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William M. Goldstein

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## SECTION 341(d) AND (e) — A JOURNEY INTO NEVER-NEVER LAND

By WILLIAM M. GOLDSTEIN†

THIS ARTICLE is concerned with certain "relief" provisions. Such provisions do not, however, relieve either the lawyer's brain or the client's burden of legal and accounting fees, and they may not even provide very much tax relief.

Section 341, like its predecessor, was intended to counter a particular tax-avoidance technique. Essentially such technique involved: (a) the development (by construction, production or purchase) of a property brimming with ordinary income potential (a motion picture, stock of inventory, apartment house, shopping center, etc.); (b) the use of a corporation to accomplish such development; and (c) the "collapse", usually by stock sale or liquidation, of such corporation prior to realization of such ordinary income. If successful, the result was a single capital gains tax at the shareholder level rather than either, (1) ordinary income tax on the shareholders (if they had developed the project themselves) or (2) corporate income tax followed by a later capital gains tax on the shareholders (if a corporate "developer" had been employed but not collapsed).

To avoid missing any practitioners of the above technique, Congress spread its net quite widely. In so doing, it trapped a good many taxpayers whose activities did not evoke the legislation in question. Perhaps the best example of this is furnished by the recent decision in *Braunstein v. Commissioner*,<sup>1</sup> resolving a controversy among the lower courts.<sup>2</sup> The Supreme Court held that collapsible corporation treatment will obtain if the technical requirements of the statute are met despite

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† A.B., 1957, Princeton University; LL.B., 1960, Harvard University; member of Pennsylvania Bar.

1. 374 U.S. 65 (1963).

2. Compare *Ivey v. United States*, 303 F.2d 109 (5th Cir. 1962), with *Sproul Realty Co.*, 38 T.C. 844 (1962).

the fact that the shareholder in question would have realized a capital gain if he had developed the property himself.

When a statute is so broad-brushed, the limitations and exceptions contained therein assume great importance. This article will deal with sections 341(d)(2) and (3) and section 341(e), the provisions which contain the most important of such limitations and exceptions. Even without going into any detail on the crucial "dealer status" questions under section 341(e), it will be seen that the problems presented are many, varied and difficult. Furthermore, since it will be shown that the regulations under these provisions are either perverse or, more commonly, inadequate, and since rulings and cases are also conspicuous by their absence, this article must necessarily be a "think-piece".

## I.

### BACKGROUND

Before turning to sections 341(d) and (e) themselves, it seems advisable to list several reasons why one or the other of these provisions may so often be the only reliable avenue of relief for the tax planner:

1) The careful planner will be loath to base his case upon any of the following arguments under the section 341(b) definition of a collapsible corporation:

a) that the requisite view to "collapse" the corporation never existed;

b) that if it did exist, it only came into being after the completion of construction, production, etc.; or

c) that the "collapse" did not occur before the corporation realized a substantial part of the income from its property.

Argument (a) necessarily involves a subjective test in which the most convincing evidence of intent may be the fact of the collapse itself. Furthermore, section 341(c) creates a presumption of collapsibility which can hurt, but not help, the taxpayer. Argument (b) is only helpful, under the regulations<sup>3</sup> if the collapse is attributable solely to circumstances which arose after the development of the property, and the Second Circuit would reject this argument under any circumstances.<sup>4</sup> Argument (c) involves one of the most perplexing ambigu-

3. Treas. Reg. § 1.341-2(a)(3); see *Jacobson v. Commissioner*, 281 F.2d 703 (3d Cir. 1960).

4. See *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958).

ities in the entire Code — *i.e.*, whether the “substantial part” is the part already realized or the part yet to be realized. The courts have split on this question,<sup>5</sup> the meaning of “substantial” being an enigma in itself.

2) Contrary to the impression of many practitioners, there is no *general* three-year holding period rule which frees a corporation from collapsible status.<sup>6</sup> To be more specific, section 341(b)(1) defines a collapsible corporation as one which: “(i) manufactures, constructs, or produces property; (ii) purchases property described in section 341(b)(3); or (iii) holds stock in a corporation which engages in the aforementioned activities.”<sup>7</sup> Section 341(b)(3) includes in the definition of “section 341 assets” only property which is held for less than three years, and thus the mere *purchase* of property to be held for at least three years is not considered collapsible activity. But, because there is no similar reference to section 341(b)(3) with respect to the manufacture, construction or production of property, or the holding of stock in a corporation which engages in these activities, the practice of these functions will render a corporation subject to collapsible treatment regardless of the period for which such property is held.<sup>8</sup> Moreover, a corporation will be deemed to have manufactured, constructed or produced property if it engages in these activities “to any extent”,<sup>9</sup> and the Service and the courts hold that almost any action with respect to property amounts to “construction”.<sup>10</sup> Finally, the three-year escape clause which applies to purchased property will not be available if the

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5. Compare *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961), with *Abbott v. Commissioner*, 258 F.2d 537 (3rd Cir. 1958). See also Treas. Reg. § 1.341-5(c)(2); Rev. Rul. 62-12, 1962-1 CUM. BULL. 321.

6. The three-year rule of section 341(d)(3), to be discussed in detail below, does not so qualify. It merely limits the impact of collapsible status in those situations to which it applies and, as will also be seen below, the restrictions on its applicability are quite significant.

7. See Treas. Reg. § 1.341-2(a)(1).

8. See, *e.g.*, Mandell, *Twelve-Month Liquidations and Collapsibility of Real Estate Corporations*, N.Y.U. 21ST INST. ON FED. TAX 715, 719 (1963), where the author states:

Also, if the corporation constructed property, it is by definition a collapsible corporation, regardless of when the construction was completed.

It is arguable that the final sentence in section 341(b)(3) implies that, contrary to the punctuation in section 341(b)(1), the definition of a collapsible corporation includes only those corporations which manufacture, construct or produce “section 341 assets”. Such sentence states:

In determining whether the 3-year holding period specified in this paragraph has been satisfied, section 1223 shall apply, but no such period shall be deemed to begin before the completion of the manufacture, construction, production, or purchase. (Emphasis added.)

