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COLLAPSIBLE CORPORATIONS—SOME "SOFTSPOTS" IN SECTION 341

STUART I. ODELL*

The color of vernacular is rare, indeed, in the staid vernacular of legal verbosity known as the Internal Revenue Code. Only once in a decade does a word creep into that catacomb which is at once precise, descriptive, suggestive, conversational and warm—a word not of art but of an artist. Such is the word "collapsible" in the title "collapsible corporations."†

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I. INTRODUCTION

A. *Historical Background*

In 1950, in response to an increased use by taxpayers of the collapsible corporation device,[1] Congress passed an amendment to the In-

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† Altman, *Collapsible Corporations*, 28 TAXES 1013 (1950).

1. Prior to 1950, the Internal Revenue Service was not equipped, either statutorily or judicially, to cope with the corporate device which taxpayers were utilizing to avoid ordinary income tax rates. See H.R. REP. No. 2319, 81st Cong., 2d Sess. 96-99 (1950); S. REP. No. 2375, 81st Cong., 2d Sess. 88-91 (1950). The Internal Revenue Service unsuccessfully employed three basic arguments in a futile attempt to combat the collapsible corporation device.

1) The Commissioner argued that the corporate entity was a sham and should be disregarded for tax purposes. The courts answered this by finding that the factors surrounding the entity were indigenous to a corporation, that the entity was engaged in normal corporate activity, and that a corporation does not lose its identity merely because it is organized for a single purpose. See Herbert v. Riddell, 103 F. Supp. 369, 374-75 (S.D. Cal. 1952).

2) The argument was advanced that the corporation was guilty of anticipatory assignment of income and that the basic *Fruit-Tree Doctrine* should be applied. United States v. Joliet & Chicago R.R., 315 U.S. 44 (1942); Lucas v. Earl, 281 U.S. 111 (1930). The courts answered that the principles governing anticipatory assignments were inapplicable because the corporation was dissolved by liquidation prior to the time when the income was earned and, therefore, the income resulting from the original corporate activity was not attributable to the corporation because it was no longer in existence. See Herbert v. Riddell, *supra*.

3) The third argument was that a corporation could not perform all preliminary matters relating to a sale of its assets and then dissolve and pass the benefit of the contract of

ternal Revenue Code of 1939.[2] The purpose of this amendment was to defeat a scheme "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 the rate of 25 per cent."[3]

It appears that the collapsible corporation first came into vogue with the businesses providing entertainment, particularly, the motion picture industry.[4] Actors, directors, writers and others who were in the higher tax brackets and whose salaries would have been taxable as ordinary income, utilized temporary, one-picture corporations as devices for converting the value of their services into corporate assets, represented by corporate stock. When the film was completed, the corporation was either liquidated and the assets distributed to the shareholders in exchange for their stock, or the appreciated stock was sold outright. If the corporation were liquidated, the basis of the assets in the hands of the distributees would be its fair market value.[5] At that time, the distributees would realize gain to the extent that the fair market value of the film received in liquidation exceeded the basis of the shares they relinquished.[6] If the stock were sold outright, the gain would be realized to the extent that the sales price exceeded the basis of the stock.[7] Since ordinary income would normally flow from the film-producing activities, the corporate device enabled the stockholders to convert their ordinary income producing activities into a capital asset and thereby take advantage of the lower tax rates granted to the privileged sale or exchange of capital assets held in excess of six months.[8]

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sale to its shareholders. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945). This theory was rejected on the ground that the corporation was not engaged in negotiating a sale, but only in dissolving the corporation assets. Pat O'Brien, 25 T.C. 376 (1955); Frank E. Gilman 14 T.C. 833 (1950).

For an article suggesting possible non-legislative solutions, see Bittker & Redlick, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437 (1950).

2. Int. Rev. Code of 1939, § 117(m), added by ch. 994, § 212, 64 Stat. 934 (1950). The first regulations adopted under section 117(m) were issued on March 26, 1953. Treas. Reg. 118, § 39.117(m)-1 (1953).

3. S. REP. No. 2375, 81st Cong., 2d Sess. 88 (1950); H.R. REP. No. 2319, 81st Cong., 2d Sess. 96 (1950).

4. Herbert v. Riddell, 103 F. Supp. 369 (S.D. Cal. 1952); Pat O'Brien, 25 T.C. 376 (1955). See Taubman, *Motion Picture Co-Production Deals and Theatrical Business Organization*, 11 TAX L. REV. 113 (1956).

5. See INT. REV. CODE OF 1954, § 334(a). The *basis* of property received in liquidation is a separate subject and outside the scope of this paper. See generally Merritt, *Real Estate: Methods of Acquisition—Assets or Stock?* N.Y.U. 14TH INST. ON FED. TAX 235, 252 (1956).

6. The distributee also received a stepped-up basis for the property. In the case of a film (or any depreciable, amortizable or depletable property), the stepped-up basis enabled the distributee to offset the income earned by the film with a high depreciation expense.

7. INT. REV. CODE OF 1954, §§ 1001, 1002.

8. INT. REV. CODE OF 1954, §§ 1201, 1202, 1221, 1223, 1231, 1245. There is a possibility that the stock will not be a capital asset with respect to a particular taxpayer. An example

Later on, the collapsible corporation device was seized upon by builders of apartment projects using mortgages insured by the Federal Housing Administration.[9] Judging from the reported cases, it apparently was possible, in some instances, for the builder to secure a larger F.H.A. loan than was required to finance the building. The usual pattern seems to have been to incorporate and issue more than one class of stock. Upon completion of the project, the building would then be written up above its actual cost, thereby creating a revaluation surplus, usually equal to the amount by which the F.H.A. loan exceeded the actual construction cost. The revaluation surplus would then be used to redeem some of the stock and thus would be put into the hands of the incorporators as an apparent capital gain.[10]

Section 117(m),[11] was intended to prevent these practices by treating gain that fell within its purview as gain from the sale of property that is not a capital asset.[12] Several amendments to the original amendatory statute became necessary due to a failure of the original enactment to embrace some specific abuses. A minor amendment, adopted in 1951, was aimed specifically at the whiskey industry.[13] In 1954, a broad revision of the collapsible corporation provisions was included in the Internal Revenue Code of 1954.[14] That statute was given its present section number, 341, and was considered to have solved the collapsible cor-

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is where the taxpayer is a dealer in securities and the stock sold is part of his inventory. Any gain on a sale or liquidation would result in ordinary income.

9. Glickman v. Commissioner, 256 F.2d 108 (2d Cir. 1958); Commissioner v. Gross, 236 F.2d 612 (2d Cir. 1956); Paul Braude, 35 T.C. 1158 (1961); Elizabeth M. August, 30 T.C. 969 (1958); W. H. Weaver, 25 T.C. 1067 (1956); Thomas Wilson, 25 T.C. 1058 (1956). See Rev. Rul. 57-357, 1957-2 CUM. BULL. 900, stating that distributions of excess mortgage proceeds, subsequent to December 31, 1949, should be taken into consideration in determining whether a corporation is collapsible and whether any gain is subject to the collapsible corporation provisions.

10. In addition to the distribution of excess mortgage proceeds, some of the construction corporations were liquidated, either completely or partially. Any gain on the liquidation would also receive capital gains treatment, although the increase in value was due to the construction activity.

11. *Supra* note 2.

12. Gain from the sale or exchange . . . of stock of a collapsible corporation, to the extent that it would be considered . . . as gain from the sale or exchange of a capital asset held for more than 6 months, shall . . . be considered as gain from the sale or exchange of property which is not a capital asset. Int. Rev. Code of 1939, § 117(m)(1).

13. INT. REV. CODE of 1939, ch. 994, § 212, 64 Stat. 934 (1950), as amended, 65 Stat. 502 (1951). Individuals were transferring whiskey inventories to a corporation in exchange for its stock. Whiskey appreciates in value merely by the passage of time (aging) and the appreciation produces ordinary income when the whiskey is sold. By selling the appreciated stock or liquidating the corporation and receiving the whiskey in exchange for the stock, taxpayers were converting ordinary income into capital gains. The amendment prevented this result by including purchased property within the definition of a collapsible corporation. This amendment was made applicable to tax years ending after August 31, 1951, with respect to gains realized after that date.

14. INT. REV. CODE OF 1954, § 341. The 1954 amendments were enacted, in the words of the Senate Finance Committee, "with a view to strengthening . . . effectiveness" of the law. S. REP. No. 1622, 83d Cong., 2d Sess. 260 (1954).

poration problem. The 1954 enactment closed the "loopholes" so securely that subsection (e) was subsequently enacted to provide *relief to taxpayers.*[15] Subsection (e) marks the last collapsible corporation legislation to date.

Few legislative enactments have engendered as much literary enthusiasm in tax circles as the enactment of the collapsible corporation provisions.[16] Because of this mass of literature on the subject, the scope of this paper will be confined to an analysis and discussion of some of the "softspots" that have evolved. Some consideration will also be given to the practical aspects of the various "softspots." It will become evident to the reader that the interplay between the code, the Service, and the practitioner has resulted in a rather complex situation.

B. *The Statute in General*

The labyrinth of section 341 does not easily lend itself to simplification; yet, its basic pattern must first be grasped before the "softspots" can be examined. The chart on page 650 is intended to give the reader an insight into the structure of section 341. The following discussion is merely a predicate for an understanding of the chart. It is suggested that if the reader is unfamiliar with the collapsible corporation provisions, the code sections alluded to should be read in conjunction with this article.

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15. INT. REV. CODE OF 1954, § 341(e), as amended, 72 Stat. 1615 (1958). Subsection (e)(12) was added in 1962.

