</sup> INT. REV. CODE OF 1954, § 341(b)(2)(B).

<sup>17</sup> INT. REV. CODE OF 1954, § 341(b)(2)(C).

<sup>18</sup> Rev. Rul. 56-137, 1956-1 CUM. BULL. 178.

<sup>19</sup> *J. D. Abbott*, 28 T.C. 795 (1957), *aff'd*, 258 F.2d 537 (3d Cir. 1958). See also *Sproul Realty Co.*, 38 T.C. 844 (1962), *acq.* 1963-1 CUM. BULL. 4; *Jack Farber*, 36 T.C. 1142 (1961), *aff'd*, 312 F.2d 729 (2d Cir. 1963); *Ellisworth J. Sterner*, 32 T.C. 1144 (1959); *Leland D. Payne*, 30 T.C. 1044 (1958), *aff'd*, 268 F.2d 617 (5th Cir. 1959).

<sup>20</sup> INT. REV. CODE OF 1954, § 341(b)(2)(A).

statute as the justification for the broad interpretation of "construction." The Second Circuit,<sup>21</sup> by way of dictum, has said:

We are not obliged to rely wholly on the filing of applications for permits and loans guarantees and the payment of required filing fees, although we do not say that, in this age when real estate development is so dependent upon governmental licenses and financial aid, the filing of papers to procure these could not, as much as the digging of a cellar excavation, constitute "construction . . . to any extent."<sup>22</sup>

The Tax Court has held, however, that the mere filing of a tentative plat was not "construction."<sup>23</sup>

The scope of application of the terms "manufacture, construction, or production" has yet to be satisfactorily defined by the courts. The problem is most acute in such areas as the natural resources industries. The revenue service has ruled,<sup>24</sup> for example, that section 341 applies to a corporation which has acquired wildcat oil leases. The corporation in question had completed producing wells on the properties, and the value of the leases was thereby substantially increased. The stockholders capitalized on their good fortune by selling their stock at a price which reflected the augmented value. The revenue service found that the collapsible definition did apply, that is, that the corporation was engaged in the "construction or production" of property.

On the other hand, another revenue ruling<sup>25</sup> indicates that unsuccessful exploratory activity on an oil and gas lease does not constitute "construction or production." The latter ruling is helpful in applying a specific limitation to section 341.<sup>26</sup> As for the general definition of a collapsible corporation, however, the ruling would appear to help only those who would use the corporate vehicle for the drilling of dry holes.

A federal district court<sup>27</sup> has said that a reasonable interpretation of the phrase "construction or production" would include the activities of obtaining leases, drilling wells on them, and equipping the productive wells. However, this was merely dictum since the court determined that the requisite "view" to a sale was absent.

The plight of the natural resources industries under the statute was the subject of comment in the committee reports on the Technical

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<sup>21</sup> *Farber v. Commissioner*, 312 F.2d 729 (2d Cir. 1963).

<sup>22</sup> *Id.* at 734.

<sup>23</sup> *Vernon W. McPherson*, 21 CCH Tax Ct. Mem. 583 (1962). See also *Morris Cohen*, 39 T.C. 886 (1963) (efforts to rezone and to assure availability of water and sewer service).

<sup>24</sup> Rev. Rul. 57-346, 1957-2 CUM. BULL. 236.

<sup>25</sup> Rev. Rul. 64-125, 1964-1 CUM. BULL. 131.

<sup>26</sup> See notes 145-51 *infra* and accompanying text.

<sup>27</sup> *Honaker Drilling, Inc. v. Koehler*, 190 F. Supp. 287 (D. Kan. 1960).

Amendments Act of 1958.<sup>28</sup> There it was noted that in the case of a corporation with continuing development activity, there can be no certainty as to its collapsibility. This is so even though the corporation has little or no inventories and even though gain on the sale of the property would be capital gain if sold by the shareholders. The importance of the nature of the gain when imputed to the stockholders will be discussed later in this Article.

#### D. "Section 341 Assets"

Another proscribed corporate activity is the purchase of property which the code calls "section 341 assets."<sup>29</sup> Included in this term are assets held for *less than three years* which are:

- (1) Inventory items;<sup>30</sup>
- (2) Property held primarily for sale to customers in the ordinary course of the purchasing corporation's business;<sup>31</sup>
- (3) Property used in the purchasing corporation's business (section 1231(b) property), except for property which is used to produce property described in (1) and (2) above;<sup>32</sup> or
- (4) Unrealized receivable or fees for services or for sales of property described in (1), (2), or (3) above.<sup>33</sup>

In determining the three-year holding period of section 341 assets, there is taken into account the "tacked-on" holding period which usually results from nontaxable exchanges.<sup>34</sup> In any event, however, the holding period does not begin to run until the completion of the manufacture, construction, production, or purchase.<sup>35</sup>

The revenue service<sup>36</sup> has taken the reasonable position that where a corporation is liquidated for bona fide business reasons, it is not collapsible under the given facts even though the corporation has not yet realized the income attributable to inventory appreciation. Important in the situation ruled upon was the fact that the inventory of the corporation at the time of liquidation was normal for the volume of sales and was no more than the average inventory over the past several years. This type of comparison with prior business history is also adopted in the regulations.<sup>37</sup>

<sup>28</sup> S. REP. NO. 1983, 85th Cong., 2d Sess. (1958), 1958-3 CUM. BULL. 922, 953.

<sup>29</sup> INT. REV. CODE OF 1954, § 341(b)(1), (3).

<sup>30</sup> INT. REV. CODE OF 1954, § 341(b)(3)(A). See also notes 36-37 *infra* and accompanying text.

<sup>31</sup> INT. REV. CODE OF 1954, § 341(b)(3)(B). See, *e.g.*, *Southwest Properties, Inc.*, 38 T.C. 97 (1962).

<sup>32</sup> INT. REV. CODE OF 1954, § 341(b)(3)(D).

<sup>33</sup> INT. REV. CODE OF 1954, § 341(b)(3)(C).

<sup>34</sup> INT. REV. CODE OF 1954, § 341(b)(3); INT. REV. CODE OF 1954, § 1223.

<sup>35</sup> INT. REV. CODE OF 1954, § 341(b)(3).

<sup>36</sup> Rev. Rul. 56-244, 1956-1 CUM. BULL. 176.

<sup>37</sup> Treas. Reg. § 1.341-5(c)(1) (1955).



An Alabama federal district court in *Levenson v. United States*<sup>38</sup> took a refreshing approach to the question of when a corporation is collapsible because of its inventory. There the corporation was formed to receive a partnership's contract to purchase house trailers. Within a year the stock of the corporation was sold. Although the court recognized that there was a tax avoidance motive, the court still held that the corporation was not collapsible. The only "section 341 assets" were a contract to purchase trailers and an inventory of trailers. The court noted that 1,795 trailers had been sold by the partnership and that 109 trailers remained on hand. Using those figures, the court concluded that the seventy per cent exception (to be discussed later) applied. The trailers *to be purchased* under the contract were not taken into account as "inventory" in the computation.

#### E. Holding Stock

The remaining collapsible corporate activity is the holding of stock in a corporation which is formed or availed of for one of the activities previously described.<sup>39</sup> In order for the holding company to be regarded as a collapsible corporation, the activity of holding the stock must be a substantial one in relation to other activities.<sup>40</sup>

In 1956 the revenue service issued a ruling<sup>41</sup> dealing with a corporation which was collapsible because of holding stock. The parent corporation had sold its interest in the subsidiary and had then distributed all of the parent's assets in liquidation. The ruling held that the parent corporation incurred ordinary income on the sale of the collapsible subsidiary's stock, but that the subsequent liquidation of the parent resulted in capital gain, not ordinary income, to the parent's shareholders. The statute refers only to the realization of taxable income by the corporation producing the property and not to any realization by the corporation holding its stock. The ruling noted that a literal reading of the statute would cause the holding company still to be collapsible even though it already had been taxed as the shareholder of a collapsible corporation. The ruling states, however, that the suggested interpretation would be contrary to congressional intent; therefore, the shareholders are entitled to treat as capital gain the gain on the second liquidation.

#### F. Presumption Of Collapsibility

A presumption arises that a corporation is collapsible if the fair

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<sup>38</sup> 157 F. Supp. 244 (D. Ala. 1957).

<sup>39</sup> INT. REV. CODE OF 1954, § 341(b)(1).

<sup>40</sup> Treas. Reg. § 1.341-5(b) (1955).

<sup>41</sup> Rev. Rul. 56-50, 1956-1 CUM. BULL. 174.

market value of its section 341 assets is (1) fifty per cent or more of the fair market value of its total assets, and (2) 120 per cent or more of the adjusted basis of the section 341 assets.<sup>42</sup> Total assets, for this purpose, do not include cash, obligations which are capital assets, governmental obligations, or stock in other corporations.<sup>43</sup> This presumption works only against the corporation. Thus, the failure of a corporation to come within the requirements of the presumption does not in turn give rise to a contrary presumption that the corporation is not collapsible.<sup>44</sup>

### G. "View"

The requisite intent of the stockholders to collapse the corporation is described by the statute in terms of a "view."<sup>45</sup> The regulations adopt a very broad interpretation of this requirement:

[It] is satisfied in any case in which such action was contemplated by those persons *in a position to determine the policies of the corporation* whether by reason of their owning a majority of the voting stock or otherwise. The requirement is satisfied whether such action was contemplated, unconditionally, conditionally, or as a *recognized possibility*. If the corporation was so formed or availed of, it is immaterial [that] . . . a shareholder at such time, did not share in such view. Any gain of such shareholder on his stock shall be treated in the same manner as gain of a shareholder who did share in such view. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described.<sup>46</sup>

Moreover, several courts<sup>47</sup> have inferred the requisite view from objective facts,<sup>48</sup> without proof of even the "recognized possibility"<sup>49</sup> or reasonable foreseeability<sup>50</sup> required by the regulations. It could be argued that this is the "best evidence"<sup>51</sup> of the necessary subjective intent.

1. *Intent of Minority Shareholders* The minority shareholder who finds himself owning stock in a collapsible corporation is, to a con-

<sup>42</sup> INT. REV. CODE OF 1954, § 341(c)(1). For example of case in which presumption was rebutted, see Jack D. Saltzman, 22 CCH Tax Ct. Mem. 336 (1963). *But cf.* Max N. Tobias, 40 T.C. 84 (1963).

<sup>43</sup> INT. REV. CODE OF 1954, § 341(c)(2).

<sup>44</sup> INT. REV. CODE OF 1954, § 341(c)(1). *But see* Treas. Reg. § 1.341-5(c) (1955).

<sup>45</sup> INT. REV. CODE OF 1954, § 341(b)(1).

<sup>46</sup> Treas. Reg. § 1.341-2(a)(2) (1955). (Emphasis added.)

<sup>47</sup> *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958); *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958).

<sup>48</sup> See, e.g., Treas. Reg. § 1.341-5(b) (1955).

<sup>49</sup> Treas. Reg. § 1.341-2(a)(2) (1955).

<sup>50</sup> Treas. Reg. § 1.341-5(a)(3) (1955).

<sup>51</sup> *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959).

siderable extent, dependent upon the majority for a determination of his tax status. The regulations quoted above recognize this.<sup>52</sup>

In *Sylvester J. Lowery*,<sup>53</sup> an important case decided by the Tax Court, the taxpayer was a minority stockholder in four corporations two of which were found to be collapsible and two of which were not. As to the two corporations which were collapsible, the Tax Court said: "[T]here was a sale of *all* of the stock by *all* of the shareholders and it is clear that petitioner, in fact, shared in the view of the majority of the shareholders to sell the stock prior to the realization by the corporations of any part of the net income to be derived from the property."<sup>54</sup>

A different conclusion was reached with respect to the other two corporations. There the selling shareholder was *not* within section 341 since the majority did not have the proscribed "view." After one of those corporations had completed fifty per cent of the construction on a building, a Mr. Frankel, who was in control of the operation, determined that additional investment would be required on the part of the stockholders. The taxpayer was unable to raise additional funds. Frankel thereupon advised the taxpayer that two new investors were willing to advance a portion of the needed funds, but only on the condition that they obtained an equity interest in the corporation. The taxpayer thereupon sold his stock. The court said that:

in many respects the transactions which took place with respect to Parkway and Raleigh are similar to those which occurred with respect to Carver and Duval. One material distinction exists, however. In both Parkway and Raleigh, those owning the majority of the stock and who were not only in a position to, but did, in fact, control their policies, did not sell their stock but continued to operate the corporations. Neither corporation was availed of "with a view to" the action described in section 117(m)(2)(A), by those owning a majority of the stock and controlling its policies. It necessarily follows that petitioner did not "share" in such a view. Neither corporation was "collapsible" or was ever in fact collapsed. . . .