The better view, however — and the one espoused by the Service — is that the reference to manufacture, construction and production in the quoted sentence has significance only in identifying “section 341 assets” for purposes of the presumption in section 341(c).

9. INT. REV. CODE OF 1964, § 341(b)(2)(A).

10. See *e.g.*, Rev. Rul. 56-137, 1956-1 CUM. BULL. 178; J. Farber, 36 T.C. 1142 (1961); E. J. Sterner, 32 T.C. 1144 (1959).

basis of the property in question is determined by reference to the basis of the person who manufactured, constructed or produced it,<sup>11</sup> or by reference to the basis of other property manufactured, constructed or produced by the corporation itself.<sup>12</sup>

To illustrate the foregoing, a corporation created for the sole purpose of purchasing property, holding it for three years and then "collapsing" does not come within the definition of a collapsible corporation. On the other hand, a corporation which constructs the identical property will probably come within the definition no matter how long such property is held following the completion of construction if one-half or more of the income from such property is yet to be realized. Whether section 341(d)(3) would provide adequate relief in such a situation will be discussed below.

3) "One or the other" of subsections (d) and (e), or particular paragraphs within them, may be the sole avenue of relief because of certain statutory limitations on their availability. For example:

a) Subsection (d) is of no help to an otherwise collapsible corporation wishing to liquidate under section 337.<sup>13</sup>

b) Paragraph (d)(2) will be of no help to a collapsible corporation which has manufactured, constructed or produced property if reliance is placed on the fact that more than 30 per cent of the shareholder's gain is attributable to property held for more than three years.<sup>14</sup>

c) Paragraph (d)(3) only applies pro tanto, and may not apply at all to gain unrelated to the manufacture, construction, production or purchase of property.<sup>15</sup>

d) Subsection (e) does not apply to complete liquidations other than section 333 or 337 liquidations, nor to partial liquidations, redemptions or section 301(c)(3)(A) distributions.

4) New Section 341(f), which may in time create a "never-never land" of its own, is limited to stock sales, and its potential helpfulness depends upon the nature, position and intentions of the new and/or remaining shareholders. A discussion of the operation and utility of this third "relief" subsection is beyond the scope of this article.

11. INT. REV. CODE OF 1964, § 341(b)(2)(B).

12. INT. REV. CODE OF 1964, § 341(b)(2)(C).

13. See INT. REV. CODE OF 1964, § 337(c)(1)(A); Treas. Reg. § 1.337-1.

14. See p. 222 and note 19 *infra*.

15. See pp. 237-38 *infra*.

II.

A HYPOTHETICAL CASE

As an aid to understanding some of the problems posed by sections 341(d) and (e), we shall apply the statute and regulations to a hypothetical case. The facts are fairly simple, and hopefully not atypical. Although the property involved is real estate, most of the problems would exist regardless of the nature of the property.

Land Co. was incorporated ten years ago to engage in the business of real estate subdivision and residential construction. Its original shareholder, Mr. First, paid \$10,000 for 100 shares of \$100 par value common stock. Mr. Second became a shareholder 3 years later by buying 50 common shares from Mr. First for \$30,000. Four years ago, when the net worth of the corporation was \$200,000, a stock dividend of ten \$100 par value, 6 per cent preferred shares was declared and paid on each share of common, and Mr. First and Mr. Second each gave his \$50,000 of preferred stock to his wife.

Land Co. purchases land suitable for residential construction, subdivides and improves the land, builds houses and sells improved lots and houses. Land Co.'s wholly owned subsidiary, Apartment Co., will be described below. Land Co.'s fiscal year ends March 31, and as of April 1, 1965, its balance sheet read as follows:

LAND CO.

<i>Assets</i>		<i>Liabilities</i>	
Cash .....	\$ 60,000	Income Taxes Payable..	\$ 10,000
Project X <sup>1</sup> (Land & Improvements) .....	210,000	Bank Loan .....	50,000
Project Y <sup>2</sup> (Land & Improvements) .....	90,000	Mortgage Loans .....	150,000
Lot A <sup>3</sup> .....	100,000	<i>Net Worth</i>	
Equipment & Supplies <sup>4</sup> ..	30,000	Preferred Stock .....	100,000
Stock of Apartment Co...	10,000	Common Stock .....	10,000
	<hr/>	Retained Earnings .....	180,000
	\$500,000		<hr/>
			\$500,000

<sup>1</sup> Project X is a residential subdivision in which 70 per cent of the lots and houses have been sold. Houses in varying stages of completion stand upon the remaining 17 improved lots. It is estimated that the average net profit on each unsold house will be \$2,000.

<sup>2</sup> Project Y is a residential subdivision in which 20 per cent of the lots and houses have been sold. Mr. Jones has an option, expiring December 31, 1965, to purchase the remaining 40 improved lots for a total of \$180,000.

<sup>3</sup> Lot A, undeveloped land, was purchased one year ago. It is regarded as investment land by the corporation and may be worth as much as \$200,000 if certain zoning changes can be accomplished.

<sup>4</sup> The fair market value of the equipment and supplies is equal to its book value.

Apartment Co. was incorporated five years ago to construct and operate rental property. Its 100 shares of \$100 par common stock have at all times been owned by Land Co. Apartment Co. immediately embarked upon the construction of the Delux Apartments and completed the "Washington" unit in February, 1962. The "Jefferson" unit, located on an adjacent tract of land and having the same general building style, was commenced in 1963 and completed in June, 1964.

Apartment Co.'s fiscal year ends March 31, and as of April 1, 1965, its balance sheet read as follows:

APARTMENT CO.			
<i>Assets</i>		<i>Liabilities</i>	
Cash .....	\$ 55,000	Income Taxes Payable..	\$ 5,000
Washington Unit <sup>1</sup> (net of depreciation) .....	300,000	Mortgage Loans .....	700,000
Jefferson Unit <sup>1</sup> (net of depreciation) .....	400,000	<i>Net Worth</i>	
	\$755,000	Common Stock .....	10,000
		Retained Earnings .....	40,000
			\$755,000

<sup>1</sup> The double-declining balance method of depreciation is used for both book and tax purposes.