16. The following bibliography represents some, but not all of the articles written on collapsible corporations since its enactment. BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 299-320 (stud. ed. 1962); Altman, *Collapsible Corporations; 1957 Developments,* N.Y.U. 16TH INST. ON FED. TAX 659 (1958); Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment,* 58 COLUM. L. REV. 1146 (1958); Anthoine, *Recent Developments in Collapsible Corporations,* N.Y.U. 14TH INST. ON FED. TAX 761 (1956); Axelrad, *Collapsible Corporations and Collapsible Partnerships,* 1960 So. CALIF. TAX INST. 269; Axelrad, *Recent Developments in Collapsible Corporations,* 36 TAXES 893 (1958); Axelrad & Kostas, *A Re-examination of Collapsible Corporations "With a view to" Co-existing with Section 341,* 1956 So. CALIF. TAX INST. 549; Cavitch, *Collapsible Corporations,* 13 W. RES. L. REV. 278 (1962); Cohen, Surrey, Tarleau & Warren, *A Proposed Revision of the Sale of a Business Enterprise—American Law Institute Draft,* 54 COLUM. L. REV. 157 (1954); Conner, *Collapsible Corporations—A Question of Intent,* 3 WM. & M. L. REV. 483 (1962); DeWind & Anthoine, *Collapsible Corporations,* 56 COLUM. L. REV. 475 (1956); Donaldson, *Collapsible Corporations,* 36 TAXES 777 (1958); Landry, *Some Tax Considerations in the Sale or Purchase of a Corporate Business,* 9 SYRACUSE L. REV. 210 (1958); Mandel, *Twelve-Month Liquidations and Collapsibility of Real Estate Corporations,* N.Y.U. 21ST. INST. ON FED. TAX 715 (1963); Miller, *Capital Gains Taxation Under the Revenue Act of 1950,* N.Y.U. 9TH INST. ON FED. TAX 675, 683-90 (1951); Modrall, *Collapsible Corporations and Subsection (e),* 37 TAXES 895 (1959); Nordberg, *"Collapsible" Corporations and the "View,"* 40 TAXES 372 (1962); Peel, *Recent Collapsible Developments: Inadvertent Collapsibility,* N.Y.U. 20TH INST. ON FED. TAX 850 (1962); Taubman, *Motion Picture Co-Production Deals and Theatrical Business Organization,* 11 TAX L. REV. 113 (1956); Note, *Relief for Collapsible Corporations Under Subsection (e),* 51 GEO. L.J. 346 (1963); Note, *Taxation—Collapsible Corporations—Judicial Interpretation of "Substantial" Part of Net Income,* 8 N.Y.L.F. 544 (1962); Note, *Legislative Response to the Collapsible Corporation,* 51 COLUM. L. REV. 361 (1951).

Section 341 (and its predecessor) attacks the collapsible corporation device on the shareholder level rather than on the corporate level. The remedial effect of the statute is punitive in nature in that any gain that falls within its purview receives ordinary income treatment. Section 341(a) provides that in three situations, gain which would otherwise be treated as realized from the sale or exchange of a capital asset held in excess of six months, will be treated as gain from the sale or exchange of a non-capital asset. Subsection (a) is applicable when a corporation meets the definition of "collapsibility" as it is defined in subsection (b). Section 341(c) creates a rebuttable presumption in favor of collapsible status if certain criteria are met. Subsection (d) is composed of three limitations upon the application of subsection (a) but it does not alter collapsible status for other purposes.[17] A highly objective test is superimposed by subsection (e) which operates independently from the rest of section 341, and serves to eliminate taxpayers who can comply with its provisions from the coverage of section 341(a).[18]

The chart on page 650 is intended to present the basic provisions of section 341 in a simplified manner. Appropriate citations are made to the specific code sections.

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17. For example, a corporation falling within the definition of a collapsible corporation cannot liquidate under § 337, notwithstanding that a limitation in § 341(d) limits the application of § 341(a). INT. REV. CODE OF 1954 § 337(c)(1).

18. See II(F) of this article's text *infra.*

19. INT. REV. CODE OF 1954, § 341(b)(1).

20. INT. REV. CODE OF 1954, § 341(b)(2)(A).

21. INT. REV. CODE OF 1954, § 341(b)(2)(B).

22. INT. REV. CODE OF 1954, § 341(b)(2)(C).

23. INT. REV. CODE OF 1954, § 341(b)(3).

24. INT. REV. CODE OF 1954, § 341(b)(3)(A).

25. INT. REV. CODE OF 1954, § 341(b)(3)(B).

26. INT. REV. CODE OF 1954, § 341(b)(3)(C).

27. INT. REV. CODE OF 1954, § 341(b)(3)(D).

28. INT. REV. CODE OF 1954, § 341(b)(1)(A).

29. INT. REV. CODE OF 1954, § 341(b)(1)(B).

30. INT. REV. CODE OF 1954, § 341(a)(1).

31. INT. REV. CODE OF 1954, § 341(a)(2).

32. INT. REV. CODE OF 1954, § 341(a)(3).

33. INT. REV. CODE OF 1954, § 341(a).

34. INT. REV. CODE OF 1954, § 341(d)(1).

35. INT. REV. CODE OF 1954, § 341(d).

36. INT. REV. CODE OF 1954, § 341(d)(2).

37. INT. REV. CODE OF 1954, § 341(d)(3). The use of installment sales to permit the three-year period to run has been adversely received by the Treasury. See Rev. Rul. 60-68, 1961-1 CUM. BULL. 151.

38. INT. REV. CODE OF 1954, § 341(c)(1)(A).

39. INT. REV. CODE OF 1954, § 341(c)(2)(A)-(C).

40. INT. REV. CODE OF 1954, § 341(c)(1)(B).

41. INT. REV. CODE OF 1954, § 341(c)(1).

42. See II(F) of this article's text *infra.*

Definition of a Collapsible Corporation: Section 341(b)	Penalty Tax Treatment of Collapsible Corporations: Section 341(a)	Limitations upon the Application of Section 341(a): Section 341(d)	A Rebuttable Presumption that a Corporation is Collapsible: Section 341(c)	Exceptions to the Application of Section 341: Section 341(e)
A collapsible corporation is one formed or availed of: 1. principally to manufacture, construct, purchase, or produce property—[19] a. a corporation will meet the above requirement if: 1) it manufactures, constructs or produces property;[20] 2) it holds property whose basis is determined by reference to the cost of such property in the hands of one who did manufacture, construct or purchase it;[21] or 3) it holds property whose basis is determined by reference to cost of manufacture, construction, or purchase price.[22] b. the type of property referred to is called *Section 341 Assets*.[23] This term includes the following property *if held for less than three years:* 1) stock in trade or inventory;[24] 2) property held for sale to customers in the ordinary course of business;[25] 3) unrealized receivables or fees;[26] and 4) depreciable property used in a trade or business except that used to produce inventory and other goods for sale to customers.[27] 2. with a view to the sale or exchange of its stock, in liquidation or otherwise, or a distribution, before the realization of a substantial part of the income to be derived from the *Section 341 Assets*,[28] and the realization by shareholders of gain attributable to such property [29]	Any gain from: 1. the sale or exchange of stock of a collapsible corporation,[30] 2. a distribution in partial or complete liquidation in exchange for stock,[31] and 3. a distribution by a collapsible corporation which would normally result in capital gain treatment to the extent it exceeds basis,[32] shall be considered as gain from the sale or exchange of a non-capital asset[33] to the extent that it would be considered a gain from the sale or exchange of a capital asset held in excess of six months.	Section 341(a) does *not* apply to gain realized in respect to the stock of a collapsible corporation as defined in section 341(b) in the following instances: 1. to any shareholder owning five per cent or less of the total outstanding value of the stock of the corporation—[34] a. rules of attribution are applied;[35] 2. to all shareholders if the gain in that year is not more than seventy per cent attributable to *Section 341 Assets*;[36] and 3. to all shareholders if the gain is realized more than three years after the completion of manufacture, construction, production, or purchase of the *Section 341 Assets*.[37]	A corporation is presumed collapsible if: 1. the fair market value of its *Section 341 Assets* is fifty per cent more of its total assets—[38] a. fair market value of the total assets is determined without including cash, capital assets, and stock in other corporations;[39] and 2. the fair market value of the *Section 341 Assets* is 120 per cent or more of their adjusted bases.[40] Failure to meet these requirements will not raise a presumption in favor of collapsibility.[41]	Under certain limited transactions, the gain from the sale or exchange of stock in a corporation will not be considered gain from the sale or exchange of stock of a collapsible corporation if the net unrealized appreciation of its *Subsection (e) Assets* does not exceed fifteen per cent of the net worth of the corporation.[42]

II. SOME "SOFTSPOTS"

A. *"With a View to"—A Question of Subjective Intent*[43]

In order for a corporation to be collapsible, among other things, it must be formed or availed of with a "view" to the sale or exchange of its stock, or a distribution of its property.[44] Since the enactment of the statute, the "view" requirement has been the subject of extensive controversy.[45] The original enactment in 1950 used the same terminology as the present provision; hence, decisions under the prior provisions are still applicable.[46]

The determination as to whether the requisite "view" exists is basically a factual determination of subjective intent.[47] The regulations, however, explicitly state that the "view" must exist prior to completion of manufacture, production, construction or purchase referred to in section 341(b).[48] The "view" need not be a positive one, but may be contemplated conditionally, unconditionally, or as a recognized possibility. The protesting taxpayer need not be the party with the "view."[49] It is only necessary that the "view" be contemplated by those persons in a position to determine the policies of the corporation, whether by reason of owning a majority of the voting stock of the corporation or otherwise.[50] If the sale, exchange, or distribution is attributable to circumstances that arose after the manufacture, construction, production or purchase, other than circumstances which could have been reasonably anticipated at the time of the activity, the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been formed or availed of with the requisite "view."[51] The superimposition of these regulations on the code substitutes a semi-objective standard for the subjective one found in the code provisions.

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43. See generally Conner, *Collapsible Corporations—A Question of Intent*, 3 WM. & M. L. REV. 483 (1962).

44. INT. REV. CODE OF 1954, § 341(b)(1)(A).

45. The following cases turned upon the "view to" question: Jacobson v. Commissioner, 281 F.2d 703 (3d Cir. 1960); Spangler v. Commissioner, 278 F.2d 665 (4th Cir.), *cert. denied*, 364 U.S. 825 (1960); Sidney v. Commissioner, 273 F.2d 928 (2d Cir. 1958); Burge v. Commissioner, 253 F.2d 108 (2d Cir. 1958); Shilowitz v. United States, CCH 1963 STAND. FED. TAX REP. (63-2 U.S. Tax Cas.) ¶ 9690 (D.N.J. Aug. 30, 1963); Elliott v. United States, 205 F. Supp. 384 (D. Ore. 1962); Jack D. Saltzman, CCH TAX CT. MEM. ¶ 7412(M) (March 18, 1963); Southwest Properties, Inc., 38 T.C. 97 (1962); Charles J. Riley, 35 T.C. 848 (1961); Maxwell Temkin, 35 T.C. 906 (1961); Carl B. Rechner, 30 T.C. 186 (1958).

46. *Compare* Int. Rev. Code of 1939, § 117(m)(2)(A, with INT. REV. CODE OF 1954, § 341(b)(1).