In our opinion section 117(m) was not intended to apply where, as here, a minority shareholder is compelled, because of circumstances over which he had no control, to dispose of his investment in a corporation which is thereafter continued in operation by the majority shareholders.<sup>55</sup>

A strong dissenting opinion stated that since the sale of stock is an

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<sup>52</sup> Treas. Reg. § 1.341-2(a)(2) (1955).

<sup>53</sup> 39 T.C. 959 (1963), *aff'd*, 335 F.2d 680 (3d Cir. 1964); *accord*, Ralph J. Solow, 22 CCH Tax Ct. Mem. 398 (1963), *aff'd*, 333 F.2d 76 (2d Cir. 1964); *Goodwin v. United States*, 320 F.2d 356 (Ct. Cl. 1963).

<sup>54</sup> *Sylvester J. Lowery*, 39 T.C. 959, 967 (1963). (Emphasis in original.) See also *Max N. Tobias*, 40 T.C. 84 (1963).

<sup>55</sup> 39 T.C. 959, 970.

individual matter, the "view" of other shareholders can have only evidentiary bearing on what was in the taxpayer's mind.<sup>56</sup>

The Court of Claims has followed the Tax Court's position on the minority stockholder issue in a case involving a twenty-five per cent minority stockholder.<sup>57</sup> Numerous discussions and disagreements between the majority stockholders and the twenty-five per cent stockholder resulted in a decision to dissolve their business relationship. The minority stockholder's interest was, therefore, redeemed at a time when the corporation held excess mortgage proceeds on a construction loan. Despite the fact that the minority stockholder had apparently been active in the policy decisions of the corporation, the Court of Claims followed the Tax Court rule: "The essence of the Tax Court's rulings is that the collapsible corporation provisions are not applicable in a case in which a minority stockholder has his stock redeemed and the majority stockholder continues to own the corporation. . . . [W]e agree with the Tax Court's rulings."<sup>58</sup>

This interpretation presents a useful planning device if it means that a minority stockholder, regardless of his "view" respecting the corporation, can bail out without collapsing the corporation, as long as the majority intend to continue operations.

2. *Timing the View* Among the other unanswered issues posed by the statute is when the view<sup>59</sup> must exist. The regulations give this answer:

A corporation is formed or availed of with a view to the action described in section 341(b) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.<sup>60</sup>

The position taken by the regulations, that the view must exist

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<sup>56</sup> 39 T.C. 959, 971. This suggestion probably obtains a fairer result, by not imposing the tainted majority "view" on a minority shareholder. Such a rule would prevent many of the anomalies which result under the present statute.

<sup>57</sup> *Goodwin v. United States*, 320 F.2d 356 (Ct. Cl. 1963).

<sup>58</sup> *Id.* at 359.

<sup>59</sup> INT. REV. CODE OF 1954, § 341(b)(1).

<sup>60</sup> Treas. Reg. § 1.341-2(a)(3) (1955).

prior to completion of the manufacture, production, construction, or purchase, appears reasonable in light of the intent of the statute. It is clear—and the courts have so held<sup>61</sup>—that the view need not exist at the time the corporation is formed.

On the other hand, the regulations have been regarded by some courts, particularly the Second and Fourth Circuits,<sup>62</sup> as being too narrow. The argument is that the view is sufficient if it exists when the corporation is *availed of*, regardless of whether the view was present before completion of the manufacture, production, construction, or purchase. For example, if a corporation is used principally for the manufacture of property and it is not until after the completion of the manufacturing that the stockholders decide to “avail” themselves of the corporation—liquidate or sell in order to recognize the appreciation in the property by way of capital gain—then the corporation will still be collapsible.

The Fifth Circuit,<sup>63</sup> while not expressly disagreeing with the position that the regulations are too narrow, has pointed out by way of dictum that this seems to overlook the statute’s requirement that the corporation must be *availed of* for *construction* of property with a view to distribution, etc. According to this court, a respectable argument can be made that unless the “view” is present before or during construction the statute is not satisfied.

Other courts have gone farther than the Fifth Circuit and have expressly rejected the Second and Fourth Circuits’ interpretation. The Third Circuit<sup>64</sup> has held that the “view” must exist before the construction of the property was completed. Thus, where the intention to sell arose after completion of construction of a building and was occasioned by cracks discovered in the building, it was held that the “view” originated too late for the corporation to be collapsible.

In what might be labeled the “handy heart attack” line of cases, the Tax Court and other courts have tended to favor the taxpayer whose health has turned bad. In *Maxwell Temkin*<sup>65</sup> the Tax Court held that a corporation was not collapsible where the sale was prompted by a stockholder having a “typical attack of angina.” The Commissioner argued that since the taxpayer had previously had heart

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<sup>61</sup> E.g., *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958).

<sup>62</sup> *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958); *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958). See also *Farber v. Commissioner*, 312 F.2d 729 (2d Cir. 1963); *Sidney v. Commissioner*, 273 F.2d 928, 931 (2d Cir. 1960); cf. *Commissioner v. Solow*, 333 F.2d 76 (2d Cir. 1964).

<sup>63</sup> *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959).

<sup>64</sup> *Jacobson v. Commissioner*, 281 F.2d 703 (3d Cir. 1960).

<sup>65</sup> 35 T.C. 906 (1961). See also *Elliott v. United States*, 205 F. Supp. 384 (D. Ore. 1962); cf. *Sproul Realty Co.*, 38 T.C. 844 (1962), *acq.*, 1963-1 CUM. BULL. 4.

trouble, the angina attack was a circumstance which "reasonably could be anticipated."<sup>66</sup> The Tax Court, however, found that during construction the taxpayer did not in fact anticipate another heart attack.

Certainly respondent does not wish to have his regulation so construed as to render it statutorily impossible for anyone who has suffered a heart attack to invest in the construction or production of income-producing property without assuming the certainty that should he suffer another attack which itself occasions the sale of his stock his gains are to be treated as ordinary income and so taxed. It is reasonable to anticipate that it is statistically possible or even probable that events will occur in the ordinary business of life which might require one who has invested in property of the type referred to in section 117(m) to sell the property, but so to construe the regulation that such possibilities preclude capital gains treatment of such sales would render the regulation in that respect invalid as not within the framework of section 117(m).<sup>67</sup>

In *Charles J. Riley*,<sup>68</sup> a variation of the same theme, the taxpayer was advised by his doctor to change from the business of owning and managing apartments to something requiring more physical activity. The Tax Court concluded that the sale was attributable solely to circumstances which arose at a time substantially after the completion of construction of the corporation's apartment building. The court also found that the reason for the sale could not have been reasonably anticipated at the time of construction. Therefore, the proscribed "view" was absent. Also, the Tax Court has held for the taxpayer where it found that his discovery that others were misappropriating funds could not have been anticipated during construction.<sup>69</sup>

A district court in New Jersey went further and held that a sale occasioned by a heart attack *during* construction did not bring on collapsible results.<sup>70</sup> The court said that:

[T]he only reasonable inference that may be drawn from the affirmative proofs is that the two corporations were not formed or availed of with a view, on the part of either [stockholder] . . . , to the sale of the corporate stock before realization of substantial taxable income to be derived from the property. There is no evidence that such action on the part of either was contemplated "unconditionally, conditionally, or as a recognized possibility." A long-term investment in income-producing property was the objective. The achievement thereof on the part of Shilowitz was frustrated by his heart attack, and his withdrawal from

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<sup>66</sup> Treas. Reg. § 1.341-2(a)(3) (1955), quoted at note 49 *supra*. See also the leading case of *August v. Commissioner*, 267 F.2d 829, 833-34 (3d Cir. 1959) and *Carl B. Rechner*, 30 T.C. 186, 194 (1958).

<sup>67</sup> 35 T.C. 906, 912 (1961).

<sup>68</sup> *Charles J. Riley*, 35 T.C. 848 (1961). See also *Southwest Properties, Inc.*, 38 T.C. 97 (1962).

<sup>69</sup> *Ralph J. Solow*, 22 CCH Tax Ct. Mem. 398 (1963), *aff'd*, 333 F.2d 76 (2d Cir. 1964).

<sup>70</sup> *Shilowitz v. United States*, 221 F. Supp. 179 (D.N.J. 1963).

the joint venture by sale of his stock was an involuntary consequence of unforeseen circumstances over which he had no control. The fact that he did dispose of his stock at a gain, under the compulsion of such circumstances, is not inconsistent, as defendant urges, with the absence of the prescribed statutory view.

The test is whether unforeseen circumstances which could not have been reasonably anticipated were the sole producing cause of change of plan.<sup>71</sup>

This holding is surprisingly liberal in view of the Supreme Court's somewhat mechanical application of the statute in *Braunstein v. Commissioner* which will be discussed later.<sup>72</sup>

Along a similar vein, the revenue service has ruled<sup>73</sup> that a corporation was not collapsible where it liquidated<sup>74</sup> because of the enactment of certain legislation. The ruling emphasized that during construction there had been no basis for reasonable anticipation that the legislation would be enacted.<sup>75</sup>

The rule set forth in the regulations appears to be a reasonable interpretation of the law. If "manufacture," etc. is to be the point in time when the collapsible intent must occur, then certainly it is appropriate to inquire whether during the manufacture events were reasonably foreseeable which would lead to collapsing the corporation.<sup>76</sup>

The important question of when the manufacture is regarded as completed will be taken up in more detail with the discussion of the three-year limitation.<sup>77</sup>

3. *The Ivey-Braunstein Dichotomy* An interesting line of cases found two circuits to be in complete disagreement over the scope of the statute's application. The issue was finally resolved by the Supreme Court in *Braunstein v. Commissioner*,<sup>78</sup> which was limited to a con-

<sup>71</sup> *Id.* at 184. See also *Commissioner v. Lowery*, 335 F.2d 680 (3d Cir. 1964); *Commissioner v. Solow*, 333 F.2d 76 (2d Cir. 1964).

<sup>72</sup> 374 U.S. 65 (1963). See discussion accompanying and following note 78 *infra*.

<sup>73</sup> Rev. Rul. 75-575, 1957-2 CUM. BULL. 236. Compare *R. A. Bryan*, 32 T.C. 104 (1959), *acq.*, 1959-2 CUM. BULL. 4, *aff'd and remanded on another issue*, 281 F.2d 238 (4th Cir. 1960).

<sup>74</sup> The ruling actually dealt with the applicability of § 337 to the sale of the corporate assets. As discussed later, § 337 is generally inapplicable where the corporation is collapsible.

<sup>75</sup> In *Tibbals v. United States*, 17 Am. Fed. Tax R.2d 1213, 1221 (Ct. Cl. June 10, 1966) is the following comment: "Despite some early indications to the contrary by the . . . Second and Fourth Circuits, it now appears to be settled that the view to sale . . . must have existed before completion of the construction work for which the corporation was formed." See also *Coates v. United States*, 6 Am. Fed. Tax R.2d 5200 (D. Ore. 1960).

<sup>76</sup> See, e.g., *Mintz v. Commissioner*, 284 F.2d 554 (2d Cir. 1960), *affirming* 32 T.C. 723 (1959).

<sup>77</sup> See text accompanying notes 147-51 *infra*.

<sup>78</sup> *Braunstein v. Commissioner*, 374 U.S. 65 (1963), *affirming* 305 F.2d 949 (2d Cir. 1962). The discussion in this part borrows heavily from Malouf, *Braunstein Affirmed: 341 Applies Despite Shareholder's Capital Gain Status*, 19 J. TAXATION 80 (1963).

sideration of the following issue: "Whether Section 117(m) of the Internal Revenue Code of 1939 [Section 341 of the 1954 Code] . . . is inapplicable in circumstances where the stockholders would have been entitled to capital gains treatment had they conducted the enterprise in their individual capacities without using a corporation."<sup>79</sup> The Supreme Court held that the imputed capital-gain status of the stockholders is irrelevant in determining whether the collapsible provisions can apply. In order to appreciate the significance of the Supreme Court's decision, one should be familiar with the case development which preceded the decision.