Messrs. First and Second have received an acceptable offer to buy the Delux Apartments. The purchaser is willing to buy either the buildings (\$1,200,000) or Apartment Co. stock (\$550,000). Messrs. First and Second wish to bring the resulting profit into their own hands at the cost of a single capital gains tax, and since the possibilities of a "spin-off" or partial liquidation have been considered and rejected, they are willing to liquidate Land Co. if this would further the attainment of their basic tax goal.

### III.

#### SECTION 341(d)(2)

One possible way to achieve the tax goal in the hypothetical case would be to liquidate Land Co. and have Messrs. First and Second sell their Apartment Co. stock to the buyer. If section 341(d)(2) applied to the shareholders' gain upon the liquidation, they would pay a single capital gains tax and would realize no further gain upon the shortly subsequent stock sale. Before attempting to apply the 70-30 test to the hypothetical, however, a general review of the perplexities of section 341(d)(2) will be presented; it will be seen that most of the problems considered have some bearing upon the instant case.

Section 341(d) provides that:

In the case of gain realized by a shareholder with respect to his stock in a collapsible corporation, this section shall not apply . . . (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. . . .

#### A. General Comments

The quoted provision is brief and, at first glance, seems quite liberal. In a general way it seems to allow a considerable profit from collapsible activity to escape the section 341 penalty if there is a lesser, yet substantial, profit traceable to accumulated earnings from, or unrealized appreciation on, noncollapsible property. Rephrasing the test, as many practitioners are wont to do, it would appear that the presence of 30 per cent "clean gain" in any year of "collapse" will shield the shareholder from ordinary income treatment. Appearances are deceiving, however, and, as will be seen below, it may even be misleading to rephrase the test in the above fashion.

The second general comment on section 341(d)(2) is to note its basic perversity; *i.e.*, it encourages the retention of earnings as opposed to the payment of dividends and may result in the permanent exemption of such retained earnings from ordinary income tax.<sup>16</sup> Example (2) in Regs. § 1.341-5(d) clearly illustrates this point since if X Corporation had retained the net gain on its first building (\$50,000 less taxes) rather than distributing it, its liquidation would surely have qualified under section 341(d)(2); *i.e.*, the entire gain attributable to the second building was only \$12,000. Although Example (4) in the same regulation appears to suggest, quite properly, that a good dividend-payment record is helpful in avoiding the section 341(b) definition of a collapsible corporation, the facts just related were held insufficient to protect the shareholder of X Corporation in Example (2). To curb this perversity, I would suggest, *at the minimum*, that past dividends of clean earnings be included, on a pro rata basis, in the gain deemed recognized for purposes of the section 341(d)(2) computation.<sup>17</sup> The

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16. See Axelrad, *Tax Advantages and Pitfalls in Collapsible Corporations and Partnerships*, 34 TAXES 841, 866-67 (1956). The accumulated earnings tax, of course, places some limit upon the accumulation technique, but its bar will often prove insubstantial. For example, any corporation could accumulate up to \$100,000 of clean earnings without a section 531 problem and thereby shield a gain of \$233,000 attributable to collapsible property.

17. Past dividends of earnings attributable to collapsible projects (*i.e.*, those not "substantially complete") should, arguably, also benefit the taxpayer under the 70-30 test since such profits have, by hypothesis, borne both the appropriate corporate tax and the dividend tax to the shareholder. The risk, however, might be that corporations could too easily enable their shareholders to qualify under section 341(d) by paying this type of dividend just prior to the stock sale or liquidation.



fact that these dividends might not have been taxed in the same high bracket as the top dollars under section 341(a) should make no difference.

### B. *Specific Problems — The Property*

1) What is the "property so manufactured, constructed, produced or purchased"?

A quick answer might be "section 341 assets" as defined in section 341(b)(3), but the application of basic rules of grammar indicates that this is not the case. The immediately antecedent reference to "property" is found in section 341(d)(1) which states: "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." The reference back to such property through the use of the word "so" indicates that Congress had reference to *all* qualifying manufactured, constructed or produced property as well as to qualifying purchased section 341 assets — *i.e.*, to all section 341(b)(1) property.<sup>18</sup> Treas. Reg. § 1.341-4(c)(1) confirms this conclusion by stating that collapsible corporation treatment will not obtain unless 70 percent of the shareholder's gain is attributable to "the property referred to in section 341(b)(1)."<sup>19</sup>

2) What manufactured, constructed, produced or purchased property is included in the term "section 341(b)(1) property"?

To begin with an exclusion, property purchased and held for three years without further collapsible activity is *not* section 341(b)(1) property.<sup>20</sup> As to all other property which has been the subject of collapsible activity, the basic test is whether it was viewed with the requisite collapsible intent. For purposes of section 341(d)(2), such intent will be presumed if a substantial part of the taxable income to be derived from the property in question remains unrealized at the time of the collapse.<sup>21</sup> True enough, this presumption is not universally accepted,<sup>22</sup> but since it is the government's view, it must be employed for planning purposes. Stock in other corporations which have engaged in collapsible activity will be deemed section 341(b)(1) property "only if the activity of the corporation in holding such stock . . . is substantial in relation to the other activities of the corporation."<sup>23</sup>

18. See pp. 217-18 *supra*.

19. One consequence of the foregoing is, of course, that gain attributable to constructed property will not be excluded from the numerator of the section 341(d)(2) fraction merely because construction was completed three years prior to the "collapse". See p. 218 *supra*.

20. See p. 217 *supra*.

21. See Treas. Reg. §§ 1.341-2(a)(4) and 5(c)(2).

22. See p. 216 *supra*.

23. Treas. Reg. § 1.341-5(b).

The presence or absence of the requisite view and the percentage of unrealized taxable income will often depend upon whether and how different properties are grouped. The next two questions relate to this important problem.

3) Under what circumstances are individual properties to be grouped together for purposes of determining whether they are section 341(b)(1) property?

Treas. Reg. § 1.341-2(a)(4) provides:

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.<sup>24</sup>

4) Can an asset usually regarded as one property — *i.e.*, land and a building constructed thereon — ever be separated for purposes of section 341(b)(1) property classification?