47. The text of the code suggests the subjective intent. The regulations attempt to substitute an objective standard by stating that the "view to" requirement is met "whether such action was contemplated unconditionally, conditionally, or as a recognized possibility." Treas. Reg. § 1.341-2(a)(2) (1955).

48. Treas. Reg. § 1.341-2(a)(3) (1955).

49. Treas. Reg. § 1.341-2(a)(2) (1955).

50. *Ibid.*

51. *Supra* note 49.

Since the intent to collapse must, under the regulations, exist or be reasonably anticipated during the construction period, it is important to know when the construction period ends.[52] The courts have been very strict in delimiting the definition of construction,[53] sometimes to the point of absurdity.[54] They have refused to accept the proposition that construction ends when the building is substantially completed,[55] but have relaxed the definition to the extent of holding that construction was complete despite uncompleted landscaping, walks, driveways and steps, when the building was fully rented and producing income.[56]

In contrast to the specificity of the regulations, the courts have been so disharmonized by the "view" element that the decisions seem to have no relation to one another. However, a pattern emerges when each judicial level is examined independently.

The Tax Court has gone through a stage of vacillation, first rejecting the position of the regulations[57] and then adopting it.[58] Today, the Tax Court adheres to the regulations and requires that the "view" exist prior to completion of construction. The district courts will not be considered independently because they presumably follow the precedent of their corresponding courts of appeals.

In contrast to the uniformity of decision now present on the Tax Court level, the courts of appeals are still in conflict. The four circuits that have ruled upon this point are currently split two — two. In *Burge v. Commissioner*,[59] the Fourth Circuit rejected the regulations as being too liberal and announced that the "view" requirement is satisfied if it is present at the time the corporation is "availed of." This means, in effect, that if a sale, exchange, or distribution takes place prior to a re-

52. It is also important to know when construction is completed for purposes of determining whether the three-year limitation in § 341(d) is applicable. See the chart on page 650 and note 37 *supra*.

53. "[U]nder the correct interpretation of the statute, 'construction' should be defined technically to mean all construction required to perform the contract completely." Glickman v. Commissioner, 256 F.2d 108, 111 (2d Cir. 1958). See J. D. Abbott, 28 T.C. 795 (1957), *aff'd*, 258 F.2d 537 (3d Cir. 1958) (held that improvements to real estate such as adding sewers, water, streets, etc., were sufficient "construction" to come within the collapsible corporation provisions). See also Rev. Rul. 56-137, 1956-1 CUM. BULL. 178.

54. See Max Mintz, 32 T.C. 723 (1959), *aff'd*, 284 F.2d 554 (2d Cir. 1960) (held that construction was not complete when as little as 1.6 % of the job remained to be done), and Edward Weil, 28 T.C. 809 (1957), *aff'd*, 252 F.2d 805 (2d Cir. 1958) (held that construction was incomplete when all that remained to be done was to put up a retaining wall and finish the parking lot).

55. Glickman v. Commissioner, 256 F.2d 108 (2d Cir. 1958), *affirming*, 26 P-H TAX CT. MEM. 451 (1957).

56. Maxwell Temkin, 35 T.C. 906 (1961). See Vernon W. McPherson, 31 P-H TAX CT. MEM. 645 (1962), wherein the Tax Court held that the filing of a tentative plot is not a step in construction. See also Rev. Rul. 63-114, 1963 INT. REV. BULL. No. 24, at 9.

57. Carl B. Rechner, 30 T.C. 186 (1958).

58. Maxwell Temkin, 35 T.C. 906 (1961); Charles J. Riley, 35 T.C. 848 (1961); Elizabeth M. August, 30 T.C. 969 (1958).

59. 253 F.2d 765 (4th Cir. 1958), *cert. denied*, 346 U.S. 825 (1960).

alization of a substantial amount of income, the "view" is present and the corporation will be collapsible if the other provisions of the statute are satisfied. Strangely enough, this position was taken in a case in which the facts strongly supported a finding that the "view" existed prior to completion of construction.[60] The Fourth Circuit reaffirmed its position in a later decision.[61] The Second Circuit adopted the *Burge* doctrine in *Glickman v. Commissioner*,[62] although it was dictum in that case.[63] It later reaffirmed this position,[64] but again it was dictum because the "view" was found to exist during construction.[65]

Of the two circuits that explicitly rejected the *Burge* doctrine and adopted the regulations, the Fifth Circuit was the first. In *Payne v. Commissioner*,[66] the court said:

> [W]e recognize that . . . [the position of the Second and Fourth Circuits] seems to overlook the requirement by the statute that the corporation must be availed of for *construction* of property *with a view to* a distribution, etc. . . . [T]his means that unless the "view" is held before or during construction, the statute is not satisfied.[67]

The Third Circuit followed suit a year later,[68] by merely saying that it agreed with the Fifth Circuit on this point.

It is curious to note that the above split does not explain all of the judicial disharmony. Part of the cause can be attributed to a tendency,

60. Taxpayer's testimony that he embarked upon the enterprise with a view of making a permanent investment in an apartment house, is very largely discredited by the fact that his initial investment was only $100, that the corporate charter was so drawn as to allow the early retirement of the Class B stock which was retired as soon as the building was completed, with taxpayer and his associate drawing out the surplus money derived from the loan instead of leaving it in the treasury of the corporation . . . , that arrangements were entered into almost immediately to sell the Class A stock and that the Class A stock was sold within less than three months after the completion of the building. *Id.* at 768-69.

61. Spangler v. Commissioner, 278 F.2d 665 (4th Cir. 1960).

62. 256 F.2d 108 (2d Cir. 1958).

63. The case held that a corporation need not be liquidated to fall within the purview of § 117(m) of the Int. Rev. Code of 1939.

64. Sidney v. Commissioner, 273 F.2d 928 (2d Cir. 1960).

65. This case was further complicated because the "view" was found to exist prior to enactment of the 1950 collapsible corporation provisions, and the corporations was "availed of" after its enactment. The court said that it made no difference. It found § 117(m) applicable to taxable years ending after December 31, 1949, on gain realized after that date, notwithstanding that the "view" was formulated and construction had ceased prior to that date.

66. 268 F.2d 617 (5th Cir. 1959).

67. *Id.* at 620. The quotation indicates that the Fifth Circuit found support for its position in the code provisions. However, most experts agree that the position of the regulations represents administrative legislation—*i.e.*, there is no support for the regulations in the code or the legislative history.

68. Jacobson v. Commissioner, 281 F.2d 703 (3d Cir. 1960). The court specifically rejected *Glickman* and followed Treas. Reg. § 29.117-11 (1951), the predecessor of the current regulations, Treas. Reg. § 1.341-1(3) (1955).

by some of the courts in the earlier decisions, to find a tax avoidance intent on the part of the taxpayer.[69] This attitude, no doubt, can be traced to the statutory purpose stated in the committee reports that preceded the passage of the statute.[70] Although the structure of the statute does not include this tax avoidance intent, or its absence, some recent decisions continue to maintain this overtone.[71]

Although the regulations do not find support for their position in the code provisions, they do help the practitioner *evaluate* his position in a given case. The split in the circuits on this point does not destroy the usefulness of the regulations unless the Internal Revenue Service advocates a position contrary to its own regulations. The discretion of the government attorney in adopting a position contrary to the regulations will not be discussed, but it must happen occasionally, or *Burge* and *Glickman* would never have been decided. Thus far, the Supreme Court has refused to settle this question,[72] and unless a rash of cases on this point appears, it is unlikely that it will settle the conflict.

B. *The Minority Shareholder—The* Lowery Line[73]

A new doctrine has recently evolved from the efforts of the Tax Court to determine the existence of the elusive "view" element that is necessary for collapsible status. In order for a corporation to be collapsible, it must be formed or availed of with a "view" to a sale or exchange of its stock, or a distribution, etc.[74] The regulations state that this requirement is satisfied if the action (sale, exchange or distribution) was contemplated unconditionally, conditionally or as a recognized possibility by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of voting stock or otherwise.[75]

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69. See Note, *Legislative Response to the Collapsible Corporation*, 51 COLUM. L. REV. 361, 364-67 (1951).

70. See note 3 *supra* and accompanying text.

71. United States v. Ivey, 294 F.2d 799 (5th Cir. 1961).; Shilowitz v. United States, CCH 1963 STAND. FED. TAX REP. (63-2 U.S. Tax Cas.) ¶ 9690 (D.N.J. August 30, 1963).

72. Spangler v. Commissioner, *supra* note 61.

73. The *Lowery Line* is a phrase created by the author to designate a doctrine that has recently evolved from two Tax Court cases and a Court of Claims decision. Sylvester J. Lowery, P-H TAX CT. REP. & MEM. DEC. ¶ 39,100 (March 21, 1963); Ralph J. Solow, P-H TAX CT. REP. & MEM. DEC. ¶ 63,087 (March 27, 1963); Goodwin v. United States, CCH 1963 STAND. FED. TAX REP. (63-2 U.S. Tax Cas.) ¶ 9603 (Ct. Cl., July 12, 1963). To the author's knowledge, this paper is the first written examination of what seems to be a newly emerging doctrine. The *Lowery Line* is basically a "view to" problem.

74. *Supra* note 44. In order to spotlight the exact point under consideration, it must be assumed that all the requisites pertaining to collapsibility are present, with the exception of the "view" element. Thus, assume that the sole question involved in determining collapsible status is whether the corporation was formed or availed of "with a view to" a sale or exchange of its stock, or a distribution, prior to a realization by the corporation of a substantial amount of taxable income to be derived from its *Section 341 Assets*.

75. Treas. Reg. § 1.341-2(2) 1955. See also notes 49 & 50 *supra*, and accompanying text.

Consider a shareholder owning more than five per cent[76] and less than fifty per cent of the voting stock. It is obvious that he cannot exercise control over the policies of the corporation through his stock interest alone;[77] hence, he either fits into the "or otherwise" requirement or the "view" is lacking. When a corporation has a single shareholder who owns a majority interest and actively participates in management, it would seem that any sale, exchange or distribution by or to a minority shareholder when the majority shareholder retains control[78] would escape collapsible treatment because the requisite "view" is lacking.[79]

There are two recent decisions of the Tax Court and one by the Court of Claims that seem to follow the above reasoning. In *Sylvester J. Lowery*,[80] decided in March, 1963, the petitioner was a minority shareholder in four corporations, each of which was engaged in the construction of a high rise apartment house to be held for rental purposes upon completion of construction. In two of these corporations all the shareholders disposed of their stock prior to a realization by the corporations of a substantial amount of income to be derived from the property. The Tax Court found that the requisite "view" existed and therefore, the corporation was collapsible.[81] The petitioner owned forty per cent and thirty per cent of the outstanding stock of the other two corporations. He sold his stock while the principal assets of the corporations were still in the process of being constructed, and while the majority shareholders were in control. The Tax Court found that since those in control of the policies of the corporation had retained their controlling stock interest,

76. A shareholder owning *less* than 5 % of the voting stock can always escape § 341(a) because of § 341(d)(1). See the chart on page —— and note 34 *supra*.

