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COLLAPSIBLE CORPORATIONS—ANOTHER LIMITED LOOK

ROBERT L. HINES*

Section 341, the collapsible corporations provision of the Internal Revenue Code¹ does not yield its meaning to a simple reading. Concepts and complexities mount with each phrase until, well before the section has run its course, their accumulated weight approaches the unbearable. Within the scope of this comment, therefore, only a limited look will be attempted, with the points of focus being those areas of the statute most likely to be involved in litigation. The over-all purpose here may be stated simply, however: Every sale or redemption of stock of a closely held corporation, and every liquidation distribution from such a corporation, must be tested against the provisions of section 341. If the section applies, an expected capital gain will be converted into ordinary income, and the possible application of the section may immediately involve the stockholder or his attorney in all the complexities to be noted.²

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¹ INT. REV. CODE OF 1954, § 341. This provision of current law was carried forward substantially unchanged from section 117(m) of the 1939 Code, with the outstanding exception of the addition of section 341(e) by the Revenue Act of 1958. References hereafter will be made to section 341, without regard to the taxable year involved, except in instances where differences in statutory language would be relevant. In those instances precise statutory reference will be made.

² Many of the cases which have had section 341 applied have been cases involving loans insured by the Federal Housing Administration (FHA). In these FHA cases the loan would be in excess of the cost of the project and either the excess of the loan over the project cost would be received by a shareholder as a distribution of capital or the stock in the corporation would be sold and capital gain reported.

Sometimes the corporation would be organized with Class A and Class B stock. After receipt of the total loan proceeds and before the corporation had earnings, the Class B stock would be redeemed for the excess loan proceeds. The early redemption would eliminate the possibility of the distribution being taxed as a dividend because of the absence of earnings and accumulated surplus.

In almost all these cases the courts have decided against the taxpayers. *Braunstein v. Commissioner*, 305 F.2d 949 (2d Cir. 1962), *aff'd*, 374 U.S. 65 (1963); *Short v. Commissioner*, 302 F.2d 120 (4th Cir. 1962), *affirming* 35 T.C. 922 (1961); *Pomponio v. Commissioner*, 288 F.2d 827 (4th Cir. 1961), *affirming* 33 T.C. 1072 (1960); *Mintz v. Commissioner*, 284 F.2d 554 (2d Cir. 1960), *affirming* 32 T.C. 723 (1959); *Jacobson v. Commis-*

The origin of section 341, stated broadly, was a Congressional intent to put an end to certain—sometimes successful—efforts to convert ordinary income into capital gain through the interim use of a corporate entity followed by income realization by the individuals who owned and controlled the corporation. The statutory machine erected to serve this police purpose does not address itself to taxing the corporation involved; but, instead, directs itself squarely at the income consequence to the shareholder. In sharply selective quotation, section 341 reads as follows:

(a) TREATMENT OF GAIN TO SHAREHOLDERS.—Gain from—

(1) the sale or exchange of stock of a collapsible corporation,
 (2) a distribution in partial or complete liquidation of a collapsible corporation, which distribution is treated under this part as in part or full payment in exchange for stock, and

(3) a distribution made by a collapsible corporation which, under section 301(c)(3)(A), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property,

to the extent that it would [otherwise be treated as a long term capital gain] . . . shall, except as provided in subsection (d), be

sioner, 281 F.2d 703 (3d Cir. 1960), *reversing* 32 T.C. 893 (1959); Bryan v. Commissioner, 281 F.2d 238 (4th Cir. 1960), *affirming* 32 T.C. 104 (1959); Spangler v. Commissioner, 278 F.2d 665 (4th Cir. 1960), *affirming* 32 T.C. 782 (1959); Sidney v. Commissioner, 273 F.2d 928 (2d Cir. 1960), *affirming* 30 T.C. 1155 (1958); Payne v. Commissioner, 268 F.2d 617 (5th Cir. 1959), *affirming* 30 T.C. 1044 (1958); August v. Commissioner, 267 F.2d 829 (3d Cir. 1959), *affirming* 30 T.C. 969 (1958); Abbott v. Commissioner, 258 F.2d 537 (3d Cir. 1958), *affirming* 28 T.C. 795 (1957); Glickman v. Commissioner, 256 F.2d 108 (2d Cir. 1958), *affirming* 26 P.H. TAX CT. MEM. 451 (1957); Burge v. Commissioner, 253 F.2d 765 (4th Cir. 1958), *affirming* 28 T.C. 246 (1957); Jesse Hartman, 34 T.C. 1085 (1960); Ellsworth J. Sterner, 32 T.C. 1144 (1959); Carl B. Rechner, 30 T.C. 186 (1958); Louis Alper, 30 P.H. TAX CT. MEM. 1780 (1961); David Bass, 28 P.H. TAX CT. MEM. 59 (1959);

Numerous articles and comments have been written on the many phases of the definition of a collapsible corporation by itself, not to mention the articles dealing specifically with other portions of section 341 of the Code. Axelrad, *Tax Advantages and Pitfalls in Collapsible Corporations and Partnerships*, 34 TAXES 841 (1956); Boland, *Practical Problems of the Collapsible Corporation*, N.Y.U. 10TH INST. ON FED. TAX 537 (1952); Greenfield, *Effect of Collapsible Corporations on Real Property Holdings*, N.Y.U. 10TH INST. ON FED. TAX 91 (1952); MacLean, *Collapsible Corporations—The Statute and Regulations*, 67 HARV. L. REV. 55 (1953); Weithorn, *Collapsible Corporations:—1960 Status*, N.Y.U. 19TH INST. ON FED. TAX 593 (1961); See Commissioner v. Kelley, 293 F.2d 904, 908 n.11 (5th Cir. 1961), for an extensive list of articles on this section. See also Donaldson, *Collapsible Corporations*, 36 TAXES 777 (1958) which presents a concise discussion of the few major parts of the section prior to 1958,

considered as gain from the sale or exchange of property which is not a capital asset.

(b) DEFINITIONS

(1) COLLAPSIBLE CORPORATION.—For purposes of this section, the term “collapsible corporation” means a corporation *formed or availed of* principally for the *manufacture, construction, or production* of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a *view to*—

(A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, *before the realization* by the corporation manufacturing, constructing, producing, or purchasing the property of a *substantial part of the taxable income* to be derived from such property, and

(B) the realization by such shareholders of gain attributable to such property.

(2) PRODUCTION OR PURCHASE OF PROPERTY.—For purposes of paragraph (1), a corporation shall be deemed to have manufactured, constructed, produced, or purchased property, if—

(A) it engaged in the manufacture, construction, or production of such property to any extent,

(B) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or

(C) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation.

(3) SECTION 341 ASSETS.—For purposes of this section, the term “section 341 assets” means property held for a period of less than 3 years which is—

....

(c) PRESUMPTION IN CERTAIN CASES.—

....

(d) LIMITATIONS ON APPLICATION OF SECTION.—In the case of gain realized by a shareholder with respect to his stock in a collapsible corporation, this section shall not apply—

(1) unless, at any time after the commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in subsection (b)(3) or at any time thereafter, such shareholder (A) owned

(or was considered as owning) more than 5 percent in value of the outstanding stock of the corporation, or (B) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 5 percent in value of the outstanding stock of the corporation;

(2) to the gain recognized during a taxable year, unless more than 70 percent of such gain is attributable to the property so manufactured, constructed, produced, or purchased; and

(3) to gain realized after the expiration of 3 years following the completion of such manufacture, construction, production or purchase.

....

(e) EXCEPTIONS TO APPLICATION OF SECTION.—³

Four major areas of battle have developed under section 341—being indicated by the emphasized portions of the quoted statutory language. Stated in the form of questions, the major points of issue are these: (1) When is a corporation “formed or availed of” for activities and purposes condemned by section 341? (2) What are the limits in time and activity of the “manufacture, construction, or production” of property, within the meaning of section 341? (3) What nature or purpose or intention is comprehended by the requirement of “a view to” sale or exchange, etc., and when must that purpose exist, in order for the “view” to be one condemned by section 341? (4) What is meant by a sale or exchange, etc., “before the realization . . . of a substantial part of the taxable income” to be derived from the property, *i.e.*, is the condemnation limited to sales or exchanges which precede the realization of any substantial part of the derivable income, or is the condemnation much broader so that it reaches sales or exchanges which come at a time while a substantial part of the derivable income remains unrealized by the corporation?

I. THE AFFAIRS OF MR. A

By way of illustrating how all four problem areas just noted may have bearing on the affairs of an average business man, the facts of a common transaction may be used. Mr. A, resident in a growing city recently purchased a tract of land near a proposed shopping center. His purpose for the purchase was to enjoy an expected increase in land values, and, if possible, to accelerate that increase by

³ INT. REV. CODE OF 1954, §§ 341(a)-(e). (Emphasis added.)

securing a zoning change for the land from residential to either business or office institution. Mr. *A* also had in mind, if his zoning change came through, the erection of a commercial building on the tract.

Mr. *A* either acquired land in a corporation owned by himself and his immediate family, or he purchased the land individually and then transferred it to the family corporation. After success before the zoning board, the corporation started construction of an office building. Shortly after the building was ready for occupancy, another investor approached Mr. *A* and offered an excellent price for the land and building. Mr. *A*, keeping in mind that he had been told always to buy assets and sell stock, and, as the realty involved was the only asset of the family corporation, he declined to have the corporation sell the realty—but he countered with a proposal to sell all of the stock of the corporation to the generous second investor.

At the time Mr. *A* first decided to build on the land he was convinced that such a development would be a good long-term investment. The price offered by the second investor, however, was so favorable as to lead him to sell. When he made his counter-offer, for sale of stock at a favorable price, he gave no particular thought to the timing of income from the building; but, instead, considered only the margin of profit available to him. He thought of that profit as arising largely from his success in securing a zoning change and in erecting a quality building for a reasonable cost.

Mr. *A* has never before purchased or built or sold any form of real property, and the proposed stock sale will also be the first in his history. Nonetheless, due to section 341, it is possible that his profit on sale of the stock will be taxable as ordinary income. This unhappy result, wholly independent of any trade or business engagement by Mr. *A*,⁴ would be almost certain if the stock sale involved were one taking place before September 2, 1958, as the possibility of relief under section 341(e) would not then exist.⁵ Even for years following the effective date of the exceptions granted by this section, however, there remains a danger of ordinary income treatment—as the reach of the section has not yet been clearly established.

⁴ *Braunstein v. Commissioner*, 305 F.2d 949 (2d Cir. 1962), *aff'd*, 374 U.S. 65 (1963); *United States v. Ivey*, 294 F.2d 799 (5th Cir. 1961).

⁵ As indicated by the text, subsection (e) of section 341 of the Code was promulgated as a separate entity in 1958.

In general in cases such as the preceding example, and as will be noted at some length hereafter, the purpose of section 341(e) is to make section 341 inapplicable where the questioned gain on sale of stock or on distribution is attributable primarily to assets which would have produced only long-term capital gain if they had been sold directly by the corporation or by its principal shareholders (had those assets been owned directly by the principle shareholders). Apart from possible protection by subsection (e), however, Mr. A must test his proposed stock sale against the provisions of the first four subsections of section 341—and in so doing he must be aware of the four problem areas noted above. Separate discussion of those four areas of interest seems called for and will be taken up in their order of immediate importance.