In stating the problem to be considered here, taxpayers usually concede that the property in question falls within section 341(b)(1) because of construction and the absence of realization. They argue, however, that the gain attributable to such property should nevertheless be excluded from the numerator of the section 341(d)(2) fraction to the extent that such gain is not traceable to collapsible activity. More specifically, they argue that gain attributable to appreciation in land value unrelated to the corporation's construction thereon should not count against them under section 341(d)(2).

The approach just described has some serious analytical defects. First, section 341(d)(2) speaks of the property, rather than the activity or cause, to which gain is attributable when describing the crucial percentage.<sup>25</sup> Second, the proponents of an "activity" or "source" test must contend with the fact that the purchase of the land may itself have been a collapsible activity. In the latter connection, it would seem that the three-year holding period exclusion for purchased property under section 341(b)(1) can apply only if the land is considered separately from the construction thereon.<sup>26</sup>

Before turning to the possibility of obtaining the benefit of unrelated land value appreciation by separating the "property" into land

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24. See also Treas. Reg. § 1.341-5(b).

25. See Axelrad, *supra* note 16, at 868.

26. See Donnelly, *Real Estate Developers Can Still Benefit From the Collapsible Idea*, 12 J. TAXATION 197 (1960).

and building, the relevant authorities should be reviewed. Treas. Reg. § 1.341-4(c)(3) provides:

Gain may be attributable to the property referred to in section 341(b)(1) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. 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 other half.

Proponents of the "source" or "activity" test claim that the quoted regulation does not bar their approach because it deals only with gain attributable to construction.<sup>27</sup> While this may be conceded, the regulation certainly does not furnish them any affirmative support.<sup>28</sup>

Surprisingly enough, in view of the fact that the problem under consideration is in the collapsible corporation area, there is some relevant case authority. Quite a few taxpayers have attempted to avoid the impact of section 341(d)(2) by arguing that 30 per cent or more of their gain was attributable to economic appreciation in land values wholly apart from development activities. At least one writer states that the courts "seem to be willing to go along with this general proposition" if the taxpayer can prove the alleged facts,<sup>29</sup> but this appraisal seems somewhat optimistic.

No taxpayer has actually succeeded with a "source" argument under section 341(d)(2).<sup>30</sup> Some have lost by reason of a failure of proof,<sup>31</sup> and others on the grounds that any appreciation in land value was attributable to construction thereon.<sup>32</sup> It is true that none of these cases rejected the argument now under consideration on the grounds that the fact of construction renders the separate consideration of unrelated appreciation impossible, but they vary widely as to the extent to which they encourage the proponents of such argument by negative

27. *Id.* at 198.

28. For the impact of this regulation on the analysis suggested in this paper, see p. 225 *infra*.

29. See Donnelly, *supra* note 26, at 198.

30. The very recent case of Wheeler, Kelly & Hagny Investment Co. v. U.S., 64-1 U.S. Tax Cas. ¶ 9260 (D. Kan. 1964), appears to constitute an exception to this general statement. Judge Templar charged, in part, that:

This issue is whether at least 30% of the total gain realized by plaintiff was due to general appreciation in market values of land unaffected by anything done to the land in question by Midland Industrial Properties, Inc. A special question on this matter will be given to you to answer.

The jury found that Midland did not satisfy the definition of a collapsible corporation and also answered the "special question" in the affirmative.

31. *E.g.*, Mintz v. Commissioner, 284 F.2d 554, 559-60 (2d Cir. 1960).

32. *E.g.*, Payne v. Commissioner, 268 F.2d 617, 621 (5th Cir. 1959); Elizabeth M. August, 30 T.C. 969, 983-87 (1958), *other issues aff'd*, 267 F.2d 829 (3d Cir. 1959).

implication.<sup>33</sup> Actually, the most helpful case in this connection may be a recent decision in which the court laid considerable stress upon the fact that the unrelated appreciation argument was *not* made.<sup>34</sup>

While, as we have seen, the courts have indicated some willingness to consider the source or reason for the gain even where the taxpayer concedes that such gain is derived from section 341(b)(1) property, it would seem more fruitful for the taxpayer to fit his argument within the language of section 341(d)(2) by contending that the land and building should be regarded as separate properties for this purpose. It is true that this type of "vertical" separation might seem somewhat contradictory to the type of "horizontal" integration required under the "project" approach of Treas. Reg. § 1.341-2(a)(4), quoted above, but Treas. Reg. § 1.341-4(c)(3), also quoted above, seems rather encouraging;<sup>35</sup> *i.e.*, the latter regulation seems simultaneously to permit the division of a single tract into two properties and to allocate the appreciation on one tract, which is attributable to the development of the other, to the latter for purposes of section 341(d)(2).

The preceding analysis of Treas. Reg. § 1.341-4(c)(3) is essentially the recommended approach; *i.e.*, where there has been appreciation in land value unrelated to construction, the land would be considered a separate section 341(b)(1) property and such gain would not be included in the numerator of the section 341(d)(2) fraction. Gain attributable to the building would, by analogy to Treas. Reg. § 1.341-4(c)(3), include appreciation in the land which was properly attributable to the construction of the building thereon. The difficult problem of separating the two elements of land appreciation would still remain, but if this could be accomplished, the desired result would be far easier to justify under the statute than would a similar result achieved via a source or activity test.<sup>36</sup>

### C. *Specific Problems — The Crucial Fraction.*

The statute clearly states that inquiry under section 341(d)(2) is to be directed to the ratio of gain attributable to section 341(b)(1) assets to each shareholder's annual gain; *i.e.*, unless such ratio is more

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33. Compare Erwin Gerber, 32 T.C. 1199 (1959), with Mintz v. Commissioner, *supra* note 31. See also W. H. Weaver, 25 T.C. 1067 (1956); Thomas Wilson, 25 T.C. 1058 (1956).

34. Farber v. Commissioner, 312 F.2d 729 (2d Cir. 1963). Mr. Farber's argument that more than 30 per cent of his gain was attributable to construction by the corporation after the deferred-payment sale of his stock proved unsuccessful.