In *Honaker Drilling, Inc. v. United States*,<sup>80</sup> a district court case, a man and his wife were partners in an oil and gas operation. The business was transferred to a corporation after the husband was told that he had cancer, and his business advisers recommended the corporate form for continuing the business. The corporation (taxpayer) proceeded to carry on the business, drilling primarily on properties in which it owned an interest. After a year the taxpayer received, unsolicited, an especially favorable offer for the sale of its properties. The properties were sold, and the corporation distributed its assets within twelve months.

The Commissioner contended that the corporation was collapsible and that the nonrecognition provisions of section 337, dealing with certain liquidations, were therefore inapplicable.<sup>81</sup> This would have caused the corporation to recognize the gain on the sale of its assets. The court, however, found against the Commissioner. The practice legislated against, according to the court, was the attempt to convert income taxable at ordinary rates into income taxable at capital gain rates. In support of this interpretation, the court quoted the following excerpt from the Senate Finance Committee report on the Revenue Act of 1950: "The collapsible corporation is a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at a rate of 25 per cent."<sup>82</sup>

The court concluded that a reasonable interpretation of "construction or production" *would include* the activities of obtaining leases, drilling wells on them, and equipping the productive wells. It found, however, that the corporation was organized solely because of the impairment of the principal stockholder's health and that the stock-

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<sup>79</sup> *Id.* at 68.

<sup>80</sup> 190 F. Supp. 287 (D. Kan. 1960).

<sup>81</sup> See text accompanying note 184 *infra*.

<sup>82</sup> S. REP. NO. 2375, 81st Cong., 2d Sess. 88 (1950).



holders had no intention of selling until the prospect of making an attractive profit presented itself.

Apparently persuaded by the committee reports that the absence of intent to convert ordinary income into capital gains precludes, at least in part, the "view" required by the statute, the court concluded that there was no intent to liquidate the corporation before a substantial part of the taxable income from the leases had been realized.<sup>83</sup>

In October 1961, the Fifth Circuit rendered an opinion which represents a landmark in judicial attempts to avoid the harsh results of a statute's arbitrary application. *United States v. Ivey*<sup>84</sup> involved the sale of stock of a corporation formed to construct an apartment building. During construction it became apparent that the building would be completely rented. When the building was seventy-five per cent completed, the taxpayer sold his stock at a substantial gain.

In asserting that his gain was capital, the taxpayer argued that the collapsible section is inapplicable when the stockholder would be entitled to a capital gain on a sale of the assets without benefit of incorporation. The court generally accepted the taxpayer's position, setting forth two alternative approaches: (1) as a matter of statutory interpretation, section 341 is inapplicable to taxpayers who would have been entitled to capital gains treatment without incorporating; or (2) the fact that the taxpayer has no need for the corporate device simply bears on the question of "view" or "intent." The court took the first approach "because it seems closer to the underlying congressional purposes"<sup>85</sup> and held "that Section 341 does not penalize the taxpayer by converting his capital gain into ordinary income."<sup>86</sup>

The court admitted that the statutory language is clear but said that the legislative history of section 117(m) of the 1939 Code shows "beyond dispute" that the proscribed mischief was the abuse of the corporate device as a technique for transmuting ordinary income into capital gain. Only by reading this purpose into the words of the law could the law have plain meaning.<sup>87</sup>

It is interesting to note that the Fifth Circuit pointed to the *Honaker* case as the only decision which had faced the issue squarely. *Honaker*, however, may be read as taking the second alternative ap-

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<sup>83</sup> 190 F. Supp. at 295. "I find that *Honaker Drlg., Inc.*, was not formed or availed of with a view to the accomplishment of the purposes set out in § 341(b) (1) (A) and (B), and hence that it was not a collapsible corporation within the meaning of that section."

<sup>84</sup> 294 F.2d 799 (5th Cir. 1961).

<sup>85</sup> *Id.* at 802.

<sup>86</sup> *Ibid.*

<sup>87</sup> It is interesting to note that the court apportioned the capital gain between short and long term because some construction occurred within six months of the stock sale. This treatment has possibilities as an alternative to the present statute.

proach discussed by the Fifth Circuit in *Ivey*, i.e., that the taxpayer's having no need for the corporate device simply bears on the question of "view" or "intent."<sup>88</sup>

The Fifth Circuit subsequently denied rehearing in *Ivey* but took the opportunity to clarify its original opinion by stating that: "The statute's purpose is to treat the taxpayer's gain as though it had been received directly by the individual."<sup>89</sup>

Unfortunately, however, the Fifth Circuit's approach was to be short lived. Two months after the second *Ivey* opinion the Second Circuit handed down its decision in *Braunstein*.<sup>90</sup> That case involved the taxation of a stockholder on distributions from and sale of stock of two apartment corporations. The taxpayer failed to convince either the Tax Court or the Second Circuit that the corporations did not fit into the collapsible section. The taxpayer argued before the court of appeals that the collapsible provisions should not apply if the constructed apartment buildings would have produced capital gain on a sale by the taxpayer individually. The Second Circuit flatly rejected this argument, recognizing, however, that the argument had been recently accepted by the Fifth Circuit in the *Ivey* decision. The court reasoned as follows:

- (a) Although a literal reading of the statute may occasionally produce unwarranted taxation of capital gain as ordinary income, for the courts to rewrite this complex legislation would produce even more confusion.<sup>91</sup>
- (b) *Ivey* violates one of the clear policy decisions embodied in the collapsible provisions, the all-or-nothing approach to long-term capital gains.
- (c) The enactment in 1958 of subsection (e)<sup>92</sup> of section 341 was designed to narrow the imposition of ordinary income treatment in the *Ivey*-type situation. *Ivey*, however, went even further than subsection (e). Therefore, if *Ivey* is correct, either subsection (e) is unnecessary or, if it is regarded as overriding the reasoning in *Ivey*, subsection (e) expands rather than contracts the application of the collapsible provisions; this is clearly contrary to what Congress intended.

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<sup>88</sup> See text following note 93 *infra*.

<sup>89</sup> 303 F.2d 109, 110 (5th Cir. 1962). (Emphasis in original.)

<sup>90</sup> *Braunstein v. Commissioner*, 305 F.2d 949 (2d Cir. 1962), *aff'd*, 374 U.S. 65 (1963); *accord*, *Sproul Realty Co.*, 38 T.C. 844 (1962), *acq.* 1963-1 CUM. BULL. 4; *Max N. Tobias*, 40 T.C. 84 (1963).

<sup>91</sup> For an example of a ruling in which the Internal Revenue Service recognizes the harsh results that a literal reading of § 341 can produce, see Rev. Rul. 56-50, 1956-1 CUM. BULL. 174.

<sup>92</sup> See text accompanying notes 152-96 *infra*.

The Supreme Court granted certiorari in *Braunstein* on the basis of the conflict with *Ivey*. The taxpayer argued that the phrase "gain attributable to such property" must apply only to profit that would have constituted ordinary income if a corporation had not been utilized. The Court found nothing in the language or structure of the section to demand, or even justify, reading into the statute the additional requirement that the taxpayer must in fact have been using the corporate form as a device to convert ordinary income into capital gain. And even though the legislative history clearly shows that the purpose of Congress was to close a loophole, the method chosen to close this loophole was to establish a carefully and elaborately defined category of transactions in which income that might otherwise be a capital gain would have to be treated as ordinary income.

As reinforcement for this conclusion, the Court noted the "practical difficulties—indeed the impossibilities—of considering without more legislative guidance than is furnished by Section 117(m) whether there has in fact been 'conversion' of ordinary income into capital gains in a particular case."<sup>93</sup>

The Supreme Court's decision in *Braunstein* came as a disappointment but not as a surprise. The demise of *Ivey*, however, may not mean the end of all hope in this area; the *Honaker* decision may still be helpful.

The *Honaker* decision lacked much in the way of clarity. The fact that a sale of the assets by the shareholders would have resulted in capital gain was certainly persuasive to the court. It is difficult to determine, however, on what basis the court was persuaded. Did it accept the *Ivey* theory (first alternative) that as a matter of statutory interpretation the collapsible section could not apply? Or did it merely take this factor of shareholder capital-gain status into consideration (second *Ivey* alternative) in determining whether the requisite "view" was present?

One can certainly argue that the court took the latter position. If so, its holding is unaffected by *Ivey* and *Braunstein*. The *Ivey* decision did not turn on this point; it rested instead on statutory interpretation (the first alternative). Since the Supreme Court decision was restricted to the *Ivey* theory-*Braunstein* theory dichotomy, the Supreme Court may be regarded as not having passed on this point.

Is there an opening in the statutory wall? If so, it is a somewhat narrow one. This much may be said, however: Even accepting the *Braunstein* mechanical application of the statute, the collapsible issue

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<sup>93</sup> *Braunstein v. Commissioner*, 374 U.S. 65, 71 (1963).

will still turn on whether the requisite "view" exists. So long as the determination rests on this subjective standard, the absence of the conversion of ordinary income into capital gain *may*, as in *Honaker*, help persuade the court that the requisite "view" is not present.

#### H. "Substantial Part"

The definition of a collapsible corporation refers to a sale or exchange of the stock or a distribution by the corporation "before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a *substantial part* of the taxable income to be derived from such property."<sup>94</sup> The quoted phrase raises two immediate questions (1) Does "substantial part" measure income already realized at the time the corporation is collapsed or does it measure income yet to be derived at that time? And (2) what percentage of the income from the property represents a "substantial part"?

On the first question, we find the Fifth and Tenth Circuits and the Tax Court<sup>95</sup> applying what would seem to be the obvious meaning of the statute, that substantial part refers to income already realized. The Second<sup>96</sup> and Third<sup>97</sup> Circuits, on the other hand, take the position that "substantial part" refers to income not yet realized.

The Third Circuit case, *Abbott v. Commissioner*,<sup>98</sup> was an appeal from a Tax Court decision against the taxpayer. The Third Circuit interpreted the Tax Court opinion<sup>99</sup> as favoring the view that "substantial part" referred to income yet to be realized. The Tax Court, in *James B. Kelley*,<sup>100</sup> took the opportunity to set the record straight and to expressly espouse the income-already-realized theory. When the *Kelley* case reached the Fifth Circuit,<sup>101</sup> the court noted the Tax Court's apparent surprise at the Third Circuit's interpretation of the Tax Court's *Abbott* opinion. The Fifth Circuit refused to follow the Third Circuit and also refused to acknowledge that *Payne v. Com-*

<sup>94</sup> INT. REV. CODE OF 1954, § 341(b)(1)(A). (Emphasis added.)

<sup>95</sup> *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961), *affirming* 32 T.C. 135 (1959), *nonacq.*, 1962-2 CUM. BULL. 5. See also *Heft v. Commissioner*, 294 F.2d 795 (5th Cir. 1961); *Levenson v. United States*, 157 F. Supp. 244 (D. Ala. 1957); *E. J. Zongker*, 39 T.C. 1046 (1963), *aff'd*, 334 F.2d 44 (10th Cir. 1964); *Morris v. United States*, 11 Am. Fed. Tax R.2d 875 (D. Kan. 1963).

<sup>96</sup> *Farber v. Commissioner*, 312 F.2d 729 (2d Cir. 1963).

<sup>97</sup> *Abbott v. Commissioner*, 258 F.2d 537 (3d Cir. 1958).

<sup>98</sup> 258 F.2d 537 (3d Cir. 1958). Note that the result would probably have been the same here regardless of the interpretation given. Compare the percentages with those in *Max N. Tobias*, 40 T.C. 84 (1963).

<sup>99</sup> *J. D. Abbott*, 28 T.C. 795 (1957).

<sup>100</sup> 32 T.C. 135 (1959).

<sup>101</sup> 293 F.2d 904 (5th Cir. 1961).