77. This statement assumes several facts that are necessary throughout this section of the paper. First, unless otherwise indicated, the majority of the stock of any corporation discussed herein, *i.e.*, 51% or more, is owned or controlled by one individual. Second, the board of directors that makes the policy decisions of the corporation is composed of the actual stockholders, and their degree of control is in direct proportion to their stock interest. This is not an unrealistic presumption in the case of a close corporation which is usually the kind that runs afoul of the collapsible corporation provisions.

78. The retention of control by the majority shareholder is essential to this line of reasoning. However, it is possible that those in control of the policies of the corporation at the time it is formed or availed of, possess the "view" to a sale of their stock prior to a realization of a substantial amount of income but, as of the date of sale by the minority shareholder, they have not yet sold their stock. Under these facts, it seems that the sale by the minority shareholder falls within the letter of the statute.

79. It is contended that even though the minority shareholder intends to dispose of his interest in the corporation prior to a realization by the corporation of a substantial amount of its taxable income, and that this "view" existed prior to completion of construction, this is not the "view" contemplated by the regulations, since they are written in terms of the "view" of those *in control of the policies* of the corporation. Suppose, however, that the majority stockholder contemplated a redemption of the minority shares outstanding, but not of his own shares. Must the "view" by those in control of the policies of the corporation be as to all the shares, their own shares, or any shares? There has been no answer offered by the courts so that one can only guess. It is the author's guess that the "view" requirement would be satisfied.

80. P-H Tax Ct. Rep. & Mem. Dec. ¶ 39,100 (March 21, 1963).

81. *Id.* at 708.

the corporation was not formed or availed of with a view to collapsing, and therefore, the gain realized by the minority shareholder would not fall within section 341. The court emphasized the fact that the petitioner was forced to sell his interest because he was unable to supply additional capital that was needed to complete construction.[82] It is interesting to note that the petitioner was, by occupation, engaged in "placing" mortgages;[83] that he performed these services for the corporations; that at least part of the appreciation in value of the petitioner's stock was due to these services;[84] and, that he was permitted to treat the gain on the sale of his stock as long-term capital gain.

Although the *Lowery Line* was not advanced until recently,[85] it was not long in being utilized. The rationale was employed only a few weeks after the rendition of the *Lowery* decision in another Tax Court case, *Ralph J. Solow*.[86] The court permitted a minority shareholder to treat the gain on the sale of his stock in a corporation engaged in the construction of an apartment house, as gain on the sale of a capital asset held in excess of six months. The taxpayer had never been in a position to fix the policies of the corporation and the sale of his stock could not have been reasonably anticipated at the time he acquired his interest. Here, as in *Lowery*, the majority shareholders, *i.e.*, those in control of the policies of the corporation, did not dispose of their interests. The Tax Court relied directly upon *Lowery*,[87] but there was a conspicuous absence of language to the effect that the minority shareholder was forced to sell his interest due to an unanticipated need for additional capital.

The latest decision along the *Lowery Line* was *Goodwin v. United States*,[88] decided in July, 1963, by the United States Court of Claims. In this case, the taxpayer owned a twenty-five per cent interest in *C* Corporation. *C* owned all the stock in *A* Corporation which, in turn, held title to an apartment house built by *C*. Certain personal difficulties arose between the majority shareholder and the taxpayer. The taxpayer con-

82. In our opinion section 117(m) [now section 341] was not intended to apply where, as here, *a minority shareholder is compelled*, because of circumstances over which he has no control, to dispose of his investment in a corporation which is thereafter continued in operation by the majority shareholders. *Id.* at 710. (Emphasis added.)

83. The phrase "placing" mortgages refers to the occupation of obtaining temporary and permanent financing for contractors and purchasers of property. In return for these services, a placement fee is charged that is taxed to the recipient as ordinary income.

84. Many proposed construction projects get no further than the drawing board because financing is unavailable. Thus, the placement of mortgages, both permanent and temporary, is often a service that adds considerable value to the entire project.

85. Prior to the *Lowery* decision, there are no reported cases advancing the *Lowery Line*. See note 73 *supra*.

86. P-H TAX CT. REP. & MEM. DEC. ¶ 63,087 (March 27, 1963).

87. "We therefore must rely on *Sylvester J. Lowery* . . . and hold that petitioner's gain on the sale of his relevant shares was not within the purview of section 117(m) and the corresponding regulations. *Id.* at 457.

88. CCH 1963 STAND. FED. TAX REP. (63-2 U.S. Tax Cas.) ¶ 9603 (Ct. Cl., July 12, 1963).

tributed his shares of stock to a partnership and they were subsequently redeemed by *C*. The court specifically found "that the redemption or sale of the stock by [the taxpayer] . . . was attributable to circumstances present during construction."[89] Yet, it followed *Lowery* and *Solow*, holding:

> The *essence* of the Tax Court's ruling [in *Lowery* and *Solow*] 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 hold that . . . [the taxpayer's] gain should be treated as long-term capital gain.[90]

Whether the Court of Claims really followed the essence of the *Lowery* and *Solow* cases is questionable. There were strong factual situations in both *Lowery* and *Solow* to support the absence of the requisite "view." In *Lowery*, the court relied upon the involuntary nature of the sale. In *Solow*, it was specifically found that the petitioner was a mere investor who had no control over the policies of the corporation and could not reasonably have anticipated the decision to sell when he made his initial investment. In *Goodwin*, however, the circumstances which led to the redemption were found to be present during construction and, therefore, could have been reasonably anticipated. There was no finding of fact that the taxpayer was forced to sell or that he had no control over the policies of the corporation. In fact, the taxpayer was vice-president, secretary, and project manager of *C*. Thus, it is deducible that the taxpayer did have some degree of control over the policies of *C*.

A respectable argument can be made in favor of the *Lowery Line*. The doctrine is predicated upon the notion that since a minority shareholder normally cannot control the policies of the corporation, the corporation normally would not be formed or availed of with the requisite "view" even though it was entertained by that particular shareholder.[91] However, this reasoning fails under close scrutiny. For example, suppose a corporation is owned by three shareholders, each having a one-third interest. Two shareholders must act in concert to formulate and control policy. Suppose two of the shareholders disagreed as to the policy of the corporation with regard to a subsequent sale or exchange. Does the position of the third shareholder which breaks the stalemate make him the controller of policy? What about a subsequent sale by the shareholder who dissents to the sale but is overridden by the others?[92] Further, what should be the treatment of the gain on a sale of stock by the share-

89. *Id.* at 438.

90. *Id.* at 440.

91. If the minority shareholder sells his interest while the majority interest is retained, there is no implication raised that the "view" existed.

92. On its face it would seem that the "view" is present because those in control of the policies had the "view."

holder who dissents in favor of selling but is outvoted by the other two shareholders who retain their interests?[93]

A closer situation occurs when two stockholders each own one-half of the capital stock of a corporation. Policy cannot be formulated without concurrence. Suppose one stockholder had the requisite "view" while the other did not. Would a sale or exchange by the stockholder with the "view" fall within the *Lowery Line*? A recent decision by the United States District Court for New Jersey, *Shilowitz v. United States*,[94] had overtones of this issue. The taxpayer, an architect, and another person formed a corporation to build and operate an apartment house, each receiving one-half of the capital stock. While construction was still in progress, the taxpayer suffered a heart attack and was advised by his physician to dispose of his business interests. On the basis of this advice, he sold his stock in the corporation. The court treated the gain on the sale of his stock as long-term capital gain, even though the sale fell squarely within section 341. The court's rationale was that since the taxpayer did not contemplate the sale of his stock prior to a realization by the corporation of substantial taxable income when he made his investment, the requisite "view" was not present. This ruling is peculiar when one considers that, (1) the regulations require that the "view" need only exist prior to the *completion* of construction;[95] (2) the "view" contemplated by the statute is to a sale, exchange, or distribution prior to realization by the corporation of a substantial amount of taxable income;[96] and (3) the taxpayer sold his stock prior to completion of construction and before a realization by the corporation of a substantial amount of taxable income. The court cited *Lowery* in its opinion, although it is difficult to ascertain the principle for which it was cited.[97]

93. A rather interesting explanation was set forth by a federal district court judge in his instructions to a jury in a case involving a collapsible corporation. A juror asked the judge if a corporation could still be collapsible if it remains in the hands of *some* of the shareholders.

> The Court: that is a very good question, and I gave some thought to that question and in my own mind, I reached this conclusion. That if our stockholder . . . were the only one that sold his stock and the others did not, if he himself went into it with that intent, it would be collapsible to the extent of his own sale, and I based that on the language in here where it spoke of total or partial collapsibility. . . . [S]uppose there were two men in there and one of them had that intent and as to himself he went . . . and sold his stock and that the other one kept his permanently for investment, it's my own concept that as to the man who did sell his stock, that it would be a collapsible corporation to the extent of his own sale. . . . I thought that if you gave it any other interpretation, why ninety-nine per cent could be sold and one per cent of the stock could be held and you could say the corporation is therefore not collapsed, but is still going. Ivey v. United States, 5 AM. FED. TAX R.2d 1076, 1083 (N.D. Ga. 1960).

94. CCH 1963 STAND. FED. TAX REP. (63-2 U.S. Tax Cas.) ¶ 9690 (D.N.J., Aug. 30, 1963). This case was considered from a different viewpoint earlier. See note 71 *supra*.

95. Treas. Reg. § 1.341-2(3) (1963).

96. INT. REV. CODE OF 1954, § 341(b)(1)(A). See Ellsworth J. Sterner, 32 T.C. 1144 (1959).

97. The court stated that the time of the sale, standing alone, cannot be the determinative factor in finding the "view," for which proposition *Lowery* was cited. However, there is no language or innuendo in *Lowery* to rely upon for this conclusion.