35. But see Axelrad, *supra* note 16, at 868.

36. Problems related to the purchasing of land as a collapsible activity will also be easier to resolve under the suggested approach. Since the land is considered separately, the three-year rule may apply. Even more important, the taxpayer should be able to argue, with considerable force, that the requisite view was never held with respect to the purchased land if the gain thereon was solely attributable to a general appreciation in land values.

than 70 per cent, the shareholder's total gain will not be affected by section 341(a). While there can thus be little quarrel with stating the crucial fraction in terms of "dirty gain" over total gain, certain consequences of the government's manner of applying this principle can be most unfortunate. This last fact makes it most important that if one insists on rephrasing the fraction to emphasize 30 per cent "clean gain", care be taken to avoid changing the substantive result.

1) How is the denominator of the crucial fraction computed?

Each shareholder's denominator equals the gain recognized by him in a particular year with respect to his stock in the collapsible corporation. Thus, two 50 per cent shareholders will have different denominators upon a liquidation or sale for the same price if they have different bases for their stock. The important consequences of this fact will be demonstrated below.

2) How is the numerator of the crucial fraction computed?

We have previously seen that the general answer under the statute is the gain attributable to section 341(b)(1) property. But, how is the total of such gain to be allocated among the shareholders for purposes of determining their individual numerators? Treas. Reg. § 1.341-4(c)(2) provides:

For the purpose of this limitation, the gain attributable to the property referred to in section 341(b)(1) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased.

In applying this rule to a situation where the shareholders' bases are disproportionate to their stock interests, we obtain some surprising results. For example, assume that in the complete liquidation of a collapsible corporation, each of two 50 per cent shareholders receives \$30,000 in cash, representing "clean" earnings, and an undivided one-half interest in section 341(b)(1) property worth \$190,000. Assume further that the unrealized appreciation on the 341(b)(1) property equals \$140,000 and that the shareholders' respective bases on their stock are \$35,000 and \$15,000. The former's gain is \$90,000; the amount of gain he would have realized had the 341(b)(1) asset not been purchased, constructed, etc. is \$20,000 (*i.e.*, \$55,000 minus \$35,000); and the crucial fraction is 70,000/90,000. His entire gain would be taxed as ordinary income.

The other shareholder's gain is \$110,000; the amount to be subtracted therefrom to get the numerator is \$40,000; and the crucial

fraction is 70,000/110,000. No part of his gain would be taxed as ordinary income. This result, in the absence of special circumstances,<sup>37</sup> seems unjustifiable and unfair; it does, however, reflect the Service's present position on the application of section 341(d)(2).

The presence of gain on preferred stock provides another example of the peculiarities of the numerator rule of Treas. Reg. § 1.341-4(c)(2). Assume that a corporation whose sole shareholder has a basis of \$20,000 declares a dividend of \$100,000 par value preferred stock at a time when its net worth is \$200,000. Assume further that the shareholder gives such stock to his son (who would have a basis of \$10,000), and that the corporation is subsequently liquidated at a time when its net worth equals \$310,000. If \$140,000 of the total gain of \$290,000 would have been realized if the distributed section 341(b)(1) property had never been acquired, the Service would hold that the father's fraction is 150,000/200,000, and that he accordingly has ordinary income of \$200,000; *i.e.*, the government's position is that if the section 341(b)(1) property had not been acquired, the son would still have received \$100,000 under his liquidation preference and the father only \$60,000 for his common stock.

Different results would be reached in the foregoing examples under a rule which prorates the "dirty gain" in proportion to the shareholders' total gain. In the first example, the \$140,000 of "dirty gain" would be allocated 45 per cent to the former shareholder and 55 per cent to the latter with the result that both would realize capital gain. In the second example, 9/29 of the "dirty gain" would be allocated to the son, again with the result that both shareholders would realize capital gain. It would seem that this is the fairer rule, at least where the "view" of all the shareholders is the same.<sup>38</sup> Furthermore, it should be noted that this rule will not always favor the taxpayer; *e.g.*, in the first example, if another \$1,000 of gain were dirty rather than clean, *both* shareholders would have ordinary income under the suggested approach rather than only one under Treas. Reg. § 1.341-4(c)(2).<sup>39</sup>

37. If the second shareholder acquired his stock after a substantial portion of the clean earnings had been realized (which might explain his higher basis), and if the section 341(b)(1) property in question had not yet been acquired, it might not be so unfair to deny him, in effect, some of the benefit of the clean earnings. This might be particularly true if he initiated the subsequent collapsible project.

38. See note 37 *supra*.

39. The suggested approach would be more readily arrived at if one were permitted to allocate clean rather than dirty gain, *i.e.*, the tendency would be to give some to each shareholder (preferred and common) most likely in proportion to his percentage of the total gain. Such approach is not sanctioned by the regulations, however, and that is why it is dangerous to rephrase the 70-30 test. In the case cited in note 30, however, the court did rephrase the test and the report does not indicate whether the corporation had preferred stock or whether the shareholders' bases were disproportionate.

3) Is the numerator affected by the fact that each of the corporation's assets may not be proportionately divided in a liquidating or section 301(c)(3)(A) distribution?

There is no clear answer to the question whether a disproportionate distribution of clean property to one shareholder, offset by a larger distribution of section 341(b)(1) property to another, affects either's section 341(d)(2) fraction. *E.g.*, would the former shareholder's position in the first example, *supra*, be improved if he in fact got \$60,000 in cash and a 65/190 interest in the section 341(b)(1) property? The answer seems to be no — *i.e.*, that the proportion of gain attributable to dirty assets depends solely upon the percentage of stock owned.<sup>40</sup> This rule seems justifiable on the grounds that liquidations should not produce different results than sales of stock merely because the shareholders can control the allocation of the distributed property,<sup>41</sup> but it may conflict with the results achievable by making distributions in more than one year.<sup>42</sup>

4) Are realized earnings from collapsible projects included in the numerator?