*missioner*<sup>102</sup> (a 1959 Fifth Circuit decision) supported the income-to-be-realized theory.

In *Kelley* the Fifth Circuit went into an interesting discussion of semantics. The position of the court was that there can be more than one "substantial part" of the whole and that the indefinite article "a" implies that there could be two or more substantial parts.

One is not surprised that the Commissioner sides with the Third Circuit view. In *Revenue Ruling 62-12*<sup>103</sup> he announced that the Internal Revenue Service will not follow either the Tax Court or the Fifth Circuit decision in *Kelley*.

What percentage of the whole constitutes a "substantial part"? Query whether the determination of "substantial" should vary with whether one accepts the Fifth Circuit view or the Third Circuit view. In the *Abbott* case<sup>104</sup> the Third Circuit held that the corporation had not realized a "substantial part" of the income when ninety per cent remained unrealized. The Fifth Circuit has held that while one-third<sup>105</sup> already realized is a "substantial part," one-sixth<sup>106</sup> is not. A district court<sup>107</sup> in Alabama has held that realization of fifty-one per cent is a "substantial part." The Tax Court has held that both thirty-four per cent and twenty-three per cent represent substantial parts,<sup>108</sup> but that nine and one-half per cent<sup>109</sup> and seventeen per cent<sup>110</sup> do not. It is interesting to note that the Fifth Circuit stated in *Kelley*<sup>111</sup> that a mechanical percentage test should not be applied. All facts must be considered, since Congress would have provided a mechanical application if it had wanted one.

The *Honaker* case,<sup>112</sup> discussed earlier,<sup>113</sup> involved a corporation engaged in the business of acquiring, drilling, and producing oil and gas leases. The government claimed that only 4.8 per cent of the taxable income from the leases had been realized at the time of the sale.<sup>114</sup> The taxpayer claimed that about thirty-four per cent had been realized. The difference lay in the expensing of intangible drilling and development costs.<sup>115</sup>

<sup>102</sup> 268 F.2d 617 (5th Cir. 1959).

<sup>103</sup> 1962-1 CUM. BULL. 321.

<sup>104</sup> *Abbott v. Commissioner*, 258 F.2d 537 (3d Cir. 1958).

<sup>105</sup> *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961).

<sup>106</sup> *Heft v. Commissioner*, 294 F.2d 795 (5th Cir. 1961).

<sup>107</sup> *Levenson v. United States*, 157 F. Supp. 244 (D. Ala. 1957).

<sup>108</sup> *E. J. Zongker*, 39 T.C. 1046 (1963), *aff'd*, 334 F.2d 44 (10th Cir. 1964).

<sup>109</sup> *Max N. Tobias*, 40 T.C. 84 (1963).

<sup>110</sup> *G. A. Heft*, 34 T.C. 86 (1960), *aff'd*, 294 F.2d 795 (5th Cir. 1961).

<sup>111</sup> *Commissioner v. Kelley*, 293 F.2d 904, 913 (5th Cir. 1961).

<sup>112</sup> *Honaker Drilling, Inc. v. Koehler*, 190 F. Supp. 287 (D. Kan. 1960).

<sup>113</sup> See text accompanying notes 80-85 *supra*.

<sup>114</sup> The issue was whether § 337 applied to a sale of the corporate assets so as to make such sale nontaxable.

<sup>115</sup> Now authorized in INT. REV. CODE OF 1954, § 263(c).

In the government's computations the expensing of intangibles apparently was offset against income derived from the leases; the government then compared the net figure against the anticipated production from the wells. The court said that the government's argument assumed that if the leases had not been sold, there would have been no more drilling and development. The more reasonable assumption, according to the court, was that the corporation would have continued to acquire new leases, continued the drilling and development of new and old leases, and continued to incur intangible drilling and development costs. The court thus allowed the estimated cost of future income as an offset to future income in arriving at the denominator to determine the percentage of income realized.

The words "net income to be derived from such property"<sup>116</sup> have been said by another court<sup>117</sup> to mean the total amount of income which on the date the corporation is collapsed might reasonably be expected from the properties. The subsequent failure of such income to materialize was regarded as irrelevant to the determination of collapsibility. It has also been held that premiums paid by a bank to a corporation for placing its F.H.A.-insured mortgages with that bank are not "derived from" the collapsible property, though they are within "net income."<sup>118</sup>

Where on the date of the initial distribution in a series of distributions the corporation had realized 17.07 per cent of the income to be derived from the properties, but before the final distribution the corporation had realized a cumulative profit of fifty-one per cent of the total, the Fifth Circuit held that the corporation was collapsible.<sup>119</sup> The court said that collapsibility is to be determined when the shareholders *first* sell or exchange the stock; the later total realization of fifty-one per cent of the income was thus of no aid to the shareholders.

Moreover, according to the regulations the realization must also be substantial as to each section 341 asset (or "project")<sup>120</sup> and not merely as to the corporate assets as a whole.<sup>121</sup>

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<sup>116</sup> INT. REV. CODE OF 1954, § 341(b)(1)(A).

<sup>117</sup> *Short v. Commissioner*, 302 F.2d 120 (4th Cir. 1962), *affirming* 35 T.C. 922 (1961); *Bryan v. Commissioner*, 281 F.2d 238 (4th Cir. 1960), *cert. denied*, 364 U.S. 931 (1961); *Spangler v. Commissioner*, 278 F.2d 665 (4th Cir. 1960), *cert. denied*, 364 U.S. 825 (1960); *cf. Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959).

<sup>118</sup> *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960).

<sup>119</sup> *Heft v. Commissioner*, 294 F.2d 795 (5th Cir. 1961).

<sup>120</sup> Treas. Reg. § 1.341-2(a)(4) (1955).

<sup>121</sup> Treas. Reg. § 1.341-5(d) (1955), example (2).

#### IV. LIMITATIONS ON COLLAPSIBILITY—SUBSECTION (d)

Subsection (d) of section 341 provides three general limitations to the application of the collapsible rule. These will be discussed in the order in which they appear in the code.

##### A. *The Five Per Cent Limitation*

The collapsible section does not apply to a shareholder unless at any time after the commencement of the manufacture, construction, or production of the property, or at the time of (or any time after) the purchase of section 341 assets, the shareholder either (1) owns (or was considered as owning) more than five per cent in value of the outstanding stock of the corporation, or (2) owns stock which is considered as owned at such time by another shareholder who then owns (or is considered as owning) more than five per cent in value of the outstanding stock of the corporation.<sup>122</sup> For purposes of determining stock ownership the constructive ownership rules for personal holding companies apply, except that the family attribution rules are expanded by the collapsible section so that ownership is also attributed from the spouse of a member of the family.<sup>123</sup>

The constructive ownership rules which appear in the personal holding company provisions do not allow double attribution of family and partnership ownership.<sup>124</sup> For example, assume that *H* and *W* are married. *H* owns no stock. *H*'s partner, *P*, owns four per cent of the stock of a company. *H* will be regarded as owning the stock of that company owned by *P*. *W*, however, will not be regarded as owning that stock, since to do so would result in a double attribution among family and partners. For purposes of the five per cent limitation on the collapsible section, however, a person does not himself have to own the stock constructively. He is not within the exception if he merely owns stock which is constructively owned by a more-than-five per cent shareholder.<sup>125</sup> For instance, in the above example, *P* owned four per cent of the stock of a company; *H* owned none. Assume now that *W* also owned four per cent. As already shown, *W* will not be regarded as owning *P*'s four per cent; *H*, however, will be regarded as owning *P*'s four per cent as well as *W*'s four per cent. *H* will, therefore, be constructively a more-than-five per cent stockholder. Since *W* and *P* each own stock which is considered as owned

<sup>122</sup> INT. REV. CODE OF 1954, § 341(d)(1).

<sup>123</sup> INT. REV. CODE OF 1954, §§ 341(d), 544(a)(1),(2),(3),(5),(6).

<sup>124</sup> INT. REV. CODE OF 1954, § 544(a)(5).

<sup>125</sup> INT. REV. CODE OF 1954, § 341(d)(1)(B).

by a constructive more-than-five per cent shareholder (*H*), *W* and *P* do not qualify for the exception to the collapsible provision.<sup>126</sup>

### B. *The Seventy Per Cent Limitation*

The gain realized by the shareholder will be immune from collapsible treatment unless more than seventy per cent of the gain is attributable to the property manufactured, constructed, produced, or purchased.<sup>127</sup> Although taxpayers have often invoked this limitation, they have done so with little success. Many of the cases dealing with the seventy per cent limitation have involved F.H.A. overfinanced apartment corporations, where the taxpayer attempted to attribute his gain to something other than construction.<sup>128</sup> The courts have rejected arguments that the gain was attributable to a favorable purchase of stock subsequently redeemed,<sup>129</sup> that it was attributable to favorable financing<sup>130</sup> and that it was attributable to appreciation in the value of the land.<sup>131</sup> These are generally considered by the courts to be attributable to construction, either planned,<sup>132</sup> underway,<sup>133</sup> or completed.<sup>134</sup> The rationale is that "but for" the construction and loan no gain would have been realized. As the Second Circuit stated in *Farber v. Commissioner*:<sup>135</sup>

Under one interpretation, which has apparently been espoused by the Commissioner, . . . the sole test for inclusion in the seventy per cent portion is the identity of the property to which the gain in question "is attributable." If this is property that has been "manufactured, constructed, produced, or purchased" so as to meet the definition of a collapsible corporation, then all the gain "attributable to" it qualified for the seventy per cent on this view, irrespective of its cause, as for example, when the gain to the stockholder represented by the fair market value of a newly constructed office building is shown to be primarily due to the unexpected rezoning of adjacent land and the erection of a shopping center thereon. The taxpayer, reading the same words with a

<sup>126</sup> Lewis S. Jacobson, 32 T.C. 893 (1959), *rev'd without discussion of this point*, 281 F.2d 703 (3d Cir. 1960); *Butler v. Patterson*, 148 F. Supp. 197 (D. Ala. 1957).

<sup>127</sup> INT. REV. CODE OF 1954, § 341(d)(2). Raymond S. Barry, 22 CCH Tax Ct. Mem. 1129 (1963).

<sup>128</sup> Distributions of excess F.H.A. loan proceeds on or after June 22, 1954, fall within the ambit of § 312(j) of the code, which in effect causes the distribution to be taxed as a dividend to the distributee.

<sup>129</sup> E.g., *Frank B. Short*, 35 T.C. 922 (1961), *aff'd*, 302 F.2d 120 (4th Cir. 1962).

<sup>130</sup> E.g., *Paul Braude*, 35 T.C. 1158 (1961); *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958).

<sup>131</sup> E.g., *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959); *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958); *Erwin Gerber*, 32 T.C. 1199 (1959). See also *Short v. Commissioner*, 302 F.2d 120 (4th Cir. 1962).

<sup>132</sup> *Paul Braude*, 35 T.C. 1158 (1961).

<sup>133</sup> *Jack Farber*, 36 T.C. 1142 (1961), *aff'd*, 312 F.2d 729 (2d Cir. 1963); *Mintz v. Commissioner*, 284 F.2d 554 (2d Cir. 1960).

<sup>134</sup> *Erwin Gerber*, 32 T.C. 1199 (1959).

<sup>135</sup> 312 F.2d 729, 735 (2d Cir. 1963).



different intonation, contends that gain qualifies for the 70 per cent only if attributable to the construction itself, and that such construction must, in addition, be performed by the collapsible corporation.

The court, in *Farber*, refused to attempt an allocation of the gain between that attributable to construction in the hands of the corporation in question and that attributable to subsequent construction by the purchaser.

Two<sup>136</sup> of the only three<sup>137</sup> decisions favorable to the taxpayer on the seventy per cent limitation occurred because the Commissioner could not sustain the burden of proof when, because of procedural reasons, it shifted to him.

In addition, Revenue Ruling 65-184<sup>138</sup> declares that even gain attributable to "three-year property" (discussed next) must be counted in the seventy per cent portion. The rationale is that the character of the property as being "manufactured, constructed, produced, or purchased" does not change merely because section 341(d)(3) makes section 341(a) inapplicable to such property.