II. THE "VIEW" AREA

It is fairly well settled that there must be a "bad view" in order for this section to come into play.⁶ The courts, in analyzing what constitutes such a view, have pointed to some factors in the evidence indicating its existence.⁷ However, the regulations and court decisions still leave this area in semidarkness. The statute itself states that it is a "view to" a certain type of sale or exchange or distribution, namely a "sale or exchange of stock by its shareholders . . . or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing or purchasing the property of a substantial part of the taxable income to be derived from such property" That the taxpayer, even as a member of the group of shareholders, had a view to selling stock in a corporation which had constructed property is not alone sufficient. Where the

⁶ Farber v. Commissioner, 312 F.2d 729 (2d Cir. 1963); Abbott v. Commissioner, 258 F.2d 537 (3d Cir. 1958); Glickman v. Commissioner, 256 F.2d 108 (2d Cir. 1958); Burge v. Commissioner, 253 F.2d 765 (4th Cir. 1958); Edward Weil, 28 T.C. 809 (1957), *aff'd*, 252 F.2d 805 (2d Cir. 1958).

⁷ Lack of realization of any of the income to be derived from the property, Farber v. Commissioner, *supra* note 6; existence of two classes of stock at incorporation, Epstein v. United States, 221 F. Supp. 479 (N.D. Ohio 1963); issuance and redemption of class B stock, Burge v. Commissioner, *supra* note 6; sale by architect of \$219,401 par value of stock to taxpayer for \$16,750, Spangler v. Commissioner, 278 F.2d 665 (4th Cir. 1960). *But see* Honaker Drlg., Inc. v. Koehler, 190 F. Supp. 287 (D.C. Kan. 1960) where the fact that the individuals would have realized capital gains had they sold the property influenced the court to find an absence of view.

taxpayer's decision to sell his stock is not geared to the statutory reasons, section 341 should not come into play. Thus there can be a "good view" to selling as well as a bad one.⁸ Pursuant to this fact of statutory construction, the Commissioner's regulations establish a presumption that the corporation is not collapsible if the sale, exchange or distribution is attributable solely to circumstances which arose after the construction or which could not be reasonably anticipated at the time of construction.⁹

The Internal Revenue Service would eliminate the necessity of having a "bad" motive in making the sale, exchange or distribution. Attempting to make its task much easier, the Service has argued that if a sale, exchange or distribution took place within the prohibited period, the motive of the taxpayer is immaterial.^{9a} This approach has been bolstered by the suggestion that there would be chaos in attempting to apply section 341 if proof of good motive for selling could overcome the statute.¹⁰ Other sections of the Code often re-

⁸ Ralph J. Solow, P-H TAX CT. REP. & MEM. DEC. ¶ 63,087 (1963) (co-owners disagreed and one sold to the other); Maxwell Temkin, 35 T.C. 906 (1961) (angina attack after prior refusals to sell); Charles J. Riley, 35 T.C. 848 (1961) (doctor advised petitioner to take more exercise). Cf. Sylvester J. Lowery, 39 T.C. No. 100 (March 21, 1963) (two corporations were collapsible and two not collapsible, implying a "good view" as to the latter). "In our opinion section 117(m) was not intended to apply where, as here, a minority shareholder is compelled, because of circumstances over which he had no control, to dispose of his investment in a corporation which is thereafter continued in operation by the majority shareholders. The legislative history does not indicate it was so intended and we are aware of no case which has held otherwise." *Id.* at 12.

⁹ Treas. Reg. § 1.341-2(a)(3) (1955), provides that: "A corporation is formed or availed of with a view to the action described in section 341(b) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of."

See cases cited note 7 *supra*.

^{9a} See note 13 *infra* and accompanying text.

¹⁰ Nordberg, "Collapsible" Corporations and the "View," 40 TAXES 372, 379 contends "if, as suggested, a compelling fact to the contrary could negate the presence of the prohibited view and thereby prevent the application of Section 341, chaos would reign supreme. In every situation the court or jury

quire the existence of an improper motive¹¹—thus permitting the taxpayer to show subjectively that a certain section is not applicable to him. Even though the statute provides for a presumption of collapsibility,¹² as applied to section 341 the establishment of a

would be called upon to determine the presence or absence of the magic "compelling factor to the contrary."

Treas. Reg. § 1.341-5(b) (1955), list the facts which will ordinarily cause collapsible section problems:

"The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (a) of this section and paragraph (c) of this section) to establish that a corporation is a collapsible corporation:

(1) A shareholder of the corporation sells or exchanges his stock or receives a liquidating distribution, or a distribution described in section 301(c)(3)(A).

(2) Upon such sale, exchange, or distribution, such shareholder realizes gain attributable to the property described in subparagraphs (4) and (5) of this paragraph, and

(3) At the time of the manufacture, construction, production, or purchase of the property described in subparagraphs (4) and (5) of this paragraph, such activity was substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to in subparagraphs (2) and (3) of this paragraph is that property or the aggregate of those properties which meet the following two requirements:

(4) The property is manufactured, constructed, or produced by the corporation or by another corporation stock of which is held by the corporation, or is property purchased by the corporation or by such other corporation which (in the hands of the corporation holding such property) is property described in section 341(b)(3), and

(5) At the time of the sale, exchange, or distribution described in subparagraph (1) of this paragraph, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the taxable income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this subparagraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. Under the rules of this subparagraph, a corporation shall be considered a collapsible corporation by reason of holding stock in other corporations which manufactured, constructed, produced, or purchased the property only if the activity of the corporation in holding stock in such other corporations is substantial in relation to the other activities of the corporation."

¹¹ INT. REV. CODE OF 1954, §§ 269 (acquisitions made to evade or avoid income tax), 302(c) (acquisition of stock within a 10-year period), 532(a) (accumulated earnings tax on corporation "formed or availed of" to avoid income tax).

¹² INT. REV. CODE OF 1954, § 341(c). However, this presumption does not materially assist the Commissioner. See Jack D. Saltzman, P-H TAX CT. REP. & MEM. DEC. ¶ 63,080 (1963), where the Tax Court felt "that the evidence in this case which is sufficient to overcome the presumption of cor-

"good view" should thus bring the taxpayer out from under the statute. Any other interpretation of the Congressional intent in using the word "view" would strike many unwary taxpayers in the tax pocketbook where their intent to sell was based on something else, such as a heart attack which renders them unable to continue.

In *Shilowitz v. United States*,¹³ the government attempted to remove from the intent to sell any consideration of motive. There the petitioner, an architect, had entered into an arrangement with a builder to build two apartment projects for investment. Approximately seven months after construction had begun, the petitioner suffered a heart attack. Later, *before the project was complete*, additional financing was needed and the petitioner was unable to supply the funds. The builder then demanded sole ownership on the grounds that he was to have the responsibility of obtaining the additional funds. The petitioner then had no choice but to sell the stock of the two corporations to the builder. On trial, the Government contended that the sale of stock which was induced by circumstances present during the period of construction, occurred before construction was completed and that this was sufficient per se to make the sale that of stock in a collapsible corporation. Relying completely upon this theory the Government did not even assert that the requisite view was present, *i.e.*, that there was any motive for sale other than the heart attack and the builder's insistence that the petitioner withdraw from the venture. By this argument a sale after construction is completed, attributable to circumstances present during construction would be placed on different footing from such a sale which took place during construction. A further broadening of the applicability of the section was thus requested. By following the Government's line of reasoning, any sale prior to completion of construction of stock in a corporation otherwise meeting the definition of a collapsible corporation would thus automatically make the corporation collapsible. Since Congress did not add a proviso or a special subsection to this part of the Code to state that sales during construction, production or manufacture would eliminate the neces-

rectness of respondent's determination is also sufficient to rebut the presumption created by section 341(c)." *Id.* at 384.

The taxpayer failed to overcome the presumption of correctness in *Arthur Sorin*, 29 T.C. 959 (1958), *aff'd per curiam*, 271 F.2d 741 (2d Cir. 1959), when he could not show that the requirements of the statute were lacking.

¹³ 221 F. Supp. 179 (D.N.J. 1963).

sity of possessing the proscribed view, the New Jersey District Court properly refused to adopt the unwarranted limitation on the requirement of a bad view, stating:

In fact, it is difficult to conceive how, in rational application of the Regulation, the time element of the sale of stock, standing alone and apart from circumstances inducing it, could be considered a determining factor in whether gain realized should be treated as capital gain or ordinary income.¹⁴

One of the best statements as to kind of intent or motive out of which the view to sale, exchange or distribution must come was stated by one writer as early as 1952. It clearly expresses the subjective state:

Yet, the literal wording of the Statute seems to require that the shareholders of a collapsible corporation must have in mind at some time during the production of the property an idea of withdrawing from the enterprise prior to realization at the corporate level of a substantial part of the anticipated gain from the property thus produced.¹⁵

This definition immediately brings us to a consideration of specific taxpayer motive. The courts have been conscious of good motives since the statute was first enacted. Little by little, however, there have been inroads made on the requirement of intent or motive by decisions directly ignoring the requirement of motive,¹⁶ by continuous Commissioner urging of narrower interpretation,¹⁷ and by

¹⁴ *Id.* at 184.

¹⁵ Boland, *Practical Problems of the Collapsible Corporation*, N.Y.U. 10TH INST. ON FED. TAX 537, 549 (1952). Another explanation of the view is in 3B MERTENS, *FEDERAL INCOME TAXATION* § 22.58, at 251 (1958): "The 'view' or intent, which is required to be present at the proper time in the proper minds, is to do two things: to collapse the corporation or the investment before the corporation realizes a 'substantial' part of the 'taxable income' to be derived from the collapsible property; and to arrange for the stockholders to realize the income." This is the Tax Court's view, Jack D. Saltzman, P-H TAX CT. REP. & MEM. DEC. ¶ 63,080 (1963).

"The question is, therefore, whether at the time the apartment building was purchased, One Fifteen had a view to distributing the asset to petitioner before the realization by One Fifteen of a substantial part of the taxable income to be derived from such property, and the realization by petitioner of gain attributable to such property." *Id.* at 383.

¹⁶ *E.g.*, James B. Kelley, 32 T.C. 135 (1959), *aff'd*, 293 F.2d 904 (5th Cir. 1961), where the court decided on the basis that a substantial part of the income had actually been realized, and never reached a consideration of view.

¹⁷ *Shilowitz v. United States*, 221 F. Supp. 179 (D.N.J. 1963).

dicta,¹⁸ later available for urging by the Commissioner to be the established rule. Indeed courts have had a tendency to shortcut the full definition of a collapsible corporation by stating that as long as there was a view to selling during construction, the corporation was collapsible,¹⁹ or so long as there was a view to *sale after construction* and the circumstances had not changed, the corporation was collapsible,²⁰ or so long as there was a *view after completion* of construction to sale and circumstances had not changed since completion of construction, the corporation was collapsible.²¹

Suppose a taxpayer, after his solely-owned corporation built an office building, without change of circumstances since completion and after receiving approximately five per cent of the estimated income

¹⁸ Even *United States v. Ivey*, 294 F.2d 799 (5th Cir. 1961) said "and the corporation may be 'availed of with a view to' effecting a tax avoidance scheme." *Id.* at 806. Only when the courts indicate that there is something left out between "availed of" and "with a view to" will dicta not be used improperly.

¹⁹ *Spangler v. Commissioner*, 278 F.2d 665 (4th Cir. 1960), *cert. denied*, 364 U.S. 825 (1960), quoted the shortened version of the "availed of" theory in *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958), *affirming* 28 T.C. 246 (1957), which left out "for construction"; then indicated two different stages of "view"—one when the corporation was formed, another when it was "availed of." Both cases seem to say that "formed or availed of for construction" means "formed for construction" or "availed of for sale." Certainly this is not within the statute.

²⁰ See *Burge v. Commissioner*, *supra* note 19.