Treas. Reg. § 1.341-4(c)(4) makes it clear that the answer is yes. In the example there given, the sole shareholder's gain is composed of the following elements: \$100,000 of accumulated earnings (after taxes) from a completed project; \$340,000 of unrealized appreciation on a collapsible project; and \$60,000 of accumulated earn-

40. Where a complete liquidation is *not* involved, Treas. Reg. § 1.341-4(c)(2) requires a pro rata attribution of dirty gain regardless of the assets actually distributed — at least where such treatment favors the government. Such regulation provides:

In the case of gain on a distribution in partial liquidation or a distribution described in section 301(c)(3)(A), the gain attributable to the property *shall not be less than* an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation. (Emphasis added.)

The proper treatment of disproportionate distributions in *redemptions* which do not constitute partial liquidations is not clear. First of all, section 341(a)(2) does not apply to such redemptions because such section speaks only of exchange treatment "under this part" — *i.e.*, Part II ("Corporate Liquidations") rather than Part I ("Distributions by Corporations"). See Treas. Reg. §§ 1.341-1 and 4(c)(2), quoted *supra*.

It has been argued that section 341(a)(1) is also inapplicable to redemptions because Treas. Reg. § 1.341-1 speaks of "actual" sales and exchanges, but in *Short v. Commissioner*, 302 F.2d 120 (4th Cir. 1962), section 341(a) was held applicable to a redemption of stock out of the proceeds of an FHA mortgage. The gain realized was found to be wholly attributable to the construction of the mortgaged property despite the shareholders' contention that a favorable purchase price for the redeemed stock was the real cause of their gain. The court thus not only applied section 341(a) to a redemption, but also looked to the source of the sales proceeds — an analysis more in keeping with a partial liquidation than a sale.

41. It will be seen that acceptance of the corporation's allocation would permit both shareholders in the example given at p. 226 to achieve ratios of 70 per cent — *i.e.*, if the former shareholder was given \$37,000 in cash.

42. See Donnelly, *supra* note 26, at 198, and p. 231 *infra*.

ings (after taxes) from the latter project. The regulation holds that section 341(d)(2) does not benefit the taxpayer because his percentage is 80 per cent; *i.e.*, the earnings on the collapsible project are grouped with the unrealized appreciation for this purpose. It will be seen that the result is to tax the entire gain of \$500,000 as ordinary income despite the fact that 32 per cent thereof is attributable to *after tax* earnings.

5) Where dividends have been paid, how can you tell if the remaining accumulated earnings are attributable to section 341(b)(1) property or not?

This problem is not present in the example in Treas. Reg. § 1.341-4(c)(4) since no dividends were paid. In Example (2) in Treas. Reg. § 1.341-5(d),<sup>43</sup> all the earnings from the first project were distributed before the second project was commenced, and there were no realized earnings from the latter. The regulations thus offer no guidance to this perplexing problem.<sup>44</sup>

Where the time sequence is such that dividends must have been paid out of the earnings from a particular project, they should be allocated accordingly. Where this is not possible, however, it has been suggested that a FIFO approach be used or, alternatively, that the corporate directors be permitted to designate the project which gave rise to the distributed earnings.<sup>45</sup> It can be seen that the former suggestion would usually operate to the taxpayer's detriment while the latter might be too favorable.<sup>46</sup> In any event, there exists an enigma which could involve a great many tax dollars in a particular case.<sup>47</sup>

6) How does the grouping of corporate assets affect the computation of the numerator?

We have already considered the proper grouping of assets for purposes of determining whether they are section 341(b)(1) property. Such grouping may be extremely important where the character of a

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43. See p. 221 *supra*.

44. Many other perplexing unresolved problems can readily be suggested where accumulated earnings or appreciation on non-collapsible assets are involved. If earnings from a dirty project are invested in stock which appreciates in value, should such appreciation be attributed to such project? On the other hand, should clean earnings be increased for purposes of applying Regs. § 1.341-4(c)(2) on the theory that if a collapsible project had not been commenced, it would not have been necessary to pay expenses related thereto? See Axelrad, *Recent Developments in Collapsible Corporations*, 36 TAXES 893, 904 (1958). He too finds we are in "never-never land."

45. See Axelrad, *supra* note 16, at 867.

46. Compare the suggested treatment of past dividends at p. 221 and note 17 *supra*.

47. A somewhat similar puzzle could develop with respect to the problem considered under question C.3, *supra*. *I.e.*, if, in a corporate liquidation, a disproportionate distribution of cash representing accumulated earnings may affect the 341(d)(2) numerator, how can you tell if the excess cash received by one shareholder is attributable to a clean or dirty project?



particular group is to depend solely upon the "substantial realization" test. The Service early took the position, in letter rulings, that 50 per cent would be considered "substantial" for this purpose.<sup>48</sup> While there is no published authority to this effect, we may assume the existence of such a rule for purposes of analysis.<sup>49</sup> If the corporation has realized \$20,000 out of a potential \$40,000 on one homebuilding project and has realized no part of a potential gain of \$60,000 on a similar project, the result under section 341(d)(2) will depend upon whether the projects are to be treated as a unit.<sup>50</sup> Projects located on the same tract or adjacent tracts may be difficult to separate, although the Service has indicated it will look to the original building plan of such projects as multi-unit apartment developments.

7) Where a particular shareholder purchases his stock after collapsible activity has occurred, what is the gain he would have realized in the absence of such activity?

Axelrad provides us with a beautiful example of the chaos that can result under Treas. Reg. § 1.341-4(c)(2) in this situation. He writes:<sup>51</sup>

Let us assume a simple case. *A* incorporates Corporation *X*, paying in \$500,000 for 5,000 shares of its stock. Corporation *X* produces a motion picture, which has a value of \$1,100,000. Now *B* buys from Corporation *X* 5,000 of its shares for, say, \$1,000,000 in cash.

If Corporation *X* earns \$60,000 through investment of its cash, and then dissolves, *A* gets \$530,000 cash and a half interest (worth \$550,000) in the picture. He has a gain of \$580,000. *B* gets \$530,000 cash and a half interest in the picture. He has a gain of \$80,000.