Although *Shilowitz* is justifiable from an equitable viewpoint,[98] it is contrary to the regulations and the code. The court simply held that a taxpayer can sell his interest in a potentially collapsible corporation prior to completion of construction and prior to a realization of a substantial amount of taxable income without a "view" to doing exactly what he did, in fact. A situation where extraneous circumstances are present, such as a physician's advice to sell for health purposes, is of the type that best lends itself to a revenue ruling, if one can be obtained on so elusive an issue. The taxpayer could thereby obtain relief from the provisions of section 341 without disturbing the balance of the code provisions. It is not contended that a favorable ruling would necessarily be obtained, but one can assume that the same compassion that moved the court in *Shilowitz* might have a like effect on the rulings division.

An evaluation of the *Lowery Line* must be accomplished with caution. There have not been enough decisions dealing with the question to indicate a definite trend. Certainly, the Tax Court has been rather shortsighted in using strong language in its opinions, and the Court of Claims was absolutely careless in *Shilowitz*. However, until a court of appeals rules on one of these cases, it would be dangerous to rely upon the *Lowery Line*.[99] This line of decisions does bear watching for future developments, and there is a strong possibility that the taxpayer will be the beneficiary.

C. *Perpetual Collapsible Status—A Negative Implication*

Suppose that *X* Corporation is deemed collapsible because of a distribution to its shareholders in partial liquidation prior to a realization by the corporation of a substantial part of its income. The code has no provision relieving the corporation of its collapsible status once an event has occurred which brings it within that definition. The question arises whether there is any event or activity that will subsequently relieve the corporation of its collapsible status so that a sale or exchange, or a distribution, can be made safely?

The Second Circuit, in *Glickman v. Commissioner*,[100] said by way of dictum that a subsequent realization of a substantial amount of income by the corporation will relieve the corporation of its collapsible status.[101] Also, the limitations in section 341(d), when applicable, will

98. The taxpayer's decision to sell was to protect his health by relieving himself of business pressure. Undoubtedly, the "penalty" treatment in § 341(a) was not aimed at this type of situation, although any attempt to provide a statutory exception would make the provisions too complex to be comprehendible.

99. At the time of this writing, *Lowery* was on appeal to the Third Circuit. P-H FED. TAX SER. CIT. 19, 160 (Nov. 29, 1963).

100. 256 F.2d 108 (2d Cir. 1958).

101. Although the court found that the distribution and the sale of stock by the taxpayer were part of the same transaction, it went on to say that

the statute contains no provision relieving collapsible status once an event has

prevent the application of section 341(a) with regard to a particular transaction, although the limitations will not affect the corporation's collapsible status.[102]

The dictum in *Glickman* was the first formal statement by an appellate court regarding relief from collapsible status. However, a strict reading of the statute demands a different conclusion, as evidenced in a decision by the Fifth Circuit on this point. In *Heft v. Commissioner*,[103] the petitioner formed a corporation that purchased fifty-three lots and constructed a single family dwelling on each. After sixteen of these had been sold, a voluntary liquidation was commenced and twenty-six of the remaining thirty-seven properties were distributed to the petitioner. The remaining eleven properties were sold by the corporation and the proceeds were distributed to the petitioner. The Tax Court found that the first distribution was from a collapsible corporation because only seventeen per cent of the total estimated gain had been realized by the corporation from the sale of the sixteen houses, which did not constitute a substantial amount of the corporation's income.[104] The Fifth Circuit held that once the corporation is collapsible, it cannot purge itself of that status by later realizing a substantial amount of income. Therefore, even though the sale of the eleven houses plus the sale of the sixteen houses resulted in the corporation realizing a substantial amount of the income to be derived from the property, once the corporation was designated as collapsible, the status remained.

This decision elevated form over substance. If the corporation in *Heft* first sold the twenty-seven houses and then distributed the remaining twenty-six to the taxpayer, the collapsible corporation provisions would not have been applicable.[105] Yet, there is no substantive difference between the two situations.[106]

> occurred which brings it within that definition . . . . And if, subsequent to a condemned distribution, but prior to a stock sale, the corporation realizes a substantial part of net income, a court should have no difficulty in holding . . . [§ 341] inapplicable to such transaction. *Id.* at 112.

See also Donaldson, *Collapsible Corporations*, 36 TAXES 777, 779 (1958).

102. Section 341(d), by its terms, presupposes that the corporation to which it is being applied is collapsible within § 341(b). Whether the collapsible status results from a present sale, exchange, or distribution, or a prior transaction, does not change the fact that the corporation remains collapsible even though § 341(d) prevents the application of § 341(a).

103. 294 F.2d 795 (5th Cir. 1961).

104. The court estimated the total gain to be $45,700 on all fifty-three houses and found the gain realized at the time of distribution to be $7,797 or 17.07%.

105. The corporation would have realized nearly 50% of the total gain, a substantial amount in light of the Fifth Circuit's finding that 33% is substantial. See Kelley v. Commissioner, 293 F.2d 904 (5th Cir. 1961). See generally II(D) of this article's text *infra*.

106. The effect of the *Heft* doctrine on the results of future controversies is questionable. In most situations, § 341(d) will save the taxpayer from abuse by *Heft*. However, one can certainly construct a hypothet where the taxpayer will be unduly burdened by the *Heft* decision. The prime example is the natural resource corporation that is engaged in continual development. The 70-30 limitation might never apply and the same might be true

Thus far, only two circuits have ruled on this question and they reached opposite results.[107] The *Heft* holding finds justification by way of negative implication,[108] while the *Glickman* dictum is more in accord with the underlying theory of section 341.[109] The strict reading of the code demands the *Heft* result. The need of the business community for specific guides is partially satisfied by the decision. The fact that there has been only one reported case directly on point during the thirteen-year existence of the collapsible corporation provisions may indicate that the *Heft* doctrine poses no real threat to most taxpayers.

D. *"Substantial"—A Double Ambiguity*[110]

A corporation is not collapsible under section 341 if a substantial part of the income to be derived from its Section 341 assets has been realized prior to a sale or exchange of its stock, or a distribution in respect thereof.[111] The statute left to the courts the problem of deciding what constitutes a substantial amount in a given situation. However, a seemingly unanticipated controversy has developed over the following question: To what income does substantial refer—the amount of income realized, or the amount of income that remains to be realized? The answer may occasion divergent tax consequences.[112] A literal reading of

as to the three-year rule. All that is left is the 5% limitation which, by definition, is applicable only to shareholders owning 5% or less of the corporation.

107. To repeat, *Glickman* never so held but the dictum is clear. It is questionable whether this position would be followed today in light of the *Heft* decision and the complete absence of a statutory foundation. *But see* Ivey v. Commissioner, 294 F.2d 799 (5th Cir. 1961), where the Fifth Circuit wrote an entirely new qualification into § 341. See II(E) of this article's text *infra*.

108. Since the code does not positively provide for loss of collapsible status, once it is obtained, there is a negative implication that it is never lost.

109. By way of the "substantial" requirement in § 341(b), the 70-30 limitation in § (d) and the basic structure of § (e), a corporation will normally escape collapsible treatment through one of these routes if it has realized a *large* portion of its income. This underlying theory runs through the entire section but is defeated by the *Heft* doctrine.

110. See generally Note, 8 N.Y.L.F. 544 (1962).

111. INT. REV. CODE OF 1954, § 341(b)(1)(A).

112. For example, assume that any amount in excess of 20% of the total income will be considered "substantial," and that the total estimated income to be realized by *X* Corporation is $1,000,000, computed as follows—200 houses to be built by December 31, 1963, at an estimated profit of $5,000 per house. *A*, the sole shareholder in *X* Corporation, is in the 72% tax bracket for the year 1963 from income derived from sources other than *X* Corporation. Consider three possible alternatives through which *A* could realize the potential profit from *X* Corporation.

1) *X* Corporation sells all the houses by the end of 1963, pays the 52% corporate tax on the $1,000,000 profits, distributes its net earnings after taxes to *A* who includes them in his income as a dividend, and pays taxes on this income, at the 72% level (the dividend credit and exclusion are ignored for purposes of this problem). *A*'s net disposable income after taxes on the $1,000,000 would be $61,680 or 6.1% of the total income earned by *X*.

2) If "substantial" refers to the amount of income *already realized* then *X* Corporation must sell 40 houses, realizing $200,000 or 20% of estimated income in order to escape collapsible treatment on a subsequent liquidation. If this is done and *X* Corporation pays taxes on the profit, distributes this to *A* as a dividend, liquidates the corporation and distributes the remaining 160 houses as a liquidating dividend to *A*, *A* would receive property valued at $800,000 in exchange for his stock, (presumably having a nominal basis)

the code favors the first interpretation.[113] However, the Internal Revenue Service takes the position that a corporation is collapsible if, prior to the sale of stock by the shareholders, there *remains* a substantial part of the income yet to be derived from the property.[114] It is difficult to understand how the Service can advocate this interpretation in light of the "plain meaning" of the code and the adverse response by the Tax Court.[115]

The courts of appeals are divided on this issue. The Fifth Circuit follows the Tax Court and the obvious "plain meaning" of the code,[116] and the Third Circuit supports the position of the Service.[117] The other courts of appeals have not yet ruled on this point.

Notwithstanding the conflicting positions taken by the Service and the Tax Court, the factual determination as to what amount of potential income is substantial will greatly affect the practical difference between the two positions. The following example will serve as an illustration: *A* Corporation is a construction company formed for the express purpose of building and selling a subdivision composed of ten houses. When the ten houses were completed and four had been sold, the stockholders of *A* decided to redeem all of their stock and to distribute the unsold houses to the shareholders in exchange. Forty per cent of the total estimated income had been realized and sixty per cent remained to be realized. Assume that the issue of collapsible status hinges upon whether a substantial realization has occurred prior to the liquidation. If the trial court determines that thirty-three per cent of the total estimated income represents a substantial amount, clearly the forty per cent already realized

and he would realize capital gain (presumably long-term). *A*'s net disposable income under the above facts would be $616,185 or 61.6% of the total profit potential.

3) If "substantial" refers to the amount of income that *remains to be realized*, then *X* Corporation would have to sell 160 houses to escape § 341 via the collapsible route. After a distribution of corporate income after taxes and a liquidating dividend of the remaining 40 houses, the net disposable income in *A*'s hands would be $383,815 or 38% of the total potential profits.

In example 2), *A* has more than ten times the disposable income than in example 1), and nearly two-thirds more than in example 3). Although the figures in the hypothet are exaggerated, the tax benefits are present for any taxpayer who can fall within the capital gains taxation rates. *The use of 20% as "substantial" is only for illustrative purposes.* See note 119 *infra* and accompanying text.