²¹ *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958), implying that the existence of the view at the time of availing for sale was sufficient, ignoring the normally accepted premise that "availing" applies to "for construction." *Treas. Reg. § 1.341-2(a) (4)* (1955), indicates that the requisite view in order to make a corporation collapsible must exist with respect to *property*, and lends weight to the position that the view is a subjective consideration of receipt of income and its relationship to the time of sale:

"The property referred to in section 341(b) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 341(b) there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination whether the requisite view existed shall be made only if a substantial part of the taxable income to be derived from the project has not been realized at the time of the sale, exchange, or distribution, and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project."

See Ruecker, *Collapsible Dangers Can Be Avoided*, 18 J. TAXATION 77 (1963).

from the project, sells the stock of the corporation at a considerable profit (thirty percent) because he decides to shift from real estate investment into the stock market. Assuming this sale takes place within three years after completion, he will have an almost insurmountable task of proving to the courts that his decision to sell was reached solely because of his desire to change his type of investment. On those facts—standing by themselves—in the light of the two presumptions which bolster the Commissioner's position, he will at best have protracted litigation, with the probability of losing the case. This would be the result, even though the taxpayer never heard of collapsible corporations or of section 341 and even though he testified that he gave no consideration as to when his corporation was to receive its income. *A fortiori*, with all of the apartments and other housing projects being built often by a wholly-owned corporation, section 341 is immediately dangerous for anyone who changes his mind in an apartment venture.

There is no absolute safeguard that can be put in the statutes to protect such an individual and still protect the Commissioner in the discharge of his responsibility for collecting revenue and preventing circumvention of the taxing statutes unless by legal means. In the illustrated situation, the Commissioner's determination would be presumptively correct and the corporation would presumptively be a collapsible corporation. Nevertheless, under the statute, the taxpayer still has the right to overcome these presumptions by his own evidence.

Going back into history to determine the original purpose of the section²² it seems to the writer that, without question, in order for the corporation to be collapsible, consideration must have been given, in forming the view to sell, to the taxable income to be received from the property constructed and the timing of the sale before its actual receipt. The Commissioner's own regulations uphold this interpretation.²³

²² H.R. REP. No. 2319, 81st Cong., 2d Sess. 96 (1950).

²³ Treas. Reg. § 1.341-2(a)(2) (1955), provides that: "Under section 341(b)(1) the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and the realization by the shareholders of gain attributable to such property."

See *Epstein v. United States*, 221 F. Supp. 479 (N.D. Ohio 1963), where

Under section 341(b)(1)(A), the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them prior to the "realization by the corporation... of a substantial part of the taxable income to be derived from such property...."^{23a}

"The requisite view is a subjective state of mind which must be determined through assessing the objective facts."²⁴ And it is in

the question of a "view" (intent) was said to be "a subjective mental state and one that is difficult to determine. This is particularly true where the issue to be determined is the time when the subjective mental state was originally developed." *Id.* at 486.

^{23a} INT. REV. CODE OF 1954 § 341(b)(1)(a).

²⁴ Jack D. Saltzman, P-H TAX CT. REP. & MEM. DEC. ¶ 63,080 at 383 (1963), citing *Braunstein v. Commissioner*, 305 F.2d 949 (2d Cir. 1962). The court emphasized its unwillingness to rely solely on the taxpayer's version of his intent stating: "If petitioner's conclusion as to his intent were required to be accepted in accordance with his statement, disposition of the question here involved could be made on the basis of this testimony of petitioner." *Ibid.* Involved here was a "purchase," not construction, of property.

But the petitioner in *Charles J. Riley*, 35 T.C. 848 (1961), gave uncontradicted testimony about his intent to build for investment corroborated by a real estate broker who testified of his refusal to sell, and by his doctor—and carried his burden of proving the sale was attributable solely to circumstances arising subsequent to completion of construction. Five judges dissented on the grounds that petitioner's testimony was unreliable and had no *impartial* evidence to support it.

Although there is no requirement that the sale be made to outsiders, in *Sylvester J. Lowery*, 39 T.C. No. 100 at 959 (1963), the court distinguished between sales of all the outstanding stock to outsiders and a sale from a minority stockholder to the majority.

"In the case of both *Carver* and *Duval* there was a sale of *all* of the stock by *all* of the shareholders and it is clear that petitioner, in fact, shared in the view of the majority of the shareholders to sell the stock prior to the realization by the corporations of any part of the net income to be derived from the property." *Id.* at 9.

"One material distinction exists, however. In both *Parkway* and *Raleigh*, those owning the majority of the stock and who were not only in a position to, but did, in fact, control their policies, did not sell their stock but continued to operate the corporations. Neither corporation was availed of 'with a view to' the action described in section 117(m)(2)(A), by those owning a majority of the stock and controlling its policies. It necessarily follows that petitioner did not 'share' in such a view. Neither corporation was 'collapsible' or was ever in fact collapsed. The situation here presented is distinguishable from those cases in which corporations have been held collapsible even though the corporation as such continued in existence since, in those cases, all shareholders sold their stock with a view, shared by all, to the realization of gain prior to the realization by the corporation of a substantial part of the net income to be derived from the property constructed." *Id.* at 10-11.

And yet Judge Opper, dissenting, keeps our eyes in focus on the "view"

the assessment of the objective facts that the court must, as Congress has prescribed, determine whether or not the intent was to sell before realization of substantial income.²⁵

Still addressing ourselves to the type of view which Congress intended that the taxpayer possess to be brought within the provision of section 341, it is certainly not a view to sell occasioned by a heart attack and physician's advice;²⁶ it is not a view to sell occasioned by discovery of cracks in buildings shortly after completion;²⁷ it is not a view to sell occasioned by a doctor's advice to retire;²⁸ it is not a view automatically inferred where the sole circumstance which brought about the sale of the property is the enactment of legislation by Congress after completion of the construction of the property.²⁹

When must the view arise? Keeping in mind the basic purpose of the statute at its inception in 1950 was aimed at devices whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to the long term capital gains taxable only at a rate of twenty-five per cent, it would seem that a view of selling the stock which arises after the completion of the manufacture, construction or production, or which is not in existence at the time of purchase of section 341 property, would not be a proscribed view within the statute. Yet this

of the individual shareholder, rather than the view of those controlling: "The Court's opinion seems to me painted with much too broad a brush. The fact that 'neither corporation was availed of 'with a view to' the action described in section 117(m)(2)(A), by those owning a majority of the stock and controlling its policies' does not 'necessarily' lead to the conclusion that the corporation was not availed of by this petitioner with the requisite 'view.' Since the sale of stock is an individual matter, the 'view' of other shareholders can have only evidentiary bearing on what was in petitioner's mind." *Id.* at 13.

²⁵ *Braunstein v. Commissioner*, 305 F.2d 949 (2d Cir. 1962), *aff'd*, 374 U.S. 65 (1963).

²⁶ *Maxwell Temkin*, 35 T.C. 906 (1961). Here the taxpayer was bolstered by two heart attacks and prior reliance on his doctor. The taxpayer had suffered a heart attack in 1947, and, on physician's advice, resigned from a mortgage firm to build the apartment house involved in the collapsible litigation. After advice from his physician following angina pains, taxpayer signed the sales contract the next day.

²⁷ *Jacobson v. Commissioner*, 281 F.2d 703 (3d Cir. 1960). Bolstering the taxpayer's position a real estate broker was twice informed the properties were not for sale.

²⁸ See *Elliott v. United States*, 205 F. Supp. 384 (D. Oregon 1962). The case actually was decided on the ground that the view arose after completion.

²⁹ Rev. Rul. 57-575, 1957-2 CUM. BULL. 236. The ruling makes such broad assumptions that it is of little benefit to taxpayers generally.

question remains open. The regulations state⁸⁰ that the corporation is formed or availed of with a view to the action described in the section if the view existed at any time *during the manufacture, construction, production or purchase*. The *Braunstein* case⁸¹ in the Second Circuit unequivocally stated that the "view" to such sale or distribution must exist at some time "during construction," citing the Treasury's regulations.⁸² The Tax Court continues to agree with its prior position and the *Braunstein* decision.⁸³

According to commentators and other decisions the only circuit court which has implied that this view may arise subsequent to the completion of construction is the Fourth Circuit.⁸⁴ However, an

⁸⁰ Treas. Reg. § 1.341-2(a)(3) (1955), provides that: "A corporation is formed or availed of with a view to the action described in section 341(b) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of."

⁸¹ *Braunstein v. Commissioner*, 305 F.2d 949 (2d Cir. 1962), *aff'd* 374 U.S. 65 (1963).

⁸² "The 'view' to such sale or distribution must exist at some time 'during construction.'" *Id.* at 951.

And the view of individual shareholders to construct after liquidation was a "bad view" in *Abbott v. Commissioner*, 258 F.2d 537 (3d Cir. 1958): "[T]hat petitioners, as the sole stockholders of the corporation, felt themselves in a position to make the agreements as individuals, knowing that their controlled corporation could be counted upon to take whatever subsequent action their commitments called for, is merely a further reason why the provisions of section 117(m) must necessarily be invoked. If it were otherwise, and if individuals could thus project the acts which would take place after distribution and dissolution as though the corporation was in no sense a participant, all of the provisions in question would be meaningless." *Id.* at 541, quoting from *Abbott v. Commissioner*, 28 T.C. 795, 807-08 (1957).

⁸³ Since *Braunstein* was decided after the dictum in *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958), which implied that the interpretation of the regulations was narrower than that of the statute, it would seem that the direct statement in the *Braunstein* case, which refers to the *Glickman* dictum, would place the Second Circuit in line with the Third Circuit and the Tax Court that the proscribed view must exist during construction.

⁸⁴ *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958). The Third Circuit doesn't imply, it categorically states that the view may not arise subsequent to completion, *Jacobson v. Commissioner*, 281 F.2d 703, 705 (3d Cir. 1960). "On the face of the statute Congress is here indicating a state of

analysis of *Burge v. Commissioner*³⁵ indicates that there was a dictum indicating there might be a different application of the term "availed of" there. The court stated that "it is not necessary that the 'view' exist at the time the corporation is formed. It is sufficient that it exist when the corporation is 'availed of'; and the corporation was availed of here to dispose of all interest that the shareholders had in the project"³⁶

There was a minimum investment of one hundred dollars to build an apartment building costing over a million and a half dollars, issuance of Class A and Class B stock and the redemption of Class B stock when the proceeds of the FHA loan exceeded the cost of construction. The Fourth Circuit stated that the taxpayer's testimony of a permanent investment was "very largely discredited," and that his testimony as to his intent was not sufficient to overcome the Commissioner's presumption of correctness. The court agreed with the Tax Court that the "view" was clearly established by circumstances relating to the issuance and redemption of Class B stock, and further stated:

[N]othing occurred prior to the sale of the Class A stock, less than three months later, to warrant a holding that there had been a change of "view" in the meantime [W]e think it clear also that the liquidation of the Class B stock should be considered along with the sale of the Class A stock and that, when so considered, there is no reason for holding that the corporation was not "availed of" with the "view" required by the statute with respect to both transactions.³⁷

In effect, the Fourth Circuit seemed to be saying that the requisite "view" existed earlier, that the Tax Court had indicated there was no change in view, and that both the redemption and the sales must be considered together.

mind which must attend and gives significance to certain action. That action, as specified in the statute, is not merely any formation or use of a corporation but rather the formation or use of a corporation to construct or produce property. The 'view' with which a corporation is used for a particular purpose must necessarily be a view entertained at the time of such use. Thus, only by distorting disregard of the phrase 'for the *** construction *** of property' is it possible to reach the conclusion that the 'view to *** sale' contemplated by the statute can arise for the first time in connection with corporate activity after the work of construction is completed."

³⁵ Note 34 *supra*.

³⁶ 253 F.2d at 769.