### C. The Three-Year Limitation

The collapsible treatment will not be imposed on a shareholder to the extent that gain is realized after the expiration of three years following the completion of the manufacture, construction, production, or purchase.<sup>139</sup> The regulations<sup>140</sup> say that this limitation applies "to that portion" of a shareholder's gain realized more than three years after the actual completion of the manufacture, construction, production, or purchase of the property to which such portion is attributable. A clarifying amendment to the regulations in 1964 adds that "if the actual completion . . . occurred more than 3 years before the date on which the gain is realized, this section shall not apply to any part of the gain realized."<sup>141</sup> Query whether the limitation could be used to exempt gain attributable to a *part* of a project which has been completed.

Where a stockholder transfers property tax-free to a corporation in exchange for stock,<sup>142</sup> the revenue service has ruled<sup>143</sup> that the period

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<sup>136</sup> W. H. Weaver, 25 T.C. 1067 (1956); Thomas Wilson, 25 T.C. 1058 (1956). However, as a result of a subsequent case, C. D. Spangler, 32 T.C. 782 (1959), *aff'd*, 278 F.2d 665 (4th Cir. 1960), the Commissioner no longer has the burden of proof in such cases.

<sup>137</sup> The other is *Levenson v. United States*, 157 F. Supp. 244 (D. Ala. 1957).

<sup>138</sup> 1965-2 CUM. BULL. 91.

<sup>139</sup> INT. REV. CODE OF 1954, § 341(d)(3).

<sup>140</sup> Treas. Reg. § 1.341-4(d) (1955).

<sup>141</sup> 1964-2 CUM. BULL. 95.

<sup>142</sup> Section 351(a) of the code provides for the non-taxability of such an exchange.

<sup>143</sup> Rev. Rul. 57-491, 1957-2 CUM. BULL. 232.

during which the stockholder held the property should be "tacked on" in measuring the three years since manufacture, etc.

In another ruling<sup>144</sup> the revenue service examined the effect of the shareholder's reporting gain on the installment method (as permitted by section 453) where an installment of the sales price is received after the three-year period. Reasoning that section 453 does not postpone the date of realization of income but serves merely to postpone taxation, the service takes the position that the installment reporting would not affect the application of section 341. This ruling raises an interesting question as to the application of section 341 to a cash basis taxpayer who sells his stock within the three-year period but who receives a contract right incapable of being valued. When does the seller "realize" the gain—at the time of sale or upon fruition of his receivable? The ruling would indicate the former, even though "recognition" of gain is postponed.

The familiar question of when construction is completed appears again in the application of the three-year limitation. It was held in *Glickman v. Commissioner*<sup>145</sup> that *substantial* completion is insufficient, and 98.4 per cent completion has been so treated.<sup>146</sup> The revenue service has ruled<sup>147</sup> that rezoning for construction of a shopping center may constitute an integral step in the construction of the shopping center. If the corporation has no other construction activity with relation to the land, the three-year period begins on the day following the date on which the rezoning became final.

In another shopping center fact situation<sup>148</sup> the Tax Court has held that the construction of a retaining wall and the laying of a parking lot were integrated and necessary aspects of construction. The court said that these were required to be finished before the whole could be placed in effective operation. Final completion could not be fixed earlier than the time when the project was ready to begin earning a "substantial part" of the "net income." However, in a later case<sup>149</sup> dealing with an apartment house, the Tax Court failed to comment on the fact that at the time in question work yet remained for repairs to the walks, driveways, and steps, as well as considerable landscaping, including putting in a lawn. The two cases are reconcilable under a ready-for-use test: Whereas an apartment house can conceivably

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<sup>144</sup> Rev. Rul. 60-68, 1960-1 CUM. BULL. 151.

<sup>145</sup> 256 F.2d 108 (2d Cir. 1958).

<sup>146</sup> *Mintz v. Commissioner*, 284 F.2d 554 (2d Cir. 1960), *affirming* 32 T.C. 723 (1959).

<sup>147</sup> Rev. Rul. 56-137, 1956-1 CUM. BULL. 178.

<sup>148</sup> *Edward Weil*, 28 T.C. 809 (1957), *aff'd*, 252 F.2d 805 (2d Cir. 1958).

<sup>149</sup> *Maxwell Tempkin*, 35 T.C. 906 (1961).

operate without a lawn, a shopping center would have extreme difficulty operating without parking facilities.

Also consistent with this theory is a revenue ruling<sup>150</sup> dealing with the construction of a multi-story office building. All of the construction described in the plans and specifications was completed by December 31, 1958. The building was totally leased and occupied by that date. After the last tenant had secured occupancy and during the subsequent three years, the corporation expended certain sums in making minor alterations and corrections. The minor alterations and corrections included a change in the decor of the interior of the building, the removal of an obstruction for the convenience of the tenants (but this did not increase the rentable area), and the installation of additional rest room facilities. Further alterations were made in order to provide an office suitable for a new tenant's use and occupancy. The alterations and corrections did not change the character of the structure in any respect. There was no appreciable change in the fair market value of the building. Emphasizing (1) the absence of increase in rentable area, (2) the lack of change of character of the structure, and (3) the failure to increase the fair market value of the building and its realizable net income, the revenue service ruled that the minor alterations and corrections were not "construction." Therefore, since the initial construction was completed on December 31, 1958, the three-year limitation period had begun on that date.

In Revenue Ruling 64-125<sup>151</sup> the *M* corporation, immediately after its organization in 1955, acquired an unproven and untested oil and gas lease on a single tract of land. Late in 1955 oil was discovered on the tract, and on November 30, 1958, *M* completed the sixth successful well on the lease. From December, 1958, to May, 1959, three dry holes were drilled on the tract, and all subsequent exploration failed to add to *M*'s known recoverable oil and gas reserves. The revenue service declared that, for the purposes of the three-year test, *M* had completed all "construction" or "production" of its property on November 30, 1958, with the completion of the last producing well.

#### V. EXCEPTIONS TO COLLAPSIBILITY— SUBSECTION (e)

The Technical Amendments Act of 1958 added subsection (e) to section 341 and thereby provided certain exceptions to the collapsible rules. The expressed congressional intent in enacting subsection

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<sup>150</sup> Rev. Rul. 63-114, 1963-1 CUM. BULL. 74.

<sup>151</sup> Rev. Rul. 64-125, 1964-1 CUM. BULL. 131.

(e) may be studied in the following quotation from the report of the Senate Committee on Finance:

The purpose of this provision [section 341], enacted originally in 1950, is to prevent income which would otherwise be taxed at ordinary income-tax rates from being converted into income taxable at capital-gain rates merely by use of the corporate entity. . . . The collapsible-corporation provisions of present law, however, both by their terms and as interpreted, are so broad that in a number of situations they have exactly the opposite effect from that intended—instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordinary income. The applicability of the provisions of present law, moreover, depends upon the subjective intent of the parties, a matter which is obviously difficult to determine. Furthermore, if the collapsible-corporation provisions do apply, the entire gain of the shareholder is taxed at ordinary income rates, notwithstanding the fact that had the shareholder not employed the corporate entity a large part of his gain might have been taxed at capital gain rates. For these reasons, the collapsible corporation provisions of present law frequently impede or prevent legitimate business transactions and in some cases even result in the imposition of ordinary income taxes which would not be imposed if the shareholders of such corporations had not employed the corporate method of doing business. . . . Your committee believes that this amendment is desirable in order to avoid determination of subjective intent in the situations described in this Amendment and also to avoid the possibility in this area of the conversion of capital gain into ordinary income.<sup>152</sup>

The intent of the amendment was thus in part, to relieve the taxpayer of the harsh results of collapsibility where that taxpayer would have enjoyed capital gain without the corporate device. This is unquestionably a problem area, as can be shown by the *Ivey-Honaker* series of cases.<sup>153</sup> Unfortunately, however, the relief does not go far enough. Even though the amendment seeks "to avoid determination of subjective intent,"<sup>154</sup> the back door remains open through the use of a "dealer" test in determining whether the amendment applies.<sup>155</sup> Another fault of the subsection is that it is a statutory monster, with sentences hundreds of words in length.

Subsection (e) creates four exceptions to the collapsible provisions. These exceptions relate to (1) sales or exchanges of stock (other than sales or exchanges of stock to the issuing corporation or to certain related persons); (2) distributions in complete liquidation taxed as capital gains under section 331; (3) complete liquidations for which

<sup>152</sup> S. REP. NO. 1983, 85th Cong., 2d Sess. (1958), 1958-3 CUM. BULL. 922, 952.

<sup>153</sup> See notes 78-94 *supra*, and accompanying text.

<sup>154</sup> S. REP. NO. 1983, 85th Cong., 2d Sess. (1958), 1958-3 CUM. BULL. 922, 953.

<sup>155</sup> The explanation for this subjectivity lies in the fact that there is subjectivity in the respective *non*-corporate situation.

nonrecognition treatment is provided under section 333; and (4) sales or exchanges of property by the corporation under section 337 (relating to nonrecognition of gain or loss to the corporation on sales or exchanges in connection with liquidations). In order for a transaction to come within any of these exceptions, the net unrealized appreciation in "subsection (e) assets" of the corporation must not exceed fifteen per cent of the net worth of the corporation. "Net worth" is used more in the economic sense rather than in its usual accounting sense; the term is defined in subsection (e) to mean the excess in fair market value of all assets over all liabilities.<sup>156</sup>

#### A. Ordinary Income Assets

One of the definitions necessary to an understanding of subsection (e) is that of "subsection (e) assets," which have come to be known in the tax community as "ordinary income assets." Included are:

- (1) Property (other than property used in the trade or business) which if sold<sup>157</sup> at a gain by the corporation would result in ordinary income. Also included is property of the corporation which if owned and sold at a gain by a more-than-twenty per cent<sup>158</sup> shareholder would result in ordinary income to that shareholder.<sup>159</sup> It should be noted that this and the provisions which follow impute to the corporation the dealer status of any twenty per cent shareholder.
- (2) If there is a net unrealized *appreciation*<sup>160</sup> on all property used in the trade or business, then that property used in the trade or business which if owned and sold by a more-than-twenty per cent shareholder would result in ordinary income to him.<sup>161</sup>
- (3) Property used in the trade or business of the corporation, but only if there is a net unrealized depreciation on all such property.<sup>162</sup> Since the basic fifteen per cent test in subsection (e)

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<sup>156</sup> INT. REV. CODE OF 1954, § 341(e)(7). If the corporation makes a distribution, in complete liquidation, the amount of the distribution is used in determining such excess. INT. REV. CODE OF 1954, § 341(e)(7)(A)(ii). Increases in net worth attributable to stock sales or capital contributions during the preceding year will not be taken into account unless they were for a bona fide business purpose. INT. REV. CODE OF 1954, § 341(e)(7).

<sup>157</sup> The code assumes that all property of the corporation is sold or exchanged to one person in one transaction. INT. REV. CODE OF 1954, § 341(e)(5)(A).

<sup>158</sup> The percentages of ownership used throughout subsection (e) refer to the per cent which the value of the shareholder's stock is of the total value of the outstanding stock.

<sup>159</sup> INT. REV. CODE OF 1954, § 341(e)(5)(A)(i).

<sup>160</sup> "Net unrealized appreciation" is defined in INT. REV. CODE OF 1954, § 341(e)(6) as the amount by which the unrealized appreciation exceeds the unrealized depreciation. The term "unrealized appreciation" means the amount by which the fair market value of an asset exceeds its adjusted basis. Conversely, "unrealized depreciation" means the amount by which the adjusted basis of the asset exceeds its fair market value.

<sup>161</sup> INT. REV. CODE OF 1954, § 341(e)(5)(A)(iii).

<sup>162</sup> INT. REV. CODE OF 1954, § 341(e)(5)(A)(ii).

involves the net unrealized *appreciation* in subsection (e) assets, and since property used in a trade or business is a subsection (e) asset (absent a twenty per cent shareholder) only if there is net unrealized *depreciation* in such property, the inclusion of such property favors the taxpayer, by reducing the appreciation in ordinary income assets.