113. The code states that a corporation will be collapsible if the sale, exchange, or distribution takes place *"before a realization by the corporation . . . of a substantial part of the income to be derived from such property . . . ."* INT. REV. CODE OF 1954, § 341(b)(1)(A). (Emphasis added.)

114. Rev. Rul. 62-12, 1962-1 CUM. BULL. 321, based on Technical Information Release No. 349, December 11, 1961.

115. The majority of the Tax Court has followed the literal interpretation. *E.g.*, Max N. Tobias, P-H TAX CT. REP. & MEM. DEC. ¶ 40,14 (April 22, 1963); E.J. Zongker, P-H TAX CT. REP. & MEM. DEC. ¶ 39,107 (March 26, 1963); Rose Sidney, 30 T.C. 1155 (1958), *aff'd*, 273 F.2d 928 (2d Cir. 1960); J.B. Kelley, 32 T.C. 135 (1959). See also Levenson v. United States, 157 F. Supp. 244 (D. Ala. 1957).

116. Kelley v. Commissioner, 293 F.2d 904 (5th Cir. 1961).

117. Abbott v. Commissioner, 258 F.2d 537 (3d Cir. 1958).

is substantial so that collapsible status will not attach if the position of the Tax Court is followed. However, under the position advocated by the Service, *A* would be a collapsible corporation because a substantial amount—sixty per cent—remains to be realized. If the trial court determines that sixty per cent would represent a substantial amount, *A* would be collapsible under both positions because a substantial amount has not yet been realized—*i.e.*, forty per cent—and a substantial amount remains to be realized—*i.e.*, sixty per cent.

The problem of potentially different conclusions resulting from the two positions has not been reduced by factual determinations that substantial means an amount in excess of fifty per cent. On the contrary, the Tax Court has leaned heavily toward low percentages.[118] In *E. J. Zongker*,[119] the Tax Court found twenty-three per cent to be substantial, but in another decision, it found that seventeen per cent was not.[120] If these factual determinations can be used as respectable guides for future litigation (and there is evidence that they can in the Tax Court)[121] a taxpayer may find that with a little planning he can use the collapsible corporation device to his tax advantage.[122] Of course, if a great deal of abuse is generated by the liberality of the Tax Court, the court may revert to the position of the Service.

Perhaps the most significant decision was the one rendered by the Fifth Circuit in *Kelley v. Commissioner*.[123] The court held that one-third represents a substantial amount of income. The Service has indicated that it will not acquiese to *Kelley*, and will oppose the taxpayer when the amount realized is less than fifty per cent.[124]

118. Based on recent cases, the delineation of "substantial" from the context of collapsibility is as follows:

Case	Per Cent Realized	"Substantial"
Max N. Tobias	9%	No
J.D. Abbott	10%	No
G.A. Heft	17%	No
E.J. Zongker	23%	Yes
J.B. Kelley	33%	Yes
A.E. Levenson	51%	Yes

See respectively notes 115, 117, 120, 115, 116, 115.

119. P-H TAX CT. REP. & MEM. DEC. ¶ 39,107 (March 26, 1963).

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

121. "[W]e find . . . [no case] where more than 20 percent of total net profits has been held substantial. . . . Under no approximation of the post-sale anticipated income could a figure be reached in comparison with which the pre-sale income would be regarded as less than substantial." *Id* at 772. *But see* Kelley v. Commissioner, 293 F.2d 904, 913 (5th Cir. 1961), where the court stated that the question must be resolved on the facts in each case since the statute would have been phrased accordingly if Congress wanted the test to be the mechanical application of a percentage.

122. See note 112 *supra*.

123. 293 F.2d 904 (5th Cir. 1961).

124. Rev. Rul. 62-12, 1962-1 CUM. BULL. 321.

From a planning viewpoint, fifty per cent or more represents a safe position. If litigation is economically feasible, thirty-three per cent should be sufficient to escape section 341, at least in the Fifth Circuit. And for those daring taxpayers, or those that are ill-advised, *E. J. Zongker* provides some authority, however tenuous it may be, for a determination of substantial realization when less than thirty-three per cent has been realized.

The effectiveness of section 341 in preventing the collapsible corporation abuse has been reduced by the liberality of the courts in interpreting the word "substantial." However, the Service's position does not offer the proper solution. Regulations could be enacted to raise a presumption of substantial realization when an arbitrary amount (perhaps fifty per cent) of total estimated income has been realized. However, there are problems with this approach. For example, when the income being estimated is rental income, the courts must consider such factors as estimated useful life of the property, estimated occupancy, and others. However, as long as the collapsible corporation provisions necessitate the computation of total estimated income, there will remain the difficulty of projecting the amounts of these factors.

E. Braunstein v. Commissioner—*The "Ivey" Is Cut*

Although the basic purpose of the collapsible corporation provisions is to prevent the conversion of ordinary income into capital gain through the use of the corporate device, the statute itself does not approach the problem in these terms.[125] Thus, it is possible to fall within the provisions of the statute and receive ordinary income treatment notwithstanding that the taxpayer would have been entitled to capital gain treatment if a corporate entity had not been used.[126] In 1958, Congress reacted to this problem by adding section 341(e) to the code[127] which, as described below, provides a measure of relief in this area.[128] Subsequent to this amendment, however, the Fifth Circuit advanced a judicial solution to the same problem,[129] and thereby laid the predicate for circuit disharmony and Supreme Court settlement.

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125. See chart on page 650 *supra*.

126. For example, if a taxpayer constructs an apartment as an investment and later decides to sell the building because of a good offer before the apartment is complete, he is normally entitled to treat his gain (or loss) on the sale as one from the sale of a capital asset. However, if the same facts occur and a corporation is used, there is a good possibility that the sale will fall within the collapsible corporation provisions.

127. 72 Stat. 1615, adding § 341(e) to the INT. REV. CODE OF 1954.

128. A proposed amendment to section 341(e) was recently released from committee. See H.R. 7301, 88th Cong., 2d Sess. (1963) (UTT Bill).

129. Although the Fifth Circuit solution was advanced after the Technical Amendments Act was passed, the act itself was not applicable to the facts in that case because the facts had transpired prior to the act's passage, and the act was specifically limited to facts that occurred subsequent to its passage.

In *Ivey v. Commissioner*,[130] the taxpayer and two associates formed a corporation, each receiving one-third of the capital stock.[131] Later, the plaintiff[132] transferred a parcel of land with a basis of 45,000 dollars to the corporation in exchange for the corporation's note of 25,000 dollars and 250 shares of stock having an aggregate par value of 25,000 dollars. Construction of an apartment house was begun on the property, and when the building was seventy-five per cent complete, the plaintiff sold all his stock in the corporation for 100,000 dollars, realizing a gain of 55,000 dollars.[133] The government asserted that the gain was from the sale of stock in a collapsible corporation and subject to tax at ordinary income rates. The taxpayer contended that the gain was from the sale of a long-term capital investment and entitled to long-term capital gain treatment. The district court rendered a judgment from which both parties appealed.[134] The government's contention on appeal was that the judge incorrectly instructed the jury in stating that the requisite intent to collapse must exist at the time one becomes a stockholder; that is, before construction is begun.[135] The taxpayer based his appeal on the argument that the collapsible corporation had not been used.[136] The court of appeals adopted the taxpayer's contention and held that the collapsible corporation provisions will not apply if the income would have been taxed as capital gain to the individual in the absence of a corporation. The case was remanded to the trial court for determination of the nature of the gain to the individual. The court justified its holding in several ways. First, it examined the Senate Committee Report accompanying the Technical Amendments Act of 1958

130. 294 F.2d 799 (5th Cir. 1961).

131. The reported facts do not indicate the amount or the value of the original capital stock issued to the three incorporators.

132. The opinion states that "*they* transferred" the property to the corporation, implying that all three incorporators made the transfer. Ivey v. Commissioner, 294 F.2d 799, 801 (5th Cir. 1961). However, it is also stated that the taxpayer (Harold Ivey) owned the lot and that he alone received the stock and the note given in exchange for the property.

133. The report of the facts raises certain implications as to certain facts that were not indicated. The court said that the gain to the taxpayer from the sale of stock was $55,000. Therefore, the basis of the stock sold must have been $45,000, the exact value of the property transferred to the corporation. However, the taxpayer received a note for $25,000 and stock with a par value of $25,000. Assuming the par value of the stock reflected its actual value at that time, the taxpayer realized a gain of $5,000 on this transfer. If the gain was recognized at this time, then his basis for the note and the stock was $25,000 each. In order for him to have sold stock with a basis of $45,000, the basis of the original shares issued equally to each of the three incorporators must have been $20,000 each. Thus, after the transfer of the property, the taxpayer must have owned 45/85 of the capital stock of the corporation or 53%. This would make him the controlling stockholder. Thus, his "view" to the sale of his stock prior to the completion of construction was the "view" of those in control of the policies of the corporation, making the *Lowery Line* doctrine inapplicable. See II (*B*) of this article's text *supra*.

134. Although no report of the decision by the district court is available, an edited version of the trial judge's instructions to the jury can be found in 5 AM. FED. TAX R.2d 1076 (1960).

135. 294 F.2d 799, 800 (5th Cir. 1961).

136. *Ibid.*

which added section 341(e), and found that the committee had been concerned with the same problem.[137] Since section 341(e) did not apply to *Ivey*,[138] the court felt justified in offering judicial relief. Second, it relied upon a revenue ruling[139] which stated that when a corporation holding the stock of a collapsible corporation sells the stock and realizes ordinary income on the gain, the gain realized on a subsequent liquidation of the "holding" corporation will not fall within section 341(a).[140] The Service justified this ruling by reasoning that although the subsequent liquidation fell within the literal reading of the statute, "to impose the tax treatment provided for in section 341(a) of the code twice as to the same underlying collapsible property would extend the statute beyond its intended purpose."[141] The Fifth Circuit interpreted this ruling as an invitation to the courts to ignore the wording of the statute, if necessary, to prevent its application beyond the intended purpose.[142] Third, the court, after paying proper judicial respect to the "plain meaning rule," rejected it in favor of the "legislative intent" doctrine, and found that the legislative intent was not satisfied unless the decisions was rendered as it was.[143] Fourth, the court examined the general pattern of capital gains-ordinary income taxation and found that to construe the statute otherwise would be inconsistent with this pattern. Finally, the court examined a prior district court decision that was substantially in accord with its own conclusions.[144]

A subsequent petition for rehearing was denied with an opinion which "clarified" the court's earlier decision.[145] It was stated that:

> The proper approach for the court to follow is to determine first whether the collapsible corporation provisions in terms apply to the transaction in question. If they apply, the taxpayer should be allowed to show that in the absence of a corporation he would have been entitled to treat all or part of his gain as

137. *Id.* at 802.