³⁷ *Id.* at 770.

The court seemed also in its opinion to imply that the corporation was "availed of" when the shareholders decided to sell.³⁸ And yet, the Second Circuit in *Farber v. Commissioner*³⁹ states that "availed of" modifies for manufacture, construction or production, implying that a corporation is not availed of for sale.⁴⁰ The Tax Court in the *Burge* case⁴¹ indicated that there was no testimony or "other evidence to the fact that the petitioner and other stockholders, at the time of the formation of the corporation, did not intend to cause the corporation to redeem the Class B stock out of any available cash resulting from the loan in excess of the cost of the improvements."⁴² It then concluded that the petitioner had failed to overcome the Commissioner's presumption of correctness. The statement in the *Burge* case by the Fourth Circuit that it is sufficient that the view exist when the corporation is availed of must be read in the light of its peculiar facts where there was evidently no change in view from that during construction. The provision of the statute may exist merely to overcome the argument of a taxpayer who utilizes (avails himself of) an existing corporation instead of forming a new corporation.

III. SUBSTANTIAL PART OF INCOME

Section 341 also requires that the view must be to effecting a sale, exchange or distribution prior to the receipt of a substantial part of the taxable income to be derived from the property which has been constructed, manufactured, produced or purchased. Probably the most basic disagreement in this area is whether the words "prior to the realization of a substantial part" apply to the portion of the estimated taxable income which has been realized at the time of sale or to the portion of the taxable income which at that time remains unrealized.⁴³

³⁸ The *Burge* case is an oft cited case with quotations and yet the actual decision was merely the affirmation that the view was present at the time required by the statute. Other references to it should be accorded only the weight of dicta, but greater weight seems to be evidenced.

³⁹ 312 F.2d 729 (2d Cir. 1963).

⁴⁰ "The first requirement is that the corporation be formed or availed of principally for the *** construction *** of property." *Id.* at 733.

⁴¹ Raymond G. Burge, 28 T.C. 246 (1957).

⁴² *Id.* at 262.

⁴³ When this section came into law, The House Ways and Means Committee in H.R. REP. No. 2319, 81st Cong., 2d Sess. 96 (1950), indicated its purpose to be that of preventing an attempt to convert ordinary income into

Under the erroneous impression that the Tax Court had construed the statute to refer to the portion of income remaining unrealized at time of sale or exchange, the Third Circuit in *Abbott v. Commissioner*⁴⁴ applied this same harsh test. As so interpreted, the statute condemns as collapsible the corporation which has already realized a substantial part of the income derivable, if the portion of income not yet realized also bulks large enough to be considered as "substantial." In short, under the *Abbott* theory it is recognized that there may be two or more substantial parts, and if even one of them remains unrealized then the penalties of section 341 are called into play.

The Internal Revenue Service still contends that as long as there is a substantial portion of the taxable income unrealized, the corporation can be held collapsible. Assuming the Service to be correct in its approach, a corporation could receive seventy or eighty per cent of its taxable income to be derived from a project and still be held to be collapsible. The Service, though, reports that it will continue to follow the rule in the *Abbott* case.⁴⁵

However, the Tax Court⁴⁶ in no uncertain terms let the Third

long-term capital gain by use of a temporary corporation. The committee was closing the loophole where the corporation was liquidated prior to the realization by it of any income therefrom.

Compare § 1.341-5(d), Example 4, of the regulations covering a corporation producing and licensing motion pictures. The corporation had received 500,000 dollars from completed motion pictures between the date of material completion of the last picture and the date of sale. The fair market value of this last picture exceeded its cost by 50,000 dollars. The regulation states that since the amount of the unrealized income from the property is not substantial in relation to the amount of income realized, the corporation is not collapsible.

⁴⁴ 258 F.2d 537 (3d Cir. 1958). "The real question posed by the statute, however, is not whether a substantial part of the total profit was realized prior to dissolution, but rather, whether that part of the total profit realized after dissolution was substantial. This was the test correctly applied by the Tax Court in making its finding that the dissolution took place before a substantial part (nearly 90 per cent) of the total profit was realized." *Id.* at 542.

⁴⁵ Rev. Rul. 62-12, 1962-1 CUM. BULL. 321.

⁴⁶ James B. Kelley, 32 T.C. 135 (1959), *aff'd*, 293 F.2d 904 (5th Cir. 1961):

"With all due deference to the Court of Appeals for the Third Circuit, we were not aware that we made the finding and applied the test referred to in the above quotation. The matter being now squarely before us, it is our opinion that the question posed by the statute is, to quote the statute itself, whether there was "a view to—(i) the sale*** of stock by*** shareholders*** prior to the realization by the corporation*** constructing*** or purchasing the property of a substantial part of the net income

Circuit know that it had erroneously interpreted what the Tax Court had held in the *Abbott* decision and then proceeded to apply the test accepted by most legal commentators—that “substantial” refers to the portion of the income already realized at the time of the sale or exchange.⁴⁷

Had Congress intended that there must remain only an insubstantial part of the taxable income it, no doubt, would have required that “substantially all” of the taxable income to be derived from the property must have been received prior to the sale. All that Congress required was that to be collapsible a corporation must have just been “formed or availed of . . . with a view to—(A) the sale . . . before the realization . . . of a substantial part . . .” A literal interpretation of this part of the statute could mean that actual realization or non-realization of income has nothing to do with the determination of the collapsible status. The courts could hold, for example, that even though only three per cent of the taxable income had been received and all of the other factors were present except that time of receipt of income was never considered in the formation of the view to sale, the corporation was still not collapsible.

Actually, what the courts seemed to have been doing is looking at the actual receipt of taxable income and, though not alluding to the type of intent involved, considering that the expression of in-

to be derived from such property . . . Put more succinctly, it is our opinion that the question to be decided is whether the *realized* income is a substantial part of the net income to be derived from the property and not whether the *unrealized* income is a substantial part of such net income It is our further opinion that there may be two (or more) substantial parts of a whole, and therefore a finding that the unrealized part of such net income is substantial does not preclude a finding that the realized part of such net income is substantial.” *Id.* at 149-50.

⁴⁷ See *Heft v. Commissioner*, 294 F.2d 795 (5th Cir. 1961), where the argument was made that the corporation received, after the distribution, over fifty per cent of the income, and the court refused to accept it.

“Unfortunately for the petitioners, the statute focuses on the timing of the transactions: the corporation is collapsible, if the exchange of stock occurs ‘prior to the realization’; the corporation must realize a ‘substantial part of its net income’ *before* the stockholders sell or exchange their stock. The collapsibility of the corporation is determined, therefore, when the shareholders first sell or exchange stock in the corporation. Since the test is embodied in the definition of ‘collapsible corporation’ and the statute applies indiscriminately to any gain from the sale or exchange of stock in a collapsible corporation, if an initial liquidating distribution falls within the statute all subsequent distributions also come within the ambit of the statute irrespective of whether at the time of a later distribution the corporation has earned a substantial part of its income.” *Id.* at 798.

tent as evidenced by the receipt of income was such that if a substantial part of the taxable income had been realized prior to sale, there would be no collapsibility. It would, indeed, be difficult to hold that a corporation was collapsible after receipt of sixty per cent of its taxable income to be derived from constructed property on the ground that the view to sale was formed with the intent to sell prior to realization of the income, even though the intent was not carried out.

The statute specifically states that the consideration of income involves the "realization by the corporation" of the substantial part of the income.

What is the substantial part of income? The District Court for the northern district of Alabama has held 51.37 per cent of the estimated income to be a substantial part.⁴⁸ The Fifth Circuit has held 33⅓ per cent to be substantial⁴⁹ while 17 per cent is not.⁵⁰ The

⁴⁸ *Levenson v. United States*, 157 F. Supp. 244 (N.D. Ala. 1957). Of 3,495 trailers in the original contract, 1,795 had been sold and 1,700 remained when the stock was sold. Although the original basis of the court's decision that there was no collapsibility was that the executory contract was a capital asset, it stated a second ground, that more than fifty per cent of the net income already realized constituted a "substantial part." At the same time it suggested that Congress might amend the law to fix an arbitrary percentage.

⁴⁹ *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961), *affirming* 32 T.C. 135 (1959). The taxpayers had planned to obtain an FHA loan but failed, and also could not obtain private financing. After selling about one-third of the improved property, five of seven shareholders sold their stock to the corporation. A few months later, the taxpayers sold their stock in the corporation. Rejecting again the government's contention that "substantial" refers to the unrealized, not the realized, part of the net income, the court concluded that one-third of the net income constituted a substantial part. Judge Rives' dissent was not concerned with percentages. He agreed with the Commissioner that the unrealized part was that which was determinable.

In Rev. Rul. 62-12, 1962-1 CUM. BULL. 321, the Commissioner not only disagreed with the decision, he served notice that he would continue to adhere to the position that "substantial" refers to the unrealized income stating: "The Internal Revenue Service will not follow the decision of the United States Court of Appeals for the Fifth Circuit in *Commissioner v. James B. Kelley*...."

"The Service's position is that a corporation is collapsible under section 117(m)(2)(A) of the 1939 Code and section 341(b)(1)(A) of the Internal Revenue Code of 1954 if prior to the sale of the stock by the shareholders there remains a substantial part of the net income yet to be derived from the property.

"The Service contended in the *Kelley* case since a substantial amount (two-thirds) of the net income remained to be derived prior to the sale of stock, the corporation was collapsible. However, the court held that the phrase 'substantial part' appearing in section 117(m)(2)(A) of the 1939

Tax Court has found that 23 per cent is substantial⁶¹ while 10 per cent is not.⁶²

"Substantial," though, cannot be separated from its context—

Code, which defines a collapsible corporation, has reference to that part of the total anticipated net income to be derived from the property which had already been realized at the time of the stock sale, and since one-third of the income realized by the corporation prior to the sale of the stock is a substantial part of the total net income to be derived from the property, the corporation was not collapsible.

"Although review by the Supreme Court of the United States was not requested in the *Kelley* case, the decision will not be followed as a precedent in the disposition of similar cases, and the Internal Revenue Service position will be maintained pending further clarification of the issue." *Ibid.*

In the Tax Court, 32 T.C. at 154, Judge Oppen had dissented, with four judges joining him. He asserts that it is the "view" which governs and that basing decisions on actual receipt of income is an "open invitation to calculated schemes of avoidance," and further that section 341 now has a loophole of the size of two-thirds of the gain.

⁶⁰ *Heft v. Commissioner*, 294 F.2d 795 (5th Cir. 1961). This case was decided just after *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961), in the same circuit and indicated that no arbitrary percentage could be set. "In contrast to a fixed relative term, such as twenty per cent, expressing the same proportional relationship in every context, 'substantial' may indicate a certain proportion in one instance, a different proportion in another. To ascertain its meaning in any particular context one must examine the frame of reference and the purpose intended by use of the term." *Id.* at 797.

Further removing the "view" from the "realization of income," the court stated, "by its terms, however, it does not apply if the owners hold their stock until after a 'substantial' part of the corporation's income has been realized. This restriction enables taxpayers to continue to bring a considerable part of the corporation's ordinary income through the hole in the fence to the greener pasture of capital gains treatment." *Ibid.*

⁶¹ *E. J. Zongker*, 39 T.C. No. 107 (March 26, 1963). The Tax Court may in this case have given its first indication of a rule of thumb which it might apply absent special influencing factors. "No case is cited, and we find none, where more than 20 per cent of total net profits has been held insubstantial." *Id.* at 8. Whether or not it will use this dictum will remain to be seen. Peel, *Recent Collapsible Developments: Inadvertent Collapsibility*, N.Y.U. 20TH INST. ON FED. TAX 851 (1962), has a good discussion of "substantial." As a sidelight it could well be noted that in the *Zongker* case the facts showed approximately 34 per cent received prior to the sale but the Tax Court went further and assumed a different price so that only 23 per cent of the total income had been received prior to the sale.