- (4) A copyright, a literary, musical, or artistic composition, or similar property, if created by the personal efforts of an individual who owns more than five per cent of the corporation's stock.<sup>163</sup>

For purposes of subsection (e) the term "property used in the trade or business" means "section 1231(b)" property, but without regard to the holding period therein.<sup>164</sup> Included, for example, would be depreciable personal property used in the trade or business and real property used in the trade or business.<sup>165</sup> Excluded would be such assets as inventory items<sup>166</sup> and property held primarily for sale to customers in the ordinary course of a trade or business,<sup>167</sup> although these assets would still be "ordinary income assets" for subsection (e) purposes.

For purposes of the above definition of ordinary income assets and for purposes of transactions to which subsection (e) applies, the stock ownership attribution rules described earlier<sup>168</sup> apply in determining the amount of stock owned by a shareholder.<sup>169</sup> Likewise, the trade or business of one who owns more than twenty per cent *only constructively* must be considered.<sup>170</sup> Note also that the dealership determination "shall be made as if all property of the corporation had been sold or exchanged to one person in one transaction."<sup>171</sup>

### B. "Related Person"

It will be shown later that subsection (e) does not offer relief to certain transactions<sup>172</sup> with "related persons." The following persons are considered to be related to a shareholder.<sup>173</sup>

- (A) If the shareholder is an individual—  
(i) his spouse, ancestors, and lineal descendants, and

<sup>163</sup> INT. REV. CODE OF 1954, § 341(e)(5)(A)(iv).

<sup>164</sup> INT. REV. CODE OF 1954, § 341(e)(9).

<sup>165</sup> INT. REV. CODE OF 1954, § 1231(b)(1).

<sup>166</sup> INT. REV. CODE OF 1954, § 1231(b)(1)(A).

<sup>167</sup> INT. REV. CODE OF 1954, § 1231(b)(1)(B).

<sup>168</sup> See INT. REV. CODE OF 1954, § 341(d) and discussion accompanying notes 122-51 *supra*.

<sup>169</sup> INT. REV. CODE OF 1954, § 341(e)(10).

<sup>170</sup> Treas. Reg. § 1.341-6(b)(2)(i) (1955).

<sup>171</sup> INT. REV. CODE OF 1954, § 341(e)(5)(A).

<sup>172</sup> INT. REV. CODE OF 1954, §§ 341(e)(1), 341(e)(4).

<sup>173</sup> INT. REV. CODE OF 1954, § 341(e)(8).

- (ii) a corporation which is controlled by such shareholder.
- (B) If the shareholder is a corporation—
  - (i) a corporation which controls, or is controlled by, the shareholder, and
  - (ii) if more than 50 percent in value of the outstanding stock of the shareholder is owned by any person, a corporation more than 50 percent in value of the outstanding stock of which is owned by the same person.

For purposes of determining ownership of stock in applying this definition, the attribution rules of section 267 (c) apply, except that the family of an individual is regarded as including only his spouse, ancestors, and lineal descendants. "Control," for this purpose, means stock having at least fifty per cent of the total combined voting power of all classes of stock entitled to vote or at least fifty per cent of the total value of the shares of all classes of stock of the corporation.<sup>174</sup>

### C. Subsection (e) Transactions

The four transactions which subsection (e) exempts from collapsible treatment were mentioned earlier.<sup>175</sup> They will now be treated in detail.

1. *Sales or Exchanges of Stock* The first exception relates to the sale or exchange of the corporation's stock by a shareholder. The corporation will not be considered collapsible if, at the time of the sale or exchange,<sup>176</sup> the sum of the net unrealized appreciation in certain assets does not exceed fifteen per cent of the net worth of the corporation. This exception does not apply, however, to any sale or exchange of stock to the issuing corporation; nor does it apply to the sale or exchange by a more-than-twenty per cent shareholder to any person related to him.<sup>177</sup> The figure to be used in determining the fifteen per cent is the sum of the following:

- (1) The net unrealized appreciation in ordinary income assets;<sup>178</sup>
- (2) If the selling shareholder owns more than five per cent of the outstanding stock of the corporation, the net unrealized appreciation in assets of the corporation which, if owned and

<sup>174</sup> *Ibid.*

<sup>175</sup> See text accompanying note 156 *supra*.

<sup>176</sup> Note that if a dealer with more than 20% ownership sells his stock first, no taint of dealership should continue to the corporation because of him.

<sup>177</sup> INT. REV. CODE OF 1954, § 341(e)(1). See text accompanying note 173 *supra*.

<sup>178</sup> INT. REV. CODE OF 1954, § 341(c)(1)(A).

sold by that shareholder, would result in ordinary income to him;<sup>179</sup>

- (3) Where the selling shareholder owns more than twenty per cent of the outstanding stock of the corporation, and has owned during the preceding three years more than twenty per cent of the outstanding stock of another similar corporation,<sup>180</sup> his previous sales of stock of the other corporation (or sales of assets by that corporation which were nontaxable by virtue of section 337)<sup>181</sup> will be regarded as sales by him of a proportionate part of the assets of (or assets sold by) the other corporation for purposes of determining the seller's dealership status.

If after considering these imputed sales, a dealership status is found, (*i.e.*, if the volume of similar sales, actual or imputed, is sufficiently great)<sup>182</sup> then under rules similar to (2) above, there will be added, in applying the fifteen per cent test, the net unrealized appreciation in assets of the corporation which, if owned and sold by that stockholder in his imputed dealership status, would result in ordinary income to him.

2. *Section 337 Liquidations* Section 337 provides generally that if a corporation adopts a plan of liquidation and within twelve months thereafter distributes all of its assets in complete liquidation, then no gain or loss is recognized to the corporation on the sale or exchange of its assets during the twelve-month period.<sup>183</sup> Section 337 does not apply, however, to a collapsible corporation as defined in section 341(b).<sup>184</sup> Since this exception to section 337 depends solely on the definition of a collapsible corporation and not on the whole of section 341, the limitations of collapsibility found in subsection (d) (*i.e.*, the five per cent, seventy per cent, and three-year rules) do not help

<sup>179</sup> INT. REV. CODE OF 1954, § 341(e)(1)(B). However, property used in the corporation's trade or business will not be included unless there is a net unrealized appreciation in such property. INT. REV. CODE OF 1954, § 341(e)(5)(A)(iii).

<sup>180</sup> In order for the stockholder to have this imputed dealer status, at some time during his ownership (within the preceding three years) of more than 20% of the other corporation's stock, more than 70% of the latter's assets must have been "similar or related in service or use" to more than 70% of the assets of the corporation whose stock is being sold. Treas. Reg. § 1.341-6(d)(1) (1955) defines the quoted phrase according to its meaning in § 1033 (without (g) thereof).

<sup>181</sup> INT. REV. CODE OF 1954, § 341(e)(1)(C).

<sup>182</sup> Note that the last sentence of INT. REV. CODE OF 1954, § 341(e)(5)(A) aids the shareholder in avoiding dealership status by concerting possibly repeated sales over an extended period of time into a single sale to a single individual.

<sup>183</sup> INT. REV. CODE OF 1954, § 337(a).

<sup>184</sup> INT. REV. CODE OF 1954, § 337(c)(1)(A). Sproul Realty Co., 38 T.C. 844 (1962), *acq.*, 1963-1 CUM. BULL. 4. See also Guy A. van Heusden, 44 T.C. 491 (1965).



the taxpayer.<sup>185</sup> The revenue service has ruled,<sup>186</sup> however, that if gain or loss is recognized by the corporation on the sale of all of its assets, the realization of such income will cause the corporation to be no longer collapsible; gain to the shareholders on liquidation may thus be capital gain. Although the shareholder is not faced with ordinary income on the liquidation, this is still a costly arrangement, since both the corporation and the shareholder have incurred taxes.

Two provisions in subsection (e) are designed to relieve this problem. One<sup>187</sup> sets up standards under which an otherwise collapsible corporation can enjoy the benefits of a section 337 liquidation. The other<sup>188</sup> exempts from collapsible treatment certain distributions to shareholders in section 337 liquidations.

For purposes of section 337, a corporation will not be considered collapsible with respect to any sale or exchange of its properties within the twelve-month period if all three of the following conditions are met:

- (1) At all times after the adoption of the plan of liquidation the net unrealized appreciation in ordinary income assets does not exceed fifteen per cent of the corporation's net worth;
- (2) Within the twelve-month period the corporation sells substantially all of its properties; and
- (3) No distribution is made of property which is depreciable, amortizable, or depletable. In addition, any sale or exchange of property which is depreciable, etc., by a more-than-twenty per cent shareholder or any person related to such holder will not be within section 337 (although the entire distribution is not thereby destroyed).<sup>189</sup>

If the above requirements are met to exempt the sale of corporate assets from taxability on gain, then, if certain further requirements are met, the stockholders may avoid collapsible treatment on the liquidating distributions. At all times after the adoption of the plan of liquidation the sum of the following must not exceed fifteen per cent of net worth:<sup>190</sup>

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<sup>185</sup> Rev. Rule 58-241, 1958-1 CUM. BULL. 179. Treas. Reg. § 1.337-1 (1955) provides that: "section 337 does not apply to any sale or exchange of property whenever the distribution of such property in partial or complete liquidation to the shareholders in lieu of such sale or exchange would have resulted in the taxation of the gain from such distribution in the manner provided in section 341(a) as to any shareholder or would have resulted in the taxation of the gain in such manner, but for the application of section 341(d)."

See also Rev. Rul. 63-125, 1963-2 CUM. BULL. 146.

<sup>186</sup> *Ibid.*

<sup>187</sup> INT. REV. CODE OF 1954, § 341(e)(4).

<sup>188</sup> INT. REV. CODE OF 1954, § 341(e)(2).

<sup>189</sup> INT. REV. CODE OF 1954, § 341(e)(4).

<sup>190</sup> INT. REV. CODE OF 1954, § 341(e)(2).

- (1) The net unrealized appreciation in subsection (e) assets;
- (2) If the shareholder owns more than five per cent of the stock of the corporation, the net unrealized appreciation in assets of the corporation which, if owned and sold by that shareholder, would result in ordinary income to him; and
- (3) If the selling shareholder owns more than twenty per cent of the outstanding stock of the corporation and has owned during the preceding three years more than twenty per cent of the outstanding stock of another corporation, the imputed "dealer" sales similar to those under the third element of determination in the subsection (e) exception for sales of stock.<sup>191</sup>

3. *One-Month Liquidations* Section 333 of the code allows electing shareholders to defer gain on a corporate liquidation where the distribution of all of the corporation's property occurs within one calendar month. Gain will be recognized, but only to the extent of the greater of (1) the shareholder's rateable share of earnings and profits, or (2) money received and market value of stock or securities received by the shareholder. Section 333, however, does not apply to a collapsible corporation *to which section 341(a) applies*.<sup>192</sup> This is a more flexible limitation than that found in section 337 (the twelve-month liquidation section). Section 337 is inapplicable if the corporation merely fits into the definition of a collapsible corporation.<sup>193</sup> Section 333, on the other hand, allows the corporation the three limitations on collapsibility found in section 341(d).<sup>194</sup>

The remaining subsection (e) exception<sup>195</sup> to collapsibility is designed to aid shareholders who would not otherwise be entitled to the benefits of the one-month liquidation provisions. The exception applies if at all times after the adoption of the plan of liquidation, the net unrealized appreciation in ordinary income assets of the corporation does not exceed fifteen per cent of the corporation's net worth. The definition of ordinary income assets is expanded for this purpose to impute to the corporation the dealership status of a more-than-five per cent shareholder (rather than a more-than-twenty per cent shareholder).<sup>196</sup>

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<sup>191</sup> See text accompanying note 182 *supra*.

<sup>192</sup> INT. REV. CODE OF 1954, § 333(a).

<sup>193</sup> INT. REV. CODE OF 1954, § 337(c)(1)(A). See also text accompanying note 191 *supra*.

<sup>194</sup> See text accompanying notes 122-51 *supra*.

<sup>195</sup> INT. REV. CODE OF 1954, § 341(e)(3).

<sup>196</sup> INT. REV. CODE OF 1954, § 341(e)(5)(B).