Common sense would tell us that not less than \$30,000 of *B*'s \$80,000 gain is 'attributable' to the investment income; and that the great bulk of *A*'s gain is 'attributable' to the picture. But had the picture not been produced, the corporation would have had \$1,560,000 in cash (\$500,000 from *A* and \$1,000,000 from *B* and the \$60,000 earnings). Each would have received \$780,000 — *A* having a gain of \$280,000 and *B* a loss of \$220,000.

The excess of *A*'s actual gain over what he would have had is \$300,000. The excess of *B*'s actual gain (\$80,000) over what he would have had (a loss of \$220,000) is \$300,000.

48. See Axelrad, *supra* note 16, at 859-60.

49. Cf. Mandell, *supra* note 8, at 738.

50. Assuming \$6,000 in corporate income taxes, the crucial fraction of a sole shareholder would be either 60/94 or 94/94.

51. Axelrad, *supra* note 44, at 904-05.

Shall we then say that only \$300,000 of *A*'s \$580,000 gain is attributable to the picture, so that (d) (2) exempts him from the impact of the statute, while all of *B*'s \$80,000 gain is attributable to the picture, so that he must pay ordinary income tax?

This is patently absurd; yet it literally applies the test of the regulations. Wherein lies the fallacy?

Shall we enter the realm of speculation and say that if the picture had not been made, *B* would not have paid \$1,000,000 for his stock? This is clearly true, but now we are building hypothesis on hypothesis to determine the tax.

Shall we close the books each time a new shareholder appears, and determine what portion of the 'gain' accrues after that date? And what shall we do with the 'gain' resulting from his making a favorable purchase?

If so, it is submitted that most of the 'gain,' in all but the simplest cases, will usually disappear in accountant's fees.

On this subject we have no assistance from statute, regulations or rulings. All is speculation. The subject is suggested here because it affords such an excellent example of an apparently clear and simple statement in the statute that is utterly impossible to apply to any but the very simplest situation. The draftsman apparently had in mind the one-asset corporation and used language that could be applied to it but, at the same time, extended the coverage of the statute to much more complex situations in which attempts to apply the statutory language can lead only to bafflement and bewilderment.

#### D. *Specific Problems — Timing*

Section 341(d) (2) applies "to the gain recognized during a taxable year"; since a year-by-year analysis is clearly directed by the statute, the question arises whether the crucial percentage can be affected by distributing particular assets in different years. Most writers seem to think so. One suggests that an advantage may be achieved by adopting a plan of liquidation and immediately distributing such assets as land which has appreciated in value for reasons unrelated to any collapsible activity. Subsequent distributions, in later years, might then also receive capital gain treatment by reason of substantial realization during the intervening period or the operation of section 341(d) (3).<sup>52</sup> Another writer suggests a disadvantage of the annual approach if clean earnings are distributed the first year and section 341(b) (1) property which gave rise to less than 70 per cent of the total gain is distributed in later years.<sup>53</sup>

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52. Donnelly, *supra* note 26, at 198.

53. Axelrad, *supra* note 16, at 868-69.

The principal alternative to the strict annual approach is to presume that each liquidating distribution is a pro tanto distribution of all assets regardless of the property actually distributed. Thus if one-half of the corporation's sole current project, together with all clean earnings, is distributed in year one and such earnings represent 40 per cent of the total gain in that year, section 341(d)(2) would not benefit the taxpayer; *i.e.*, assuming a zero basis, the remaining unrealized appreciation on the other one-half of the project would raise the crucial ratio to 75 per cent.<sup>54</sup> This approach is certainly more consistent with not basing determinations upon the particular assets which are actually distributed to particular shareholders in a complete liquidation during one year,<sup>55</sup> and it is also in partial accord with the treatment of partial liquidations and section 301(c)(3)(A) distributions under Treas. Reg. § 1.341-4(c)(2).<sup>56</sup> But, such a proportional approach is hard to support under the statute, and it might prove impractical if the fraction cannot be computed until the liquidation is complete.

#### E. *The Hypothetical*

It is time to apply the foregoing analysis to the liquidation of Land Co. It is apparent that the Apartment Co. stock is section 341(b)(1) property,<sup>57</sup> and that it must be distributed promptly to comply with the prospective purchaser's wishes. Accordingly, in order to improve the shareholders' section 341(d)(2) fractions in the calendar year of such distribution, all clean assets should be distributed prior to December 31, 1965, and all projects should be "cleaned-up" (sub-

54. *I.e.*, in the first year it would be presumed that 5/8 of the clean earnings and 5/8 of the unfinished project were distributed. Since the total gain attributable to the incomplete project is three times larger than the clean earnings, the crucial fraction would equal  $1 - [(.625 \times .4)]$ , or 75 per cent.

55. See pp. 228-29 *supra*.

56. See note 40 *supra*.

57. Treas. Reg. § 1.341-5(b) provides:

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 is holding stock in such other corporations is substantial in relation to the other activities of the corporation.

The quoted language should be compared with the committee reports on the predecessor of section 341 which indicated that holding companies would be deemed collapsible only if they had no business other than to separate the shareholders from the corporation undertaking the project. See H.R. Rep. No. 2319, 81st Cong., 2d Sess. 97 (1950). For other illustrations of the inaccuracy and inadequacy of section 341 as applied to holding companies see Axelrad, *supra* note 16, at 858-59; Axelrad, *supra* note 44, at 903.

Despite the foregoing, it seems clear that the Service would regard the holding of the Apartment Co. stock as a "substantial" activity within the meaning of the quoted regulation. Furthermore, we do not here have to resolve the problem of whether the corporate veil of Apartment Co. should be pierced and its assets allocated for purposes of section 341(d)(2); *i.e.*, because *all* of its assets are 341(b)(1) property. See Axelrad, *supra* note 44, at 903.

stantially completed) before that date. Because of uncertainty as to what constitutes substantial completion, it is assumed that all of Projects X and Y will be sold; because the sale of Lot A will produce additional "clean" earnings, it also will be sold. It is further assumed that the following results will obtain upon the corporation's liquidation of its properties.