⁶² *Max N. Tobias*, 40 T.C. 84 (1963). The taxpayer's corporation, Future, had realized 45,000 dollars in rentals when an option was exercised by Magnolia. Under the 10-year lease with Magnolia it would have realized 476,250 dollars in rentals. The court found that it was reasonable to expect that Future would have realized at least that amount from the real estate through rentals, and held that the amount of realized income at the time of the sale was not substantial so as to take the transaction outside the scope of section 341(b)(1)(A), comparing *Heft v. Commissioner*, 294 F.2d 795 (5th Cir. 1961), and *Rose Sidney*, 30 T.C. 1155 (1958), *aff'd*, 273 F.2d 928 (2d Cir. 1960).

a substantial *part* is what is to be considered. Necessarily involved is a determination of the total taxable income to be received from the property.⁵³ In the usual factual situation, especially those involving rental real property, the total income may be reasonably predictable, but other "taxable income" determinations will be very different. Instead, because of the ever-changing nature of our lives, a total pure income figure should be discounted, e.g., for the probability of population shifts, competition, technological improvements which make present property obsolete and key personnel losses.

IV. THE "AVAILED OF" AREA

There has been some difference of opinion on the grammatical structure of the collapsible corporation definition as to whether "principally" modifies "for the manufacture, construction or production of property" or whether it modifies "for the holding of stock in a corporation so formed or availed of."⁵⁴ Opposite views also exist as to whether "availed of" modifies "for the manufacture, construction or production of property" or whether it modifies "the

⁵³ The Tax Court in *James B. Kelley*, 32 T.C. 135 (1959), stated its position: "It is obvious that in many cases the amount of 'the whole of the net income which may be reasonably anticipated to be derived from such property' must be an approximation. In the instant cases the approximate can be close to the absolute amount since the property was liquidated within 3 years subsequent to the sale of the stock. However, there must still be some approximation since we are concerned not with gross receipts but with net profits. It would not, in our opinion, be within the legislative intent of the statute for 'the whole of the net income which may be reasonably anticipated to be derived from such property' to be measured by two different bases or two different accounting systems. Stated another way, it is our opinion that 'the whole of the net income which may be reasonably anticipated' must be approximated as of the date of the sale or exchange of the corporation's stock on the assumption that the cost basis and accounting method used by the corporation in measuring its net income from the property at that time will remain static." *Id.* at 151.

This clear statement should overcome, in that court at least, any objection by the Commissioner that in a specific case it is impossible to estimate the total income to be derived, and thus impossible to know what constitutes a "substantial" part. The approximation must be done in order for the statute itself to have meaning.

Rev. Rul. 56-50, 1956-1 CUM. BULL. 174 approves an equitable result in not taxing as ordinary income to the shareholders of a liquidating holding company the gain caused by the holding company's sale of its collapsible subsidiary where it reported its income under section 341.

⁵⁴ *Weil v. Commissioner*, 252 F.2d 805 (2d. Cir. 1958), should have settled the question, holding that it modifies "for the manufacture," for it was restated in the same circuit in *Mintz v. Commissioner*, 284 F.2d 554 (2d Cir. 1960).

sale or exchange of stock . . . or a distribution"⁵⁵ Looking first to "formed or availed of," we immediately are impressed that the breadth of this provision means that the corporation need not be newly-formed. An old corporation may be "availed of" for the purposes with the proscribed view, thus making capital gains taxable as ordinary income.⁵⁶ In *Farber v. Commissioner*,⁵⁷ decided in January, 1963, the Second Circuit found that "formed or availed of" modified the construction phrase and eliminated any further consideration of the position that a corporation could be formed or availed of for other than manufacture, construction, production or purchase. The court in *Farber* clearly established its position, stating that "we have no doubt that Eagle Mount was 'availed of principally for . . . construction,' in the light of the provision of § 117(m) (2) (B),"⁵⁸ after indicating that the first requirement of a collapsible corporation is that it be "formed or availed of principally for the . . . construction . . . of property."⁵⁹

Evidently one of the reasons that the *Burge* case of the Fourth Circuit has been cited so much is that it seemed to hold that "the availing" of the corporation need not be for manufacture, construction, production or purchase, but that it could be availing for sale. The court stated: "And the corporation was availed of here to dispose of all interests that the shareholders had in the project by sale or exchange of stock before it had realized any substantial part of the net income to be derived from the property."⁶⁰

If the Second Circuit is correct in *Farber*, the dictum in the *Burge* case must be an unwarranted extension of "availed of" to a subparagraph in section 341 dealing only with the kind of "view" the shareholders must have. However, if we ignore that there had been no "change of view" since completion of construction, we would be forced to say that the *Burge* case implies that "availed of" modifies "sale or exchange" rather than the construction phrase. If that is what the Fourth Circuit intended, it would in the opinion of this writer be wrong. If the Fourth Circuit's statement is that the cor-

⁵⁵ See *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958). The Commissioner continues to urge that "availed of" can modify "sale."

⁵⁶ H.R. REP. NO. 2319, 81st Cong., 2d Sess. 96 (1950).

⁵⁷ 312 F.2d 729 (2d Cir. 1963).

⁵⁸ *Id.* at 734.

⁵⁹ *Id.* at 733.

⁶⁰ *Burge v. Commissioner*, 253 F.2d 765, 769 (4th Cir. 1958).

poration was availed of (for construction in order) to dispose of a shareholder's interest by sale or exchange before a realization of substantial part of the taxable income, then the *Burge*-holding is correct. Any other interpretation of the *Burge* case places it in direct conflict with the Tax Court and the other Circuits⁶¹ which have released decisions since that date; and with the Regulations, which simply state that the view to sale or exchange must exist at some time during construction.⁶² For example, a corporation could be formed to build an office building with the idea of obtaining long-term tenants. The building could be completed on March 1, 1964, and national company tenants secured, all with twenty-year leases. After two years, the sole owner of the corporation (who also manages it) could become ill and remain sick for eight months, leaving the management to someone else. At that time, with doctor's advice that he would be permanently disabled and unable to run the building himself, and discovering that his interim building management was very poor, he could decide to sell. At most he would have received three-twentieths of the expected income from the building and perhaps the percentage would be even less than that since the building's life is considered longer. At this point he has made a decision to sell the corporation. He has decided to dispose of the corporation and the facts show that the part of the income received (three-twentieths) is probably not substantial. Under the supposed *Burge* theory, with the view to selling arising at the time of the "availing," it would be possible to have a collapsible corporation rather than a capital gains sale.

⁶¹ In *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959) the Tax Court was affirmed in its conclusion that the view was present at the time the corporations were organized. The Fifth Circuit placed *Burge* and *Glickman* (later called a dictum by the Second Circuit in *Braunstein*) together in overlooking part of the statutory language: "We think we need not go as far as the courts did in the two decided cases in construing the language 'availed of principally for the construction of property with a view to a distribution to shareholders.' The two opinions adopted the theory that if the intention and purpose of making a distribution to shareholders was formulated and followed by such actual distribution resulting in gain prior to the realization of a substantial part of the income from the property, then the corporation was 'availed of' for the 'proscribed purpose.' While not disagreeing with this construction of the statute, we recognize that it 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." *Id.* at 620.

⁶² Treas. Reg. § 1.341-2(a) (3) (1955).

Even the Tax Court in *Maxwell Temkin*⁶³ may have fallen into the trap of construing "availed of" as modifying something other than the construction phrase stating: "In the light of *Burge v. Commissioner* . . . and *Sidney v. Commissioner*, . . . it makes no difference whether it was so 'availed of' before or after construction of the apartment project was completed."⁶⁴ If "availed of" must modify the construction phrase, then it does make a difference and the *Burge* dictum is an improper interpretation of this complicated statutory section.

Removing "availed of" from its immediately surrounding terms of subsection (b) of section 341 would broaden the entire field of applicability of the section. This section originally enacted because of a "bad view" formed at the time of or during the manufacture, construction or production of property would now be extended to the beginning of a view to convert ordinary income into capital gains subsequent to the time of completion of construction. No sale of stock of a corporation and no liquidation of a corporation within three years after completion would be safe if the decision to sell were based on a consideration of the time of receipt of income. These extensions of the statute are improper and, in the opinion of the writer, the attempted extension of the section is in many factual situations overzealous action. It would be hoped that the normal business and investment transactions, absent such facts as were present in the *Burge* case, would not be attacked on the basis of the arising of a "bad view" only at the time of sale, thus considering the corporation as having been "availed of" for sale.

The entire history of the litigation under section 341 indicates an attempt on the part of the Internal Revenue Service to apply only objective standards where Congress clearly specified subjective considerations.

V. LIMITATIONS

Exclusive of subsection (e) which must be handled separately due to the fact it was introduced to the law in 1958 as an independent body of exceptions, there are other limitations on the applicability of section 341. When the statute was first passed by Congress, it was realized that there should be some predetermined

⁶³ 35 T.C. 906 (1961).

⁶⁴ *Id.* at 911.

limitations so that every business which had some appreciation and thus profit from property which had been manufactured, constructed or produced would not be hit with ordinary income. Three exceptions were placed into the statute originally in what is now section 341(d).

The first limitation was that a shareholder owning ten per cent or less of the company was excluded from the operation of the section. The ten per cent ownership test was amended and now is a "more than five per cent in value of the outstanding stock of the corporation" test.⁶⁵ The statute reads that the provisions shall not apply

unless, at any time after the commencement of the manufacture, construction or production of the property, or at the time of the purchase of the property described in subsection (b) (3) or at any time thereafter, such shareholder . . . owned (or was considered as owning) more than 5 percent in value of the outstanding stock of the corporation or . . . owned stock which was considered as owned at such time by another shareholder who then owned . . . more than five per cent . . .⁶⁶

The purpose, of course, of this exception is to "insure that the provision will only be applicable to a shareholder who by virtue of his stock ownership can be presumed to be an interested party to the project whether at the time of its organization or at some intermediate date."⁶⁷ Normally a shareholder owning five per cent or less will have little interest in and almost certainly no control over the policies of the corporation, and yet fixing an arbitrary percentage below which a shareholder will not be considered as owning shares in a collapsible corporation gives rise to claims that all above that are burdened with the attitudes of those who control the cor-

⁶⁵ INT. REV. CODE OF 1954, § 341(d)(1). Treas. Reg. § 1.341-4(b) (1955), states: "*Stock Ownership Rules.* (1) This section shall apply in the case of gain realized by a shareholder upon his stock in a collapsible corporation only if the shareholder, at any time after the actual commencement of the manufacture, construction, or production of the property, or at any time of the purchase of the property described in section 341(b)(3) or at any time thereafter, (i) owned, or was considered as owning, more than 5 percent in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned, or was considered as owning, more than 5 percent in value of the outstanding stock of the corporation."

⁶⁶ INT. REV. CODE OF 1954, § 341(d)(1).

⁶⁷ H.R. REP. No. 2319, 81st Cong., 2d Sess. 98 (1950).

poration. Indeed the Regulations so declare.⁶⁸ The committee reports give no reason for changing the ten per cent to five per cent, especially since special attribution rules are in effect. Thus, twenty individuals owning five per cent of the outstanding stock each and not under the attribution rules could construct property with the proscribed view fitting under all of the applicable rules of section 341 and still end up with capital gain because of the limitation. In fact, twelve individuals owning five per cent each could form a corporation to construct property having the proscribed view and sell. A forty per cent interest of one individual could then be held by one who entered the deal merely for investment purposes and with no proscribed view. The twelve individuals would receive capital gains treatment with the "clean" shareholder, *under the theory of the Regulations*, being saddled with the proscribed view of the majority stock and paying ordinary income tax.