## D. SYNOPSIS OF SUBSECTION (e)

Source of Proceeds:	(A) Sale or Exchange of Stock	(B) Section 337 Liquidation	(C) Section 333 Liquidation
Recipient of Proceeds	No collapsible treatment if:	No collapsible treatment if:	No collapsible treatment if:
(I) Ordinary shareholder (General Corporate Test)	Not more than 15% of the corporation's net worth represents net unrealized appreciation in "subsection (e) assets". <sup>197</sup>	(1) I.A. holds true at all times after adoption of a plan; (2) Substantially all corporate property is sold within 12 months; and (3) No depreciable, amortizable, or depletable property is distributed.	Same as I.B.(1). <sup>198</sup>
(II) 5%-20% shareholder (Specific Shareholder Test)	Not more than 15% of the corporation's net worth represents net unrealized appreciation in (1) "subsection (e) assets" and/or (2) assets which would result in ordinary income if sold by the shareholder.	(1) II.A. holds true at all times after adoption of a plan; (2) Same as I.B.(2); and (3) Same as I.B.(3).	Same as I.B.(1).
(III) More than 20% shareholder (Specific Shareholder Test)	Not more than 15% of the corporation's net worth represents net unrealized appreciation in (1) "Subsection (e) assets"; (2) assets which would result in ordinary income if sold by the shareholder; and/or (3) assets with respect to which dealership status is imputed to the shareholder by virtue of his substantial holdings in similar corporations. <sup>199</sup>	(1) III.A. holds true at all times after adoption of a plan; (2) Same as I.B.(2); and (3) Same as I.B.(3). (But § 337 benefits are not available for a sale or exchange to a more than 20% shareholder or his relative of property depreciable, etc., by its recipient.)	Same as I.B.(1).

<sup>197</sup> Except in § 333 liquidations, the term "subsection (e) assets" basically means assets which would result in ordinary income if sold by the corporation or by a more-than-20% shareholder. See details in text accompanying notes 158-71 *supra*.

<sup>198</sup> For § 333 liquidation purposes the definition of "subsection (e) assets" is broadened to include assets which would result in ordinary income if sold by a more-than-5% shareholder.

<sup>199</sup> See details in text accompanying notes 180-82 *supra*.

## VI. SHIFTING OF COLLAPSIBILITY—SUBSECTION (f)

Subsection (f)<sup>200</sup> allows a new route to relief in situations where selling stockholders in a collapsible corporation fail to qualify<sup>201</sup> themselves or their corporations under either the limitations of subsection (d) or the exceptions of subsection (e). In order for the stockholders to enjoy the benefits of subsection (f), the corporation must consent to recognize gain on any future disposition by the corporation of its "subsection (f) assets."<sup>202</sup>

A. *The Consent And Its Effect*

The selling stockholder's gain from stock of a collapsible corporation will not be treated as ordinary income if the corporation consents to the provisions of subsection (f).<sup>203</sup> This rule does not apply, however, if the sale is to the issuing corporation.<sup>204</sup> The consent applies to each sale of stock of the corporation made within six months of the date of the consent.<sup>205</sup>

The corporation must consent to the recognition of gain upon certain dispositions of a "subsection (f)" asset.<sup>206</sup> In the case of a sale, exchange, or involuntary conversion by the corporation, the excess of the amount realized over the adjusted basis will be recognized as gain.<sup>207</sup> In the case of any other disposition, the excess of the fair market value of the asset over the adjusted basis will be recognized as gain.<sup>208</sup> The gain thus recognized by the consenting corporation is limited to that gain which would otherwise go unrecognized because of the various provisions in the code allowing nonrecognition of gain.<sup>209</sup>

B. *Shifting The Gain*

If the consenting corporation transfers its subsection (f) assets in certain nontaxable transactions with another corporation, subsection (f) will not increase the recognized gain. However, the transferee corporation must agree to recognize gain upon the subsequent disposition of the subsection (f) assets.<sup>210</sup> This "out" for the collapsible transferor,

<sup>200</sup> Added in 1964 by Pub. L. 88-484.

<sup>201</sup> Or do not want to risk the failure to qualify.

<sup>202</sup> INT. REV. CODE OF 1954, § 341(f)(1).

<sup>203</sup> *Ibid.*

<sup>204</sup> *Ibid.*

<sup>205</sup> *Ibid.*

<sup>206</sup> INT. REV. CODE OF 1954, § 341(f)(2).

<sup>207</sup> INT. REV. CODE OF 1954, § 341(f)(2)(A).

<sup>208</sup> INT. REV. CODE OF 1954, § 341(f)(2)(B).

<sup>209</sup> INT. REV. CODE OF 1954, § 341(f)(2).

<sup>210</sup> INT. REV. CODE OF 1954, § 341(f)(3)(B).

however, will not apply if the transferee is a tax-exempt organization.<sup>211</sup>

The transactions in which the consenting transferor can thus shift gain recognition to the consenting transferee are those in which the transferor's basis carries over to the transferee by reason of sections 332 (liquidations of subsidiary), 351 (transfer to controlled corporation), 361 (reorganizations), 371(a) (receivership and bankruptcy reorganizations), and 374(a) (railroad reorganizations).

### C. Definition Of "Subsection (f) Asset"

As previously noted, subsection (f) causes recognition of gain on the disposition of a "subsection (f) asset." This term is defined to mean any property which, *as of the date of the stock sale*, is a non-capital asset and is property owned by, or subject to an option to acquire held by, the consenting corporation.<sup>212</sup> For purposes of this definition, land or any interest in real property (other than a security interest) is treated as property which is not a capital asset.<sup>213</sup> However, if within two years of the date of the stock sale, construction is commenced with respect to such land, by either the consenting corporation or by a consenting transferee of that corporation, the term "subsection (f) assets" includes the resulting improvements.<sup>214</sup> Unrealized receivables or fees from the sale of noncapital assets or from services are also treated as property which is not a capital asset.<sup>215</sup>

If manufacture, construction, or production with respect to a "subsection (f) asset" has commenced before the stock sale, the term "subsection (f) asset" does include the property resulting from the manufacture, construction, or production.<sup>216</sup>

### D. Five-Year Limitation As To Shareholders

A shareholder can utilize subsection (f) immunity only once in every five years.<sup>217</sup> A similar sale by a "related person"<sup>218</sup> within the five-year period will also disqualify the taxpayer from subsection (f) immunity.<sup>219</sup> This five-year rule has no exceptions, nor is there a provision for waiver of the rule by the Commissioner.<sup>220</sup> However, the

<sup>211</sup> INT. REV. CODE OF 1954, § 341(f)(3)(A).

<sup>212</sup> INT. REV. CODE OF 1954, § 341(f)(4)(A).

<sup>213</sup> *Ibid.*

<sup>214</sup> INT. REV. CODE OF 1954, § 341(f)(4)(C).

<sup>215</sup> INT. REV. CODE OF 1954, §§ 341(f)(4)(A), 341(b)(4).

<sup>216</sup> INT. REV. CODE OF 1954, § 341(f)(4)(B).

<sup>217</sup> INT. REV. CODE OF 1954, § 341(f)(5).

<sup>218</sup> INT. REV. CODE OF 1954, as defined in § 341(e)(8)(A). See discussion accompanying note 173 *supra*.

<sup>219</sup> INT. REV. CODE OF 1954, § 341(f)(5).

<sup>220</sup> Compare, *e.g.*, INT. REV. CODE OF 1954, § 341(f)(5).

provisions of subsection (f) do not apply to a sale of stock by the shareholder if, during the preceding five-year period, the shareholder has enjoyed the protection of selling stock in another consenting corporation.<sup>221</sup>

#### E. *Corporate Chains*

If a corporation (corporation A) owns five per cent or more<sup>222</sup> of the outstanding stock of another corporation (corporation B) and a sale of A stock is made during a six-months consent period by A, the consent by A will not be valid with respect to that sale unless B has (within six months) filed a consent with respect to its stock.<sup>223</sup> This consent will apply to assets owned by B at a time at which an A or B shareholder sells stock within six months. The same rules will apply to a whole chain of corporations connected by the five per cent ownership requirement.

#### F. *The Use Of Subsection (f)*

A corporation which, to benefit its shareholders, consents to subsection (f) pledges itself to recognize gain on the disposition of the properties. However, it does not pledge itself to dispose of the properties; nor does it pledge itself to recognize ordinary income on the disposition. One must be wary, however, when counseling a consenting corporation. For example, the trade-in of used equipment for new equipment, normally a nontaxable exchange under section 1031(a), may result in recognition of gain. All or part of this gain may be ordinary income if the depreciation recapture rules of section 1245 apply. This is a typical situation in which a tax counsel may learn of the transaction after it has occurred and when it is too late to coordinate the timing of the gain into the planned tax picture for the year.

The subsection (f) election also creates another factor which must be added to the checklist of items to be inquired about and drafted against in the acquisition of substantial blocks of corporate stock. Otherwise, the unsuspecting purchaser may fall victim to unplanned tax consequences on the disposition of the "subsection (f) assets." For example, corporation C may purchase all of the stock of electing corporation D, planning to liquidate D into C within two years and thus enjoy the stepped-up basis afforded by section 334(b)(2). C, the acquiring corporation, may well enjoy this benefit if it knows

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<sup>221</sup> INT. REV. CODE OF 1954, § 341(f)(5).

<sup>222</sup> In value.

<sup>223</sup> INT. REV. CODE OF 1954, § 341(f)(6).

that *D* has elected under subsection (f), and, if *C*, in turn, agrees to recognition of gain on the disposition of any "subsection (f) assets" received in the liquidation. If *C*, not knowing of *D*'s election, fails to agree to such recognition of gain, *C* will still get its stepped-up basis, but at the cost of *gain* recognized by *D* at the time of the liquidation.

The Treasury has not yet published proposed regulations on subsection (f). The mechanics of the consent by the corporation have, therefore, not yet been prescribed. This poses problems not only to the seller of collapsible stock but also to the purchaser, who must rely on the word of the seller and perhaps inadequate corporate records to tell him whether the seller's assets are tainted. It is submitted that the regulations should set forth a simple method for such consenting. A procedure should also be established whereby a prospective purchaser of stock can inquire as to a possible previous consent by the selling corporation. To protect the selling corporation from needless and harmful disclosure, the agreement of the selling corporation to such inquiry could be required.

All is not lost even if subsequent to a purchase the purchaser finds himself controlling an electing corporation. The "subsection (f) assets" may be retained and exploited to produce desirable income. This appears to be in line with the congressional intent in enacting subchapter (f).<sup>224</sup> If the property disposed of is property used in the acquiring corporation's trade or business, the disposition may result in capital gains. And the consenting corporation may still have available to it the "out" of a nontaxable transfer in a reorganization<sup>225</sup> or possibly a Subchapter "S" election.<sup>226</sup>

## VI. SOME OTHER WAYS OUT OF THE COLLAPSIBLE TRAP

Two of the most frequently discussed remedies for a collapsible corporation are the Subchapter "S" election and nontaxable exchanges in reorganizations. These and other planning tools are discussed below.

### A. Subchapter "S"

Subchapter "S" of the code, which was enacted in 1958, allows stockholders in certain corporations having ten or fewer stockholders to elect a quasi-partnership type taxation.<sup>227</sup> The most attractive feature of a Subchapter "S" election, for purposes of planning around section 341, is the taxing of what would otherwise be capital gains of

<sup>224</sup> See S. REP. NO. 1241, 88th Cong., 2d Sess. (1964), 1964-2 CUM. BULL. 684.

<sup>225</sup> Assuming the transferee consents. See discussion accompanying note 210 *supra*.

<sup>226</sup> INT. REV. CODE OF 1954, §§ 1371-77.

<sup>227</sup> *Ibid.*

the corporation as capital gains of the shareholders.<sup>228</sup> Since the benefits of section 337 liquidations are generally not available to a collapsible corporation, it cannot sell its capital assets and distribute the proceeds without double taxation. Neither can the shareholders sell their stock or receive distributions in cash or kind without ordinary income consequences. Subchapter "S" has generally been regarded as a means of obtaining both capital gains (at least in part) and single taxation in such a situation. Even if the shareholder is a dealer in the property, capital gains should result to him because the characterization of "capital" or "ordinary" is made at the corporate level.

Prior to 1966, if the corporation were ineligible for the Subchapter "S" election because, for example, too much of its income had come from passive type investments,<sup>229</sup> the sale of assets could be planned for the beginning of a new taxable year. The resulting gain, being the bulk of the income recognized for such year, could make the corporation eligible for the election.