138. See note 129 *supra.*

139. Rev. Rul. 56-50, 1956-1 CUM. BULL. 174.

140. *Supra* note 135, at 802-03.

141. *Supra* note 139, at 175.

142. The fallacy in relying on the revenue ruling lies in the fact that the Treasury indicated its policy only so far as the specific factual situation and did not acquiese to the taxpayer's contention in *Ivey.* If it had, the case would never have come to trial.

143. *Supra* note 135, at 803-04.

144. *Supra* note 135, at 804. The court discussed Honaker Drilling, Inc. v. Koehler, 190 F. Supp. 287 (D. Kan. 1960). That case represents a classic example of a natural resources development corporation that is unduly mistreated by the interplay of the collapsible corporation provisions and § 263(c) of the INT. REV. CODE OF 1954, permitting the expensing of intangible drilling and development costs as they are incurred. The development corporation may be in existence a long time before realizing a "substantial" amount of income, because costs of drilling and development, though responsible for producing future income, are immediately expensed, thereby reducing income realized until the latter years of production. This problem area was noted in the 1958 report of the Senate Finance Committee. U.S. CODE CONG. & AD. NEWS 4820 (1958). See Rev. Rul. 57-246, 1957-2 CUM. BULL. 236.

145. 303 F.2d 109 (5th Cir. 1962).

> a long-term capital gain. To the extent that the taxpayer can make this showing he is entitled to relief from the statute's literal application . . . . The remainder of the gain should be taxed at regular income rates as provided by the statute.[146]

The reaction to *Ivey* was less than enthusiastic,[147] and the individuality of the Fifth Circuit was short-lived. Some two months after the rehearing was denied, the Second Circuit was faced with the same problem. In that case, *Braunstein v. Commissioner*,[148] the taxpayers incorporated in 1940, and constructed two apartment houses under two separate corporations. In 1948, they received an F.H.A. mortgage commitment which, in fact, exceeded the eventual construction cost. The excess mortgage proceeds were distributed in the form of dividends, although they actually represented a return of capital because there was no surplus at the time of distribution.[149] In 1950, the taxpayers sold their stock in the corporation and treated the excess of both the money received and the mortgage proceeds, over the basis of their stock, as long-term capital gain. In the Tax Court,[150] the application of section 117(m) evolved around the factual determination of whether the "view" properly existed prior to the sale. The Tax Court properly concluded that the sale of the stock and the distributions were attributable to circumstances which were present prior to the completion of construction. The taxpayer raised three arguments on appeal,[151] the one relevant here being that section 117(m) is inapplicable if the constructed apartment buildings would have produced capital gain on a sale by the taxpayer had no corporation been formed. The court rejected this argument and the *Ivey* case, its rationale being that courts interpret laws and do not create them, and also that Congress had already provided a solution.[152]

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146. *Id.* at 110.

147. In the following cases, the courts rejected *Ivey*: Braunstein v. Commissioner, 305 F.2d 949 (2d Cir. 1962); Max N. Tobias, P-H TAX CT. REP. & MEM. DEC. ¶ 40,14 (April 22, 1963); Sproul Realty Co., 38 T.C. 844, 857-58 (1962).

148. 305 F.2d 949 (2d Cir. 1962).

149. Of course, the distribution is a return of capital only in the economic sense, and only when the distribution does not exceed the contributed capital. The asset position is reduced and since the liabilities are not reduced, the corresponding reduction must be from net worth. The argument can be made that the reason a loan was extended in excess of actual cost was because of unrecognized appreciation in value of the asset. However, this is a weak argument in view of the fact that the mortgage commitment was extended before the asset was constructed. The real reason for the higher cost estimates by mortgage companies generally is the fact that much of the work to be done by outside contractors is actually done by the stockholders. If this is the case, then the distribution is more analogous to salaries than to dividends.

150. Benjamin Braunstein, 36 T.C. 22 (1961).

151. The three arguments on appeal were: 1) that the taxpayer did not have the requisite "view" (note 148, *supra* at 951-56); 2) that not more than 70% of the gain was attributable to the constructed asset (*supra* note 148 at 956-57); and 3) section 117(m) does not apply if the assets would have produced capital gain in the absence of a corporation (*supra* note 148 at 957-59).

152. *Supra* note 148, at 957-59.

The Supreme Court granted certiorari[153] to settle the conflict between the Second and Fifth Circuits. Justice Harlan wrote the opinion for the majority of the Court and affirmed the holding by the Second Circuit.[154] In so deciding the Court advanced several arguments to support its position. First, to hold otherwise would be wholly inconsistent with the "plain meaning" of the statute.[155] Second, there is no evidence in the legislative history of the statute to indicate a congressional desire for the courts to depart from the statutory definition of a collapsible corporation. On the contrary, the drawing of arbitrary lines (as in section 341(d) raises the opposite implication.[156] The Court also raised some practical problems in applying the *Ivey* solution.[157]

Although the demise of *Ivey* was inevitable, it is puzzling why such a broad step was taken in the first place by the Fifth Circuit in light of the facts in that case. Certainly, equity did not demand relief. The fact that the court sent the case back to the trial court to determine the tax status of the transaction in the absence of a corporation indicates that the facts before the court did not demand such a radical decision.[158] The following section treats the legislative solution to the *Ivey* problem.

F. *Section 341(e)—The Objective Exceptions*

In 1958, Congress enacted the *Technical Amendments Act*.[159] The purpose of this bill was to correct inadvertent errors and ambiguities in

153. 371 U.S. 933 (1962).

154. 374 U.S. 65 (1963). The exact question on review was:

Whether Section 117(m) of the Internal Revenue Code of 1939 . . . which provides that gain "from the sale or exchange . . . of stock of a collapsible corporation" is taxable as ordinary income rather than capital gain, 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 utilizing a corporation. *Id* at 68.

155. "There is nothing in the language or structure of the section to demand or even justify reading into these provisions 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." *Id* at 70.

156. *Ibid.*

157. For example, if we were to inquire whether or not the profit would have been ordinary income had an enterprise been individually owned, would we treat each taxpaying shareholder differently and look only to his trade or business or would we consider the matter in terms of the trade or business of *any* or at least a substantial number of the shareholders? . . . [W]hat if the individual in question is not himself engaged in any trade or business but owns stock in varying amounts in a number of corporate ventures other than the one before the court? Do we pierce *each* of the corporate veils, regardless of the extent and share of the individual's investment, and charge him without being in the trade or business of each such corporation? *Id* at 68.

158. It seems that the court was taken in by the taxpayer's argument, without really considering the code. This is certainly a credit to the taxpayer's counsel, but leaves doubts as to the competency of the court.

159. INT. REV. CODE OF 1954, § 341(e), as amended, 72 Stat. 1615 (1958).

the tax statutes.[160] In reference to the addition of subsection (e) to section 341, the Senate Report said:

> The collapsible-corporation provisions of present law . . . are so broad that in a number of situations they may 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.[161]

The applicability of the pre-1958 law depended upon the subjective intent of the parties, a matter which had proved difficult to determine.[162] Also, if section 341 does apply, the entire gain is taxed as ordinary income regardless of the fact that if a corporate entity had not been used, a large portion of the gain would have received capital gain treatment.

As was mentioned previously, there are three limitations on the application of the collapsible corporation provisions.[163] However, these limitations do not solve the above mentioned problems. For example, in the case of corporations engaged in the development of natural resources which have a substantial amount of development activity, the shareholders can never really be certain as to their collapsible status.[164]

Section 341(e) provides exceptions to the collapsible corporation provisions. These exceptions are determined on a wholly objective basis, thus eliminating the subjective "view" requirement.[165]

The four exceptions relate to: (1) sales or exchanges of stock;[166] (2) certain distributions in complete liquidation taxed as capital gains under section 331;[167] (3) certain complete liquidations for which nonrecognition treatment is provided under section 333;[168] and (4) certain sales or exchanges of property by the corporation under section 337.[169] A corporation will come within these four exceptions only if the net unrealized appreciation of "ordinary income" assets[170] of the corporation

160. S. REP. No. 1983, 85th Cong., 2d Sess. 818 (1958).

161. S. REP. No. 1983, 85th Cong., 2d Sess. 818, 866 (1958).

162. See generally II (A), (B) of this article's text *supra*.

163. See chart at page 650 and notes 34-37 *supra*.

164. At any given point in time, it would be impossible to determine the total income to be derived from the property if exploration was still in progress. Therefore, the three-year limitation and the 70-30 limitation would be useless. The 5% limitation only affects the very small minority shareholders. Finally, an escape from § 341 through the "substantial" route would be dangerous because total estimated income would be difficult, if not impossible, to ascertain.

165. If the provisions of § (e) are not complied with, §§ 341(a)—(d) are called into play and an independent determination as to qualification thereunder is made.

166. INT. REV. CODE OF 1954, § 341(e)(1).

167. INT. REV. CODE OF 1954, § 341(e)(2).

168. INT. REV. CODE OF 1954, § 341(e)(3).

169. INT. REV. CODE OF 1954, § 341(e)(4).

170. The code does not use the term "ordinary income" assets; it is designated therein as "SUBSECTION 341(E) ASSETS." However, the more descriptive phrase "ordinary income" assets will be used in this paper. See § 341(e)(5).

does not exceed fifteen per cent of its net worth.[171] If any shareholder of the corporation owns more than twenty per cent of the corporation's stock, the "ordinary income" assets of the corporation include those additional assets of the corporation which, if sold at a gain by the shareholder, would result in the imposition of an ordinary income tax on the shareholder.[172]

The qualification as to "ordinary income" assets is applied on a shareholder-by-shareholder basis in the following two situations. First, it is applied where a shareholder owns more than twenty per cent of the corporation's stock and owns or owned more than twenty per cent of the stock of another corporation within the preceding three years, and more than seventy per cent of the other corporation's assets that are or were of a similar nature[173] with regard to more than seventy per cent of the assets of the corporation.[174] Similarly, any sales or exchanges of assets by the other corporation which qualifies under section 337(a) will be considered sales or exchanges by the shareholder.[175] This provision was added to prevent avoidance of collapsible status by an individual through the use of a separate corporation for each venture. Second, it is applied on a shareholder-by-shareholder basis when the shareholder owns between five and twenty per cent of the corporation's stock.[176] As to each shareholder within this group, there is taken into account the net unrealized appreciation in assets of the corporation which would be "ordinary income" assets under the definition if the shareholder had owned more than twenty per cent in value of the corporation's stock.