A shareholder must also be careful if his ownership percentage is increased by the redemption by the corporation. The corporation's redemption of all the stock of a one per cent shareholder would make a former five per cent shareholder then own a percentage interest in the corporation greater than five per cent and his prior exclusion under this subsection could be lost with his gain taxable as ordinary income. The section specifically provides that "at any time" after the commencement of manufacture, construction or production if the shareholder owns more than five per cent, he does not come within the limitations.

The extension by the Regulations of the majority shareholder's "view" to a more-than-five per cent minority shareholder seems to be an erroneous extension of the statutory language. Congress did away with the small shareholder cases in fixing the five per cent limitation, but it did not say that for all minority shareholders who

⁶⁸ Treas. Reg. § 1.341-2(a)(2) (1955), provides: "This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated, unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view. Any gain of such a shareholder on his stock in the corporation shall be treated in the same manner as of a shareholder who did share in such view...."

owned over five per cent of the stock the provisions requiring the "view" were inapplicable. It raises the question of whether a corporation when formed or availed of for construction with a prescribed view by majority shareholders can be a collapsible corporation as to those shareholders and not be a collapsible corporation as to minority shareholders who held no "bad" view.

Congress has specifically set up rules for attribution of stock ownership, using section 544(a) in one instance⁶⁹ and section 267(c) in another,⁷⁰ but nowhere does Congress require attribution of a mental attitude from controlling shareholders to minority shareholders. In those cases where the question could have arisen, the courts found that the "view" was shared by all, thus eliminating the necessity of facing the attribution of view where no clear statutory authority therefor exists.

Section 341(d)(2) provides another exception to the application of the section.⁷¹ The statute does not apply unless more than seventy per cent of the gain on the sale or exchange of stock is attributable to "the property so manufactured, constructed, produced or purchased."⁷² Under this exception, the basic point for determination is the value of the property constructed or produced.

The gain must be attributable to the property "so" manufactured, constructed, produced or purchased. Thus, gain recognized during a taxable year with respect to the stock which is not attributable to *the* property, but is attributable to other assets of the corporation (for example, stock which has a low basis and a high market value) will remove the sale from section 341, if that other gain is thirty per cent or more of the total.

The Regulations provide: "Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the

⁶⁹ INT. REV. CODE OF 1954, § 341(d).

⁷⁰ INT. REV. CODE OF 1954, § 341(e)(8).

⁷¹ And Treas. Reg § 1.341-4(c) (1955), states when none of the gain is subject to this section: "*Seventy-percent rule.* (1) This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 341(b)(1). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section."

⁷² INT. REV. CODE OF 1954, § 341(d)(2).

other half."⁷³ Failure to appreciate this point of the Regulations could snare a taxpayer who otherwise figures that he has removed himself from the application of this section.

In the determination of fair market value of the total assets of a corporation for the purpose of determining the fifty per cent presumption,⁷⁴ stock in any other corporation is not taken into account. However, in looking at the limitations on the application of section 341 geared to seventy per cent of the gain, no such elimination is required. Thus, if all of the "bad" aspects are present prior to a sale of stock by a controlling eighty per cent stockholder, can that stockholder, by feeding into the corporation under section 351 some of his personal portfolio low-basis stock, thus have thirty-five per cent of the subsequent gain on the sale of the stock in the corporation attributable to other than property so manufactured, constructed, produced or purchased? If the controlling shareholder is willing to pay a capital gains tax on the additional thirty-five per cent of the gain in order to assure all of his gain on property constructed to be capital rather than ordinary income, he has stepped up his basis on his personal portfolio stock and perhaps saved considerable tax on the otherwise collapsible property.

But subparagraph (b)(2)(B) of section 341, by attributing to the corporation the manufacture, construction, production or purchase of property which it holds "having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced or purchased the property,"⁷⁵ attempts to prevent tax-free transfers to the corporation of property, which would, if produced, etc., by the corporation, fit

⁷³ Treas. Reg. § 1.341-4(c)(3) (1955).

⁷⁴ INT. REV. CODE OF 1954, § 341(c), not discussed in this article since the presumption is of little value to the Commissioner. The applicable Regulation under that subsection is Treas. Reg. § 1.341-3 (1955): "Presumptions.—(a) Unless shown to the contrary, a corporation shall be considered to be a collapsible corporation if at the time of the transactions described in § 1.341-1 the fair market value of the section 341 assets held by it constitutes 50 percent or more of the fair market value of its total assets and the fair market value of the section 341 assets is 120 percent or more of the adjusted basis of such assets. In determining the fair market value of the total assets, cash, obligations which are capital assets in the hands of the corporation, governmental obligations, and stock in any other corporation shall not be taken into consideration. The failure of a corporation to meet the requirements of this paragraph, shall not give rise to the presumption that the corporation was not a collapsible corporation."

⁷⁵ INT. REV. CODE OF 1954, § 341(b)(2)(B).

the collapsible definition, from removing the corporation from the application of the section. Indeed, Regulations section 1.341-2(a)(5) specifically illustrates a transfer under a section 351 tax-free incorporation of property constructed by an individual and declares the property to be constructed by the corporation.⁷⁶

This provision is clear enough except when we are discussing the *purchase* of property. The attribution of the individual's action is "For purposes of paragraph (1)," and paragraph (1) in its definition of collapsible corporation applies to the purchase only of property which is a section 341 asset. Thus, even though the purchase of property is attributed to the corporation, it is not property which is a section 341 asset if it is stock in another corporation, say of IBM or General Motors.

The seventy per cent rule applies only to property referred to in section 341(b)(1) (the definition paragraph) and does not include property purchased which is not a "section 341 asset." Although it might be urged that the term "property" in Section 341(b)(2)(B) applies to any property, after following the references, it seems clear that the term, when used with "purchased," must be limited to a section 341 asset.

The third limitation in subsection (d) is that section 341 does not apply to "gain realized after the expiration of 3 years following the completion of such manufacture, construction, production, or purchase."⁷⁸ The beauty of this exception is that the bad view can be present, there can be a formation or an availing of a corporation, there can be a sale prior to the realization of substantial income and,

⁷⁶ Treas. Reg. § 1.341-2(a)(5) (1955): "Under subdivision (ii) of this subparagraph, for example, if an individual were to transfer property constructed by him to a corporation in exchange for all of the capital stock of such corporation, and such transfer qualifies under section 351, then the corporation would be deemed to have constructed the property, since the basis of the property in the hands of the corporation would, under section 362 be determined by reference to the basis of the property in the hands of the individual."

In *Erwin Gerber*, 32 T.C. 1199 (1959), the taxpayer contended that the increase in the value of the land was more than 30 per cent separate from the apartment building; but the court found a lower land value and brought the total below the 30 per cent, and then declared that some part, undetermined in the case, of the land value increase was due to the apartment constructed. And *Paul Brande*, 35 T.C. 1158 (1961), failed in an attempt to prove some of the appreciation in value preceded transfer of the property into the corporation.

⁷⁷ INT. REV. CODE OF 1954, § 341(b)(2).

⁷⁸ INT. REV. CODE OF 1954, § 341(d)(3).

yet, so long as the sale takes place and the gain is realized three years after completion of construction, etc., the sale is removed from the applicability of this section. There have been a few cases which have involved the determination of when construction is complete,⁷⁹ the Internal Revenue Service naturally contending that construction is not complete until, in effect, the last blade of grass which was planted for the landscaping has grown to a height of two inches. This is, of course, absurd; and, yet, the Service has urged conclusions almost as erroneous in trying to extend the period of construction so that its completion will be within the three-year period prior to the sale of the stock.⁸⁰ Just as the Service would benefit from successful attempts to "commence construction" almost at the moment the idea of building is conceived in the mind of the taxpayer, so it will obtain more revenue if it extends the construction period to the latest possible date.^{80a}

VI. SUBSECTION (E)

In 1958, Congress became concerned about the terms of the existing law relating to collapsible corporations and the interpreta-

⁷⁹ *E.g.*, *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958). Ninety-nine per cent completion was insufficient where *all* the work on the contract was not complete. In Rev. Rul. 56-137, 1956-1 CUM. BULL. 178, the Commissioner held that a zoning petition granted in 1952, but litigated until 1954 by objectors, constituted construction and was completed on date zoning was declared final.

⁸⁰ In Rev. Rul. 63-114, 1963 INT. REV. BULL. No. 24, at 9, the Commissioner did concede that after all work required in the plans and specifications was completed and the building totally occupied, minor alterations and corrections which "did not increase the area available for rentals and did not change the character of the structure" and "did not appreciably increase the fair market value of the structure or the net income that could be realized from the building" did not constitute continuance of construction. This is hardly a concession since it implies that had a change enabled the taxpayer to charge one tenant a slightly higher rent by giving him more area for rental, it conceivably could have been construction.

^{80a} The Government's contention of early commencement of construction has included contracts with the city to have utilities installed, *Abbott v. Commissioner*, 258 F.2d 537 (3d Cir. 1958); retention of an architect paying 300 dollars on account, and applying to the city for water and sewer, *J. Farber*, 36 T.C. 1142 (1960), *aff'd*, 312 F.2d 729 (2d Cir. 1961); purchase of land, hiring of mortgage broker and architect and obtaining financial commitment, *Ellsworth J. Sterner*, 32 T.C. 1144 (1959); and rezoning along with hiring an architect, *Sproul Realty Co.*, 38 T.C. 844 (1962). *But see* *Vernon W. McPherson*, 21 T.C.M. 583 (1962), where preparation of preliminary plats and topographical surveys did not amount to construction.

tions which had been placed on that section by the courts, feeling that "they have exactly the opposite effect from that intended—instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordinary income."⁸¹ For that reason, and because of the difficulty of determining the subjective intent, Congress amended the law by adding subsection (e) to section 341. Some of the difficulty in creating an objective standard to replace one of subjective intent is evident by the length and detail of the four exceptions enacted in subsection (e). This exception subsection is four pages long, twice as long as the entire original section 341, and critical analyses of the subsection by many writers declare it to have absurd and inconsistent features, to be a maze of interrelated subparts and generally more complicated than the original section, itself called "a briar patch of subjective tests, indefinite standards, unresolved ambiguities, statutory presumptions and objective limitations."⁸² Five years have elapsed since the subsection was enacted on September 2, 1958, applicable to years beginning after December 31, 1957 (but only with respect to sales, exchanges and distributions after the date of enactment) and there is still not even a proposed regulation for subsection (e).

The Senate Finance Committee was particularly concerned with the determination of the subjective intent in all of the various situations in this area.⁸³ The Committee was explicit, when adopting objective tests to remove the necessity in many instances of determination of subjective intent and also to eliminate the impediments to legitimate business transactions, in its declarations that the enactment of these exceptions should not create any inference that the failure of a corporation with respect to any of its shareholders to meet these requirements in subsection (e) would in any way influence basic determination of collapsibility under the rest of section

⁸¹ S. REP. NO. 1983, 85th Cong., 2d Sess. 31 (1958).

⁸² Modrall, *Collapsible Corporations and Subsection (e)*, 37 TAXES 895, 948 (1959).

⁸³ S. REP. NO. 1983, 85th Cong., 2d Sess. 32 (1958): "Your committee believes that this amendment is desirable in order to avoid determinations of subjective intent in the situations described in this amendment and also to avoid the possibility in this area of the conversion of capital gain income into ordinary income. Furthermore, it is believed that this amendment will have the effect of removing some of the impediments that presently exist in the case of legitimate business transactions without permitting the tax avoidance which the collapsible corporation provisions are intended to prevent."