In 1966 Congress sought to close this loophole by enacting a new section in Subchapter "S." Section 1378 provides, in effect, that a tax will be due on the income of such corporation if (1) the excess of a corporation's net long-term capital gain over short term capital loss exceeds \$25,000, (2) such excess is more than fifty per cent of a corporation's taxable income for the year, and (3) the corporation's taxable income for that year exceeds \$25,000.<sup>230</sup> The gain will not be taxed to the corporation, however, if it has elected Subchapter "S" for the preceeding three taxable years.<sup>231</sup> If the corporation has been in existence for less than four taxable years, the gain will not be taxed if the corporation has elected Subchapter "S" for each year of its existence.<sup>232</sup> However, even though one of these two exceptions would apply, the gain may still be taxed to the extent that it is attributable to property acquired during the current year or the preceding three years in a nontaxable transaction with another corporation in which the electing corporation took the other corporation's basis in the properties. The gain on those properties will be taxed unless the transferor corporation was under a Subchapter "S" election for that period preceding the transfer.<sup>233</sup> This amendment does not eliminate completely the usefulness of Subchapter "S" but it certainly makes it more difficult to use.

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<sup>228</sup> INT. REV. CODE OF 1954, § 1375(a).

<sup>229</sup> INT. REV. CODE OF 1954, § 1372(e)(5).

<sup>230</sup> INT. REV. CODE OF 1954, § 1378(a).

<sup>231</sup> INT. REV. CODE OF 1954, § 1378(c)(1).

<sup>232</sup> INT. REV. CODE OF 1954, § 1378(c)(2).

<sup>233</sup> INT. REV. CODE OF 1954, § 1378(c)(3).



Even those who can still fit their collapsible corporation into Subchapter "S" must cope with Regulation Section 1.1375-1(d):

Ordinarily, for purposes of determining whether gain on the sale or exchange of an asset by an electing small business corporation is capital gain, the character of the asset is determined at the corporate level. However, if an electing small business corporation is availed of by any shareholder or group of shareholders owning a substantial portion of the stock of such corporation for the purpose of selling property which in the hands of such shareholder or shareholders would not have been an asset, gain from the sale of which would be capital gain, then the gain on the sale of such property by the corporation shall not be treated as a capital gain. For this purpose, in determining the character of the asset in the hands of the shareholder, the activities of other electing small business corporations in which he is a shareholder shall be taken into consideration.

There is not express statutory authority for the Commissioner's position in the above regulation, and, in the writers' opinion, the regulation is invalid. Those who would use the Subchapter "S" device can cite the Supreme Court's *Braunstein* decision as supporting a strict reading of the statutory language. Moreover, the fact that Congress found it necessary to tighten up Subchapter "S" is a strong indication that the original Subchapter "S" failed to take the collapsible provisions into account.

One of the interesting questions raised by subsection (f) is whether, once a consent is made by a corporation, the Subchapter "S" "out" from collapsibility is still available.<sup>234</sup> Subsection (f) demands that "such gain shall be recognized notwithstanding any other provision of this subtitle, but only to the extent that such gain is not recognized under any other provision of this subtitle."<sup>235</sup> Gain or loss, for income tax purposes, is generally "recognized" unless there is some express statutory authority providing for its nonrecognition.<sup>236</sup> If it is so recognized, it becomes a part of "gross income,"<sup>237</sup> and to the extent "gross income" exceeds allowable deductions, it constitutes "taxable income."<sup>238</sup> Section 11 of the code imposes the corporate tax on such "taxable income."<sup>239</sup> If a Subchapter "S" election is made, however, the corporation is not subject "to the taxes imposed by this chapter."<sup>240</sup> Thus, even though the "recognized" gain goes into the

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<sup>234</sup> Assuming, of course, that § 1378 does not cause the gain to be recognized at the corporate level.

<sup>235</sup> INT. REV. CODE OF 1954, § 341(f)(2).

<sup>236</sup> INT. REV. CODE OF 1954, § 1002.

<sup>237</sup> INT. REV. CODE OF 1954, § 61(a).

<sup>238</sup> INT. REV. CODE OF 1954, § 63(a).

<sup>239</sup> INT. REV. CODE OF 1954, § 11(a).

<sup>240</sup> INT. REV. CODE OF 1954, § 1372(b)(1).

computation of taxable income, since Subchapter "S" causes the corporate tax not to be imposed on such income, the taxable effect of the subsection (f) consent may still be avoidable.

### B. Reorganizations

The "reorganization" provisions of the code<sup>241</sup> furnish means for combining or modifying the ownership interests in corporations without recognition of gain or loss. In order to take advantage of these provisions a corporation must comply with the strict statutory language of the code, as well as certain tests which have been established by judicial and administrative decisions. The nonstatutory tests have been given the descriptive labels of "business purpose," "continuity of business enterprise," and "continuity of interest."

Nothing in the language of the statute appears to preclude a collapsible corporation's enjoying the tax-free participation in a reorganization. Indeed, to deny a collapsible corporation access to the tax-free reorganization provisions would violate the spirit of those sections. Because of the very nature of a collapsible corporation, it is destined to be abandoned by its initial stockholders. If these same stockholders determine that they would rather hold a continuing interest in another corporation which is willing to absorb the business of the collapsible corporation, the requisite business purpose is not difficult to find. Examples might be the stronger financial structure of the combined organization, the competence of the acquiring corporation's management, and the greater diversity of risk. In the usual situation there is little doubt that the acquiring corporation is motivated by a bona fide business purpose. Likewise, the requirement of continuity of the business is generally met.

On the other hand, the continuity of interest requirement presents a more formidable obstacle, for the shareholders of the collapsible corporation may enter into the reorganization with a prearranged agreement to dispose of the stock they receive. It is fairly certain that if by prearrangement stock in the continuing corporation representing more than majority ownership in the collapsible entity is to be sold after the reorganization, there is inadequate continuity of interest.<sup>242</sup> However, if (1) the sales are on the open market and not prearranged,<sup>243</sup> (2) only a minority of collapsible cor-

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<sup>241</sup> See generally INT. REV. CODE OF 1954, §§ 361, 368(a). Note that the tax-free liquidation sections are generally not available to the collapsible corporation though. See notes 184-86 *supra* and accompanying text.

<sup>242</sup> *LeTulle v. Scofield*, 308 U.S. 415 (1940). See also Treas. Reg. § 1.368-1(b) (1966) and cases collected at 3 MERTENS, TAXATION § 20.59 (rev. ed. 1965).

<sup>243</sup> *Rena v. Farr*, 24 T.C. 350 (1955), *acq.*, 1955-2 CUM. BULL. 6.

poration shareholders arranged in advance to sell, or (3) a majority shareholder arranged in advance to sell only a minority interest, then a continuity of interest probably does exist.

If the combined corporation after a reorganization is not collapsible and there is sufficient continuity and purpose, disposition of the stock should be immune from section 341; that section treats as ordinary income gain on a sale, exchange, etc., of stock only when a "collapsible corporation" is involved.<sup>244</sup>

If the corporation resulting from the reorganization is collapsible, then the selling stockholder must rely on the limitations,<sup>245</sup> the exceptions,<sup>246</sup> or the consent,<sup>247</sup> all discussed earlier. The application of these rules is extremely difficult. Consider, for example, the most promising of the available escape routes after a reorganization, the five per cent limitation. It does not apply if *at any time* after the commencement of the manufacture, construction, or production of property, the shareholder owned more than five per cent of the stock in *the* corporation. The statute applies this test to the stock of the collapsible corporation which is sold, not to the collapsible corporation which was absorbed. For this reason, the writers believe that the Commissioner would be unsuccessful in an attempt to look back to the percentage before the reorganization, particularly if the collapsible corporation is not the survivor in the reorganization. However, this is not to say that he will not try.

The seventy per cent limitation also may cause problems in application. The reorganized corporation may have sufficient other assets so that more than seventy per cent of the gain on the sale of stock will be attributable to noncollapsible property, but this may not be sufficient. The regulations<sup>248</sup> state that the gain attributable to such property is the excess of the recognized gain over the gain which the shareholder *would have had* if the property had not been manufactured, constructed, etc. As a matter of economics, the stockholder may be recognizing gain that was earned in the collapsible efforts of his original corporation. Thus, if the seventy per cent test was inapplicable to his original corporation, it may be inapplicable, as far as he is concerned, to the organized corporation.

The three-year limitation would probably not be affected by a reorganization.

A reorganization could have a two-fold beneficial effect in apply-

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<sup>244</sup> INT. REV. CODE OF 1954, § 341(a).

<sup>245</sup> INT. REV. CODE OF 1954, § 341(d).

<sup>246</sup> INT. REV. CODE OF 1954, § 341(e).

<sup>247</sup> INT. REV. CODE OF 1954, § 341(f).

<sup>248</sup> Treas. Reg. § 1.341-4(c)(2) (1966).

ing the exceptions of subsection (e). First, since the ownership of the combined corporation is presumably spread over a larger number of people, the five per cent-twenty per cent shareholder-dealer status may be easier to avoid. And similarly, since the corporations combine both their assets and net worth, the fifteen per cent-of-net-worth test may be easier to meet.

### C. *The Seventy Per Cent Limitation*

This limitation<sup>249</sup> can be a valuable planning device. The object is, of course, to pad the thirty per cent, noncollapsible assets side of the computation.

One method for accomplishing this result is by merely transferring appreciated securities (or other non-"section 341 assets") to the corporation in a section 351 exchange or contribution to capital, preferably at the time of incorporation. One major problem with this device is that dividends and interest raise the possibility of personal holding company tax in early years. This could be combatted with substantial non-investment income, or expenses which use up the passive income. A recent amendment to the code has opened up Subchapter "S" as a means of combatting the personal holding company tax in early years.

Until recently a corporation could not elect Subchapter "S" if its passive type income (e.g., dividends, rent, and interest) was more than twenty per cent of its gross receipts. In 1966 the statute was amended to permit a Subchapter "S" election for the first and second taxable years in which a corporation conducts an active business, even though passive income exceeds twenty per cent. However, the passive income for each such year must be less than \$3,000.<sup>250</sup>

Another method of fitting into the seventy per cent limitation involves the accumulation of income by the corporation. The Commissioner takes the position that in making the seventy per cent computation, accumulated income from "Section 341 assets" must be included because it is "attributable to" those assets (even though the corporate tax has already been paid on it).<sup>251</sup> Therefore, accumulated income from noncollapsible assets should be attributable to those assets and includable on the thirty per cent side. Distributing collapsible income would thus be advantageous.

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<sup>249</sup> INT. REV. CODE OF 1954, § 341(d)(2).

<sup>250</sup> INT. REV. CODE OF 1954, § 1372(e)(5), as amended by P. L. 89-389, § 3(a) (1966).

<sup>251</sup> Treas. Reg. § 1.341-4(c)(4) (1966); *accord*, Spangler v. Commissioner, 278 F.2d 665 (4th Cir. 1960).

#### D. *Single vs. Multiple Corporations*

The choice between a single or multiple corporate framework should be made after careful consideration. As shown in the previous section, the inclusion of substantial noncollapsible property in the corporation may make compliance with the seventy per cent limitation requirements possible. For this reason it is often advisable to operate with a single corporation.

If the seventy per cent test cannot be met, multiple corporations might be preferable, so as to isolate noncollapsible properties and otherwise valid capital gains from the collapsible taint. Another advantage of using multiple corporations is that it allows piecemeal selling of interests in individual properties immediately upon expiration of the three-year limitation period.<sup>252</sup> Of course, the ever-present problems involved in any multiple corporation operation, raised by sections such as 269, 482, 1551, and 1561, must be contended with.

### VIII. CONCLUSION

The collapsible provisions of the code extend to uncharted boundaries. Even within their known limits, the provisions generate a frustrating bundle of unanswered questions. Through a careful study of the code, the regulations, the legislative history, and the administrative and judicial interpretations, one can usually chart a course that is relatively safe. But only extensive litigation or an amendment of the statute will produce clarity in the many vague areas of the collapsible corporations section of the code.

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<sup>252</sup> INT. REV. CODE OF 1954, § 341(d)(3).

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