The purpose of these tests is to insure that the amount of unrealized ordinary income is relatively small in proportion to the total assets of the corporation and that the tax status of the shareholders is included in this determination. Thus, the character of the income cannot be changed merely by using the corporate entity.

Additional requirements are imposed in the case of a complete liquidation, as distinguished from a sale of shares. The purpose of these requirements is to prevent the shareholders from liquidating their corporation, paying a capital gains tax on the excess of the fair market value of the distributed property over the basis of the stock surrendered, and then obtaining a stepped-up basis for depreciable assets. This depreciation could also be used to reduce ordinary income earned from the

171. The requirement that the "ordinary income" assets do not exceed 15% of net worth represents the essence of this exception.

172. INT. REV. CODE OF 1954, §§ 341(e)(5)(i), (5)(iii).

173. The code uses the terminology, "assets similar or related in service or use," but the apparent vagueness of these terms is essentially the same. Thus far, no regulations have been issued under § (e).

174. INT. REV. CODE OF 1954, § 341(e)(5)(A).

175. *Ibid.*

176. INT. REV. CODE OF 1954, § 341(e)(5)(B).

assets. Thus, in order for a distribution in complete liquidation under section 331 to qualify under subsection (e), three additional conditions must be met: (1) substantially all the properties of the liquidating corporation must be sold within a twelve-month period beginning on the date of the adoption of the plan for complete liquidation;[177] (2) no distribution of depreciable, depletable or amortizable property can be made to shareholders once the plan has been adopted;[178] and (3) sales or exchanges of property made by the corporation within the twelve-month period must qualify under section 337.[179]

The preceding description, though simplified, serves to illustrate the objectives and the general structure of subsection (e). To date, no regulations have been issued either to explain the operation of subsection (e) or to clear up possible ambiguities. Further, no decisions relating to the provision have been reported and only one revenue ruling has been issued.[180] The committtee reports, however, give the following example in regard to subsection (e):

> Assume that the sole asset of a corporation is appreciated land, and that the corporation is not a dealer in such property. If no shareholder of the corporation owning more than 20 percent of the corporation's stock is a dealer in such land (and if no more-than-20-percent shareholder owns or has owned, within the preceding three years, more than 20 percent of the stock in a corporation more than 70 percent in value of whose assets are property similar or related in service or use to the assets of this corporation) then gain from sale of stock by any shareholder owning more than 20 percent of the corporation's stock will not come within the provisions of section 341(a). If, on the other hand, a shareholder owning more than 20 percent in the value of the corporation's stock is a dealer in land, no sale of stock by any shareholder in the corporation will come within the statutory exception. . . . If no shareholder owning more than 20 percent of the corporation's stock is a dealer in land, but a 21 percent shareholder has owned and sold, within the past 3 years, similar stock interests in corporations having similar property, then such sales of stock shall be taken into account, as to that shareholder only, in ascertaining whether he is a dealer and therefore is prevented from coming under the exception. Similarly, if no shareholder owning more than 20 percent in value of the corporation's stock is a dealer in such land, a sale of stock by the 6 percent shareholder will not qualify under the exception, notwithstanding the face that sales of stock by other shareholders may qualify.[181]

177. INT. REV. CODE OF 1954, § 341(e)(2).
178. INT. REV. CODE OF 1954, § 341(e)(4)(C).
179. INT. REV. CODE OF 1954, § 341(e)(2).
180. Rev. Rul. 63-125, 1963 INT. REV. BULL. No. 27, at 8.
181. S. REP. No. 1983, 85th Cong., 2d Sess. 818 (1958). For additional discussion of

It can readily be seen that subsection (e) does not solve all the problems. First, if the taxpayer fails to meet one of the technical requirements he must look elsewhere for relief, notwithstanding the fact that the failure was only minimal. Second, a stock redemption cannot qualify under subsection (e),[182] nor can a distribution of excess mortgage proceeds. Third, distributions in an ordinary taxable liquidation cannot qualify unless the three additional requirements are met.[183]

III. CONCLUSION

Although the collapsible corporation provisions were enacted as a statutory weapon to prevent a specific tax avoidance device, their presence also allows a degree of security to taxpayers by providing fixed limits within which to work. When a stockholder in a close corporation decides to liquidate his investment,[184] section 341 should be of prime consideration, both as to timing and method of liquidation.

Logically, subsection (e) should be first consulted, because compliance with its technical provisions renders the entire section inapplicable, and the taxpayer can plan his liquidation on non-tax considerations.[185] If the technicalities of this provision are not satisfied, subsection (d) should be consulted next. Compliance with any of the three limitations in subsection (d) will prevent the operation of the penalty provision in subsection (a), but the corporation may remain collapsible for other purposes.[186]

Failure to comply with subsection (d) forces the taxpayer to find solace in subsection (b). Several avenues of escape are present there, but the entire subsection provides tenuous grounds because of the lack of firm lines of demarcation between compliance and non-compliance. The argument that no "view" was present during construction offers a possibility, but the regulations have been so broadly constructed,[187] and in turn, have been so broadly construed, that it is difficult to remain outside their scope. Of course, if the taxpayer owns a minority interest and the majority continues in control, the *Lowery Line* can be used to bolster the lack of "view" argument.[188]

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§ 341(e), See AMERICAN LAW INSTITUTE, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS, REPORT OF WORKING VIEWS OF A STUDY BY THE AMERICAN LAW INSTITUTE STAFF AND AMERICAN BAR ASSOCIATION SECTION OF TAXATION LIAISON COMMITTEE 153, 241-59 (1958); Modrall, *Collapsible Corporations and Subsection (e)*, 37 TAXES 895 (1959); Peel, *Recent Collapsible Developments: Inadvertent Collapsibility*, N.Y.U. 20TH INST. ON FED TAX 850 (1962); Note, 51 GEO. L.J. 346, 353-85 (1963).

182. Section 341(e) makes no provision for a stock redemption in partial liquidation.

183. See notes 169-71 *supra* and accompanying text.

184. The collapsible corporation provisions are applicable only to close corporations in all but most unusual circumstances because the opportunity to manipulate to the required degree would be difficult in a widely held corporation.

185. See INT. REV. CODE OF 1954, §§ 341(e)(1)-(4).

186. See note 17 *supra*.

187. See notes 47-50 *supra* and accompanying text.

188. See II(*B*) of this article's text *supra*.

The taxpayer can argue that a substantial amount of income has been realized,[189] but if the amount realized is less than fifty per cent of total estimated income, resistance from the Internal Revenue Service can be expected, and the taxpayer should be prepared to litigate.[190]

If the taxpayer is unsuccessful in escaping section 341, he can postpone his liquidation until a more opportune moment, or he can pay the ordinary income tax on the gain. However, it should be noted that section 341 applies only to shareholder gains. Therefore, any gain realized on a liquidation that falls within the purview of section 341 will not be subject to tax on the corporate level.[191] It is also possible for the corporation to dispose of its assets first, thereby realizing all its income, and then distributing the proceeds to its shareholders. Any gain realized upon this disposition would be subject to the fifty-two per cent corporate tax (or the twenty-five per cent capital gains rate if the particular asset is a section 1231 asset), but any gain to the shareholder on the liquidating dividend would receive capital treatment, the corporation having lost the collapsible status when it realized *all* of its income. In an appropriate situation, substantial tax saving can be obtained through the "disposition first-then distribute" approach.[192]

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189. See II(*D*) of this article's text *supra*.

190. The Internal Revenue's non-acquiescence to the *Kelley* decision, *supra* note 124, and the cases that have been litigated, indicate that the Service will not press the "substantial" issue if the amount realized exceeds 50%. There is no ruling to this effect, but by virtue of the absence of any decisions in which the amount realized exceeded 50%, the conclusion seems reasonable.

191. For taxpayers in the lower brackets, the advantage of capital gain taxation is relatively insignificant. The elimination of the intervening corporate tax by collapsing the income into a lump-sum may have tax advantages over the alternative of allowing all the income to pass through the corporation first.

192. For example, suppose that *X* Corporation was formed for the purpose of constructing an apartment house, and that the original incorporators, *A* and *B*, each own 50% of the stock. The building was started in June, 1955, and prior to its completion in June, 1958, *A* and *B* decide they would like to liquidate the corporation. At the time of this decision, the apartment house had cost $1,000,000 to construct, but due to an announcement by an aircraft firm to build a plant in the area, the fair market value had risen to $1,500,000. Presumably, any attempt to liquidate their investment at this time would fall within § 341 and *A* and *B* would each realize ordinary income of $250,000. Suppose, however, that *A* and *B* attempt to liquidate the corporation under § 337 but are prevented from so doing because the corporation is collapsible within § 341(b). In this example the corporation has liquidated its assets and has realized a gain of $500,000. This gain is included in *X* Corporation's taxable income for that year and is subject to the 52% corporate tax amounting to $254,500. This leaves $245,500 available as a liquidating dividend to *A* and *B* in exchange for their stock. However, since all the income of *X* Corporation had been realized prior to the distribution, the gain would be taxable as capital gain. The maximum tax on the capital gain (assuming it is long-term) to *A* and *B* would be 25%, or $61,375, leaving *A* and *B* the combined income after taxes of $184,125 or $92,062.50 each. Percentage-wise, the net income after taxes represents 36.8% of the total gain, the gain being taxed at an average rate of 63.2%. Obviously, any taxpayer who is already in a bracket in this vicinity would reduce his overall tax bill by liquidating first and then distributing. See Sproul Realty Co., 38 T.C. 844 (1962).

Writers have criticized[193] and advocated changes[194] in the collapsible corporation provisions, even though the statute has curbed flagrant abuses. It is the writer's position that remedial collapsible corporation provisions have performed the function for which they were intended; more cannot be expected under our taxing system.

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193. Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 COLUM. L. REV. 1146, 1176, 1178 (1958); Cavitch, *Collapsible Corporations*, W. RES. L. REV. 278, 289 (1962).

194. AMERICAN LAW INSTITUTE, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS, REPORT OF WORKING VIEWS OF A STUDY BY THE STAFF AND AMERICAN BAR ASSOCIATION SECTION OF TAXATION LIAISON COMMITTEE 153, 158-63, 186-201 (1958); Note, 1960 GEO. WASH. L. REV. 855; SUBCHAPTER C ADVISORY GROUP—REPEAL OF SECTION 341 AND SUBSTITUTION OF SECTION 343. See also note 128 *supra*.