341.⁸⁴ It seems clear that the Committee attempted to list some of the instances in which the subjective determination would be removed but did not attempt to write an all-inclusive list.

The basic test which must be met to remove the corporation from the "collapsible" status under subsection (e) is that the net unrealized appreciation on the "ordinary income" assets of the corporation does not exceed fifteen per cent of the net worth of the corporation. What are "ordinary income" assets of a corporation? The Senate Finance Committee has clearly indicated that these are the assets of the corporation which, if sold at a gain, would result in the imposition of an ordinary income tax on the corporation.⁸⁵ Actually the unrealized appreciation on the ordinary income assets must be determined at the same time one of the four exceptions is applied.

There is a new term in subsection (e) which gears all determinations thereunder to "subsection (e) assets" rather than "section 341 assets." The determination of the figures which will not "exceed an amount equal to fifteen per cent of the net worth of the corporation" is different in the four exceptions. Injection of a new definition of assets makes the applicability of the subsection as to a particular asset of the company different from the application of section 341 as a whole. To see the difference we need to look at the new definition of subsection (e) assets and the established definition of section 341 assets.⁸⁶

⁸⁴ *Id.* at 34: "The amendments contained in section 22 to the collapsible corporation provisions are not for the purpose of causing any corporation to be regarded as a collapsible corporation. Your committee recognizes that there may be legitimate corporate enterprises that will be unable to meet the terms of the limited statutory exceptions contained in section 22. Your committee does not believe that any inference should be drawn from the failure of any corporation, or the failure of any corporation with respect to any of its shareholders, to meet the requirements for any or all of the new statutory exceptions to the application of the collapsible corporation provisions. Accordingly, it is expressly provided that in determining whether any corporation is a collapsible corporation within the meaning of section 341(b) of the 1954 Code, the fact that such corporation, or such corporation with respect to any of its shareholders, does not meet the requirements of any of the new rules shall not be taken into account, and such determination shall be made as if such rules had not been enacted."

⁸⁵ *Id.* at 33.

⁸⁶ INT. REV. CODE OF 1954, § 341(b)(3): "SECTION 341 ASSETS.—For purposes of this section, the term "section 341 assets" means property held for a period of less than 3 years which is—

(A) stock in trade of the corporation, or other property of a kind

Subsection (e) assets are defined generally as:

(1) Property which in whole or in part does not produce capital gain or loss on its sale;

(2) Property used in the trade or business where unrealized depreciation exceeds unrealized appreciation;

(3) Property used in the trade or business which, if it were held by a shareholder who owns more than twenty per cent of the stock of the corporation, would be property which would not produce capital gain or loss on its sale but only if unrealized appreciation on all such property exceeds unrealized depreciation;

(4) A copyright, literary, musical or artistic composition or similar property or any interest in such property, if the property was created by the personal efforts of a more than five per cent stockholder.

A subsection (e) asset may include a capital asset; section 341 assets may not include a capital asset. The definition of a subsection (e) asset as well as the exceptions add a new concept to prevent dealers from otherwise receiving the benefits intended for investors under the 1958 exceptions. A person who owns more than twenty per cent, after attribution, and who is a "dealer" in any class of property held by the corporation is thus the cause of adding all of that class of the corporation's assets to the "ordinary income" class even though, without the dealer as a shareholder, the property would be a capital asset and productive of capital gain or loss. The inequity of this situation is that the taxable status of one individual shareholder thus may cause the exception under subsection (e) to be inapplicable with the result that, no exception being available, the determination reverts to the general parts of section 341. For example, a dealer owning twenty-one per cent of a corporation may hurt the other seventy-nine per cent by having a certain class of asset

which would properly be included in the inventory of the corporation if on hand at the close of the taxable year;

(B) property held by the corporation primarily for sale to customers in the ordinary course of its trade or business;

(C) unrealized receivables or fees, except receivables from sales of property other than property described in this paragraph; or

(D) property described in section 1231(b) (without regard to any holding period therein provided), except such property which is or has been used in connection with the manufacture, construction, production, or sale of property described in subparagraphs (A) or (B)."

thus declared "ordinary income" rather than capital. This forces shareholders of corporations to know in detail all of the activities of all other shareholders of the corporation in order to be assured that they would fall within the exceptions of subsection 341(e).

Section 1231(b) property is a subsection (e) asset if the unrealized depreciation exceeds unrealized appreciation. And, if unrealized appreciation exceeds unrealized depreciation on all property used in the trade or business, section 1231(b) property would be included in the subsection (e) assets if it would be "ordinary income" property in the hands of a more than twenty per cent shareholder. There is neither rhyme nor reason for the difference in application when there is an unrealized depreciation as against an unrealized appreciation on property used in the trade or business. It is just one of those results of attempting to cover too much under a complicated exception rather than making a simple exception and leaving it up to the courts to interpret congressional intent as applied to the particular facts at issue.

The determination of whether or not property is to be an "ordinary income" asset is to be made "as if all property of the corporation had been sold or exchanged to one person in one transaction."⁸⁷ This provision is in line with another part of the subsection which gears the net worth definition to the day of sale or exchange. Whether applying this at the corporate level or at the shareholder level to determine the extent of "ordinary income," it must be as if *all property* were sold to *one* person in *one* transaction.⁸⁸

As stated earlier, the key to subsection (e) exceptions is that the net unrealized appreciation of certain defined assets must not exceed an amount equal to fifteen per cent of the net worth of the corporation. The evident purpose of the use of this specific, if arbitrary, fifteen per cent, rather than some other percentage, was to eliminate relatively small amounts of potential ordinary income from section 341, thus permitting a fifteen per cent loophole in the law in order to obtain, in the stated exception areas, an objective

⁸⁷ INT. REV. CODE OF 1954, § 341(e)(5)(A).

⁸⁸ *Ibid.* "The determination as to whether property of the corporation in the hands of the corporation is, or in the hands of a shareholder would be, property gain from the sale or exchange of which would under any provision in this chapter be considered in whole or in part as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) shall be made as if all property of the corporation had been sold or exchanged to one person in one transaction."

test. Thus, irrespective of who is and who is not a dealer, so long as the unrealized appreciation on the assets of the corporation (and other assets which figure into the formulae) does not exceed fifteen per cent of the net worth, every stockholder fitting into one of the exceptions is home free. Everybody is home free at the corporate level. Some tests still remain at the shareholder level.³⁹

³⁹ The test applicable to most situations is that involving sales or exchanges:

“(e) EXCEPTIONS TO APPLICATION OF SECTION.—

(1) SALES OR EXCHANGES OF STOCK.—For purposes of subsection (a)(1), a corporation shall not be considered to be a collapsible corporation with respect to any sale or exchange of stock of the corporation by a shareholder, if, at the time of such sale or exchange, the sum of—

(A) the net unrealized appreciation in subsection (e) assets of the corporation (as defined in paragraph (5)(A)), plus

(B) if the shareholder owns more than 5 percent in value of the outstanding stock of the corporation, the net unrealized appreciation in assets of the corporation (other than assets described in subparagraph (A)) which would be subsection (e) assets under clauses (i) and (iii) of paragraph (5)(A) if the shareholder owned more than 20 percent in value of such stock, plus

(C) if the shareholder owns more than 20 percent in value of the outstanding stock of the corporation and owns, or at any time during the preceding 3-year period owned, more than 20 percent in value of the outstanding stock of any other corporation more than 70 percent in value of the assets of which are, or were at any time during which such shareholder owned during such 3-year period more than 20 percent in value of the outstanding stock, assets similar or related in service or use to assets comprising more than 70 percent in value of the assets of the corporation, the net unrealized appreciation in assets of the corporation (other than assets described in subparagraph (A)) which would be subsection (e) assets under clauses (i) and (iii) of paragraph (5)(A) if the determination whether the property, in the hands of such shareholder, would be property gain from the sale or exchange of which would under any provision of this chapter be considered in whole or in part as gain from the sale or exchange or property which is neither a capital asset nor property described in section 1231(b), were made—

(i) by treating any sale or exchange by such shareholder of stock in such other corporation within the preceding 3-year period (but only if at the time of such sale or exchange the shareholder owned more than 20 percent in value of the outstanding stock in such other corporation) as a sale or exchange by such shareholder of his proportionate share of the assets of such other corporation, and

(ii) by treating any sale or exchange of property by such other corporation within such 3-year period (but only if at the time of such sale or exchange the shareholder owned more than 20 percent in value of the outstanding stock in such other corporation), gain or loss on which was not recognized to such other corporation under section 337(a), as a sale or exchange by such shareholder of his proportionate share of the property sold or exchanged,

does not exceed an amount equal to 15 percent of the net worth of the cor-

It is clear that if more than fifteen per cent of the net worth of the corporation is attributable to unrealized appreciation of subsection (e) assets, none of the exceptions are applicable and we revert to section 341 prior to the 1958 amendment for determination of the collapsible status of the corporation and the resulting taxability of a particular shareholder. The definition of net worth is a normal one, fair market value of assets at the close of a business day (assuming that there has been no distribution in complete liquidation) less the liabilities at the close of the day. However, the determination of "fair market value" will have to be arbitrary in each instance. The same article may have different fair market values for a manufacturing corporation, a wholesale jobber and the retail outlet. How is fair market value thus to be determined and, if there is one price for the sale of stock, how is that sales price allocated to the underlying assets? Is there good will in the sale of stock of a going business as well as unrealized appreciation on the assets? Is each asset appraised separately and then the total appraised asset value applied proportionately to the sales price of the stock? Is an analysis and allocation by the buyer after the sale binding on the seller of stock in determining whether the fifteen per cent test opens the way for one of the four exceptions? If there is established good will, then the appreciation attributable to the subsection (e) assets should be a smaller percentage of the total net worth.

"Fair market value," along with all of the other terms and incongruities of subsection (e), must await court interpretation. It may or may not follow standard definitions. The committee reports are helpful in explaining the operation of the section, but without regulations and without any court decisions on the subsection, only our best guesses are available.

An individual attempting to bring himself within subsection (e) prior to a sale would normally think about increasing the net worth of the company by contribution to capital or paid-in surplus. This would decrease the percentage of the total net worth attributable to

poration. This paragraph shall not apply to any sale or exchange of stock to the issuing corporation or, in the case of a shareholder who owns more than 20 per cent in value of the outstanding stock of the corporation, to any sale or exchange of stock by such shareholder to any person related to him (within the meaning of paragraph (8))." INT. REV. CODE OF 1954, § 341 (e)(1).

The other tests involve distributions in certain liquidation where sections 333 and 337 are applicable and are not discussed here.

the "ordinary income" assets. However, Congress anticipated this and closed such a loophole partially.⁹⁰ If the problem is thought of soon enough, the desired result can be accomplished since the subsection requires only increases in net worth during the one-year period prior to the sale date to be eliminated from consideration as to what constitutes net worth, and these contributions within the twelve-month period will be considered if it appears that there was a bona fide business purpose for the transaction in respect of which such amount was received.⁹¹ It is not clear why words "it appears" are in the law. The section should read "if there was not a bona fide business purpose for the transaction in respect of which such amount was received." Insertion of "it appears" could mean that, even though there was no bona fide business purpose, if it appeared that there was a bona fide business purpose, the increase in net worth should be considered. However, this surely was not the intent of Congress, to permit window-dressing to govern such a determination. The fixing of a stated period of one year is in keeping with the attempt of Congress to set up objective tests in subsection (e).

Shareholders who have made sizeable loans to corporations have considered the possibility of changing the loans to capital stock or paid-in surplus more than one year prior to any sale since the reference to the "one-year period" in the net worth subsection would normally indicate that increases in capital and surplus prior to that period would not be removed from the net worth computation.

Under subsection (e), corporate ownership of property is attributed to shareholders owning more than twenty per cent in value of the outstanding stock, thus affecting all of the shareholders, but

⁹⁰ INT. REV. CODE OF 1954, § 341(e)(7), defines net worth:

"For purposes of this subsection, the net worth of a corporation, as of any day, is the amount by which—

(A) (i) the fair market value of all its assets at the close of such day, plus

(ii) the amount of any distribution in complete liquidation made by it on or before such day, exceeds

(B) All its liabilities at the close of such day.

For purposes of this paragraph, the net worth of a corporation as of any day shall not take into account any increase in net worth during the one-year period ending on such day to the extent attributable to any amount received by it for stock, or as a contribution to capital or as paid-in surplus, if it appears that there was not a bona fide business purpose for the transaction in respect of which such amount was received."

⁹¹ *Ibid.*

the determination of what is ordinary income in the hands of the shareholder raises still further questions when you have a securities dealer or real estate dealer who also holds securities or property for investment as distinguished from sale to customers. If the dealer holds his stock of the corporation in his personal investment account (according to section 1236(a) of the Code), the stock or securities in the corporation under consideration should not be ordinary income assets since the property would not be an ordinary income asset in the hands of the more than twenty per cent stockholder. Thus, back of every determination as to whether or not a more than twenty per cent stockholder is a dealer lies a still further determination of how that dealer held this stock—whether in his personal investment portfolio or for sale to customers. The reason is that if a real estate dealer does not hold his stock in this corporation (in which there is appreciated real estate) for sale to his real estate customers, but as his own personal investment, there should be no dealer taint to deny the benefit of the exception to all of the shareholders, including the dealer himself. It becomes a question of adequate proof of the dealer's own attitude toward this specific investment. However, it can be expected that such proof will be demanded by the Internal Revenue Service if and when the question arises.

In the example at the beginning of this paper, if there had been four shareholders owning twenty-five per cent of the corporate stock each, one of them a real estate dealer, there would immediately have arisen the question of the asset being an ordinary income asset and treated so at the corporate level, thereby causing all shareholders to lose any possibility of capital gains. Whether or not the real estate dealer had an investment motive or intent would thus be of major importance to all shareholders, himself included.

An easy way to remember the "corporate-level" and "shareholder-level" tests is that the determination of what constitutes a "subsection (e) asset" is a determination made at the corporate level, and thus affects all shareholders. The definition in subparagraph (e)(5) provides for the character of property in the hands of a shareholder owning more than twenty per cent to become the corporate character also. When the section is applying a "shareholder-level" test, it refers to *the* shareholder. To the corporate-level determination of the net unrealized appreciation on a subsection (e) asset is added the result of the shareholder-level tests as to *the* particular

shareholder, and if the total sum is not more than fifteen per cent of the net worth of the corporation, the sale or exchange of stock will fall within the exception as to that shareholder. If there are no dealer-shareholders in the corporation, then the only determinations and computations are those of subparagraphs (i), (ii) and (iv) of Section 341(e)(5).

As to the shareholder owning more than twenty per cent in value of the outstanding stock of the corporation, we must look into the preceding three-year period and determine if he also owned more than twenty per cent of any other corporation. If he did, a determination of the character of the assets of such other corporation is required.

VII. BRAUNSTEIN

Mention has been made that the purpose of subsection (e) was to prevent section 341 from converting into ordinary income what would seem properly to be taxable only as capital gain. It now seems apparent that just such a harsh, and surely unintended, result does flow from the application of section 341 as it stood prior to the addition of subsection (e). If we return to our fictitious Mr. A, we will note that he might well have acquired the land and had built and sold the office building without incorporating; and, had he done so his gain would have been taxable only as a capital gain—with his holding period, which might readily have extended to six months or more, possibly being such as to allow him to pay only at the long term capital gains rates. To the layman, as well as to much of the bar, it would seem that section 341 should not penalize the use of the corporate form by inflicting an ordinary income tax on an otherwise capital gain transaction, and, until the decision of the United States Court of Appeals for the Second Circuit in *Braunstein v. Commissioner*,⁹² there was at least some good reason to hope that section 341 would be so interpreted as not to “throw out the baby with the bath.”

In the early case of *Honaker Drlg., Inc., v. Koehler*,⁹³ a corporation was formed to engage in the oil and gas drilling business, leases being transferred to the corporation at the outset. The original

⁹² 305 F.2d 949 (2d Cir. 1962), *aff'd*, 374 U.S. 65 (1963). See discussion, Malouf, *Braunstein affirmed, 341 Applies Despite Shareholder's Capital Gain Status*, 19 J. TAXATION 80 (1963).

⁹³ 190 F. Supp. 287 (D.C. Kan. 1960).

reason for the incorporation was for estate planning purposes, a recommendation of taxpayer's counsel. An unsolicited offer resulted in the sale of the properties for over a million dollars under a plan of complete liquidation. The Commissioner asserted a deficiency on the ground that the corporation was collapsible. The court held the corporation not collapsible because, first, there was no intent to liquidate before a substantial part of the income from the leases had been realized and, second, because the corporation had realized a substantial part of the income. The lack of "intent" was based on the reasoning that since the gain would have been capital gain had the individuals sold the properties, there was no need to utilize the corporate form.

Following the *Honaker Drlg.* decision came *United States v. Ivey*⁹⁴ in the Court of Appeals for the Fifth Circuit. The facts of *Ivey* will parallel many situations in ordinary business and investments. A corporation was formed by taxpayer and two other individuals, transferring to it a lot. Construction of an apartment building was commenced and, before completion, the taxpayer sold his stock for a 55,000 dollar profit, reporting it as capital gain. The court held section 341 not to be applicable where the shareholder's gain would have been taxable as a capital gain had he realized the gain directly rather than through the corporation. The court also noted that the taxpayer's profit attributable to construction within six months of sale would be ordinary income.

In *Ivey* the court in effect eliminated the "view" requirement where the gain would have been capital gain if the shareholder had sold the constructed property, remanding the case for determination as to whether the assets involved were property held primarily for sale to customers in the ordinary course of business and what portion, if any, was capital gain.

Ivey discussed the *Honaker* case, but did not mention that *Honaker* was decided on the basis that the proscribed view was absent. Instead, the Fifth Circuit pointed to *Honaker* as a case which decided squarely: "If capital gains to the individual on sale of property, then capital gains to the individual on sale of stock."⁹⁵

Following the *Ivey* case, the Second Circuit decided *Braunstein*

⁹⁴ 294 F.2d 799 (5th Cir. 1961).

⁹⁵ See *id.* at 800, 804.

v. Commissioner,⁹⁶ and in doing so expressly disagreed with the *Ivey* decision. The court discussed the earlier Fifth Circuit decision, but rejected the argument that, since gain on the sale of the property would have been taxable as capital gain had it been realized by the individual, it was capital gain when the corporate stock was sold. After concluding that the Tax Court's finding that the taxpayers had the requisite "view" was correct and that more than seventy per cent of the gain was attributable to the property constructed, the court reasoned that clearly the collapsible corporation is an "all-or-nothing" proposition on capital gains and that subsection (e) would have been unnecessary, if *Ivey* were correct, or else it overruled *Ivey*, clearly contrary to Congressional intent.

Ivey was an attempt at judicial legislation because of the inapplicability of the purpose to the facts in the case. In *Braunstein*, the Second Circuit refused to interpret section 341 in light of its purpose where it would require the courts to extensively rewrite clear statutory language.

With the conflict between the circuits, the Supreme Court granted certiorari⁹⁷ and on June 10, 1963, affirmed the Second Circuit decision. Since the grant of certiorari was limited to the question on which there was conflict, no broad opinion was expected and the final opinion was so limited, although the Court fell into the common trap of generalizing about other areas of the section. The only question decided 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 at 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.⁹⁸

The petitioner's arguments were rejected as "wholly inconsistent" with the plain meaning of the statute.

In its reasoning, the Court restates the definition of a collapsible corporation and then proceeds immediately to paraphrase and, in

⁹⁶ 305 F.2d 949 (2d Cir. 1962).

⁹⁷ *Braunstein v. Commissioner*, 371 U.S. 933 (1962).

⁹⁸ *Ibid.*

doing so, changes the concept somewhat. The opinion seems to limit, by dictum, the application of section 341 to cases where the view contemplates a sale or exchange of stock soon "after completion of construction."⁹⁹ If this is actually intended, a view to a sale or exchange *before* completion of construction would not fall within the purview of the statute. In fact, if we were to lend much credence to this dictum, the Supreme Court would have held section 341 inapplicable to *Ivey* since there the sale was before completion. It is submitted that this is not the intended result of the statute, that there is no statutory language so limiting the section. The Court has, in a case concerned with the plain meaning of statutory language, created new problems by a dictum not compatible with the statute.

Even though, as the Court states, there can be no question that the purpose of the collapsible corporation section was to close the loophole being used to convert ordinary income into capital gain, there was nothing to require a determination that there be a tax avoidance motive. Great stress is placed by the Court on the difficulties of looking behind each sale or exchange to make an additional determination of the tax status had each petitioner owned a share in the enterprise individually and not through the corporation. Congress chose the *method* by which it would close the loophole, failing to leave open in every case the question, "Has there been a conversion of ordinary income into capital gains?" With two examples of the ramifications of attempting to determine whether or not the individuals would have been entitled to capital gains absent the corporate structure, the Court concluded on the note that Congress did not intend for "the Commissioner and the courts to enter this thicket."¹⁰⁰

The *Braunstein* case was disappointing because of the limitation of the grant of certiorari. It could have furnished new guidance on three areas of section 341—the view, the seventy per cent rule and the area of its actual decision. But because the conflict in the Circuits involved only the latter area, we do not have the assistance of a Supreme Court pronouncement on when the view to sale must arise or on whether retained rental income becomes "gain attributable to the property."

⁹⁹ *Braunstein v. Commissioner*, 374 U.S. 65, 71 (1963).

¹⁰⁰ *Id.* at 73.

But, neither *Ivey* nor *Braunstein* seem to affect the theory of the *Honaker Drlg.* case. Neither was decided in the "view" area based on what the taxpayer's individual, as distinguished from corporate, status would have been. In *Honaker*, it was merely evidence to indicate the absence of the proscribed view and, as such, may still be law, since it has not been overruled. Certainly, the individual status should be emphasized in all such cases, although only as evidence as to "view"; but, in light of the *Braunstein* decision, no great reliance should be placed on the theory of *Honaker*. If another decision in this same area arises in the Fifth Circuit, a decision of that court that no proscribed "view" existed, in part because there was no need to utilize a corporation for capital gains results, would probably never be considered by the Supreme Court since the "conversion" is then merely some of the evidence considered in arriving at the taxpayer's "view." Since the Supreme Court has indicated the statute has a plain meaning in this area, strict construction of the language may be argued to prevent the section's wider application.

With the new 1958 exceptions, taxpayers should attempt to bring themselves within subsection (e). Taxpayers generally, though, are unaware of the existence of section 341 and, even though in some instances aware of it, probably fail to see any connection between that provision and their decision to sell.

The safest avenue for the taxpayer is that of waiting three years after completion or purchase before selling or exchanging stock. Any other route is fraught with danger and even that avenue involves a determination of when construction was completed. Surely, one may hope for an amendment to section 341 which will make it more readily understandable and less productive of litigation. Until that day there is little the practitioner can do but hope that meaningful and clarifying regulations will be proposed under subsection (e), and that the sale or redemption of stock by his client, in any corporation constructing, producing or manufacturing, will fall within some exception.