1) All the houses in Project X will be sold at a total net profit of \$34,000.

2) Since the corporation would prefer not to wait to see if Mr. Jones will exercise his option with respect to Project Y, it will sell the improved land, subject to the option, for \$140,000, net of all expenses.

3) Lot A will be sold for \$150,000 and an \$8,000 brokerage commission paid. The net gain of \$42,000 will be reported as a capital gain.

4) The Apartment Co. stock will be sold immediately after its distribution for \$550,000.

Assuming that expenses, interest, secretarial fees, ad valorem taxes and professional fees will total \$21,000 and that no salaries will be paid to First and Second, Land Co. will have taxable income of \$105,000 and pay taxes of \$35,000.<sup>58</sup> Assuming that no preferred dividend is paid or payable prior to liquidation,<sup>59</sup> the value of the total distribution will equal \$900,000.<sup>60</sup> Each shareholder's gain (denominator) would be as follows:

- 1) Mrs. First:  $\$50,000 - \$5,000 = \$45,000$ .
- 2) Mrs. Second:  $\$50,000 - \$15,000 = \$35,000$ .
- 3) Mr. First:  $\$400,000 - \$5,000 = \$395,000$ .
- 4) Mr. Second:  $\$400,000 - \$15,000 = \$385,000$ .

The crucial fractions would be as follows:

- 1) Mrs. First:  $0/45,000 = 0\%$
- 2) Mrs. Second:  $0/35,000 = 0\%$
- 3) Mr. First:  $270,000/395,000 = 68.35\%$
- 4) Mr. Second:  $270,000/385,000 = 70.13\%$

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58. For ease of computation, a 50 per cent maximum corporate income tax rate is assumed throughout this article.

59. Payment of a preferred dividend would, of course, reduce the clean earnings available for distribution. Even if a cumulative preferred dividend was passed rather than paid, the effect would be the same; *i.e.*, the preferred shareholders would receive \$106 per share upon the liquidation all of which, in effect, would be from clean earnings. See p. 227 *supra*. If a cumulative preferred dividend was certain to fall due prior to liquidation, it might be advisable to have the subsidiary pay a dividend in like amount, reduce the selling price of the subsidiary's stock, and earmark these funds for the preferred dividend. See p. 229 *supra*.

60. *I.e.*, \$290,000 beginning net worth, plus \$70,000 in earnings and profits for 1965, plus \$540,000 in appreciation on Apartment Co. stock.

It appears that, if all assumptions proved precisely correct, three shareholders would realize capital gain but Mr. Second would have ordinary income.<sup>61</sup> While it is true that slightly more income in 1964 or a small saving in expense would reduce Mr. Second's ratio below 70 per cent, it is equally true that an overestimation of net earnings would imperil Mr. First. For example, if no net gain were realized upon the sale of Lot A, Mr. First's ratio would rise to 71.19 per cent.

Because reliance on section 341(d)(2) would be risky at best, and because even a slight surprise could result in the two common shareholders receiving a maximum of \$395,000 and \$385,000 of ordinary income all in one year,<sup>62</sup> other solutions should be considered.

#### IV.

##### SECTION 341(d)(3)

Even if section 341(d)(2) would not apply to one or more of the shareholders upon the complete liquidation discussed above, section 341(d)(3) may give partial relief. It provides:

In the case of gain realized by a shareholder with respect to his stock in a collapsible corporation, this section shall not apply— . . . (3) to gain realized after the expiration of 3 years following the completion of such manufacture, construction, production, or purchase.

##### A. *General Comments*

The regulations under section 341(d)(3) are so brief that they may be quoted in full:

(d) *Three year rule.* This section shall not apply to that portion of the gain of a shareholder that is realized more than three years after the actual completion of the manufacture, construction, production, or purchase of the property to which such portion is attributable. 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 determina-

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61. Note that neither Mrs. First's nor Mrs. Second's gain from the same liquidation may be lumped with her husband's even if they file a joint return. Section 341(d)(2) applies to each taxpayer's gain.

62. The partial relief afforded by section 341(d)(3) will be considered in the immediately following pages.

tion shall be made by reference to the aggregate of the properties constituting the single project.<sup>63</sup>

There can be no doubt that we are finally dealing with a provision where a three-year holding period is beneficial regardless of whether the property in question was purchased, manufactured or constructed. The regulations also make it quite clear that section 341(d)(3) applies pro tanto,<sup>64</sup> and imply that one should look through the corporate shell of a subsidiary to the assets actually constructed, manufactured, etc.<sup>65</sup> Several important questions remain, however.

### B. *Specific Problems*

#### 1) When is collapsible activity "actually completed"?

It was seen above that the Service and courts have considered almost any activity with respect to property to be "construction";<sup>66</sup> problems relating to the termination of collapsible activity are thus most acute in this area. For example, in Revenue Ruling 56-137,<sup>67</sup> the Service ruled that the prosecution of a rezoning petition which took over two years to complete constituted an integral step in the construction of a shopping center and that, if no construction activity subsequently occurred, the three-year periods in sections 341(b)(3) and (d)(3) would commence to run on the day following the date the rezoning became final.<sup>68</sup>

Revenue Ruling 63-114, which represents the latest word on the completion question, gives some reason to hope for a more liberal attitude in the future. The facts were recited as follows:

The *M* corporation was organized in 1957 and shortly thereafter, it began the construction of a multi-story office building. The total cost of erecting the building, including the cost of making all installations required by the original tenants, was 9,000 dollars. These expenditures were incurred prior to December 31, 1958, and all construction described in the plans and specifications was completed by that date. The building constituted *M* corporation's principal asset and was totally leased and occupied by December 31, 1958.

63. Axelrad, *supra* note 44, at 905-06, applauds this regulation for resolving the ambiguity which would otherwise exist if a corporation owns two section 341(b)(1) properties, two and four years old. But, he notes that by requiring the shareholder to calculate "portions," many of the difficulties under section 341(d)(2) are carried over into section 341(d)(3). Some of these will be discussed below.

64. This is true despite certain indications in the legislative history of this limitation that it was to be given effect only if three years had passed since the last collapsible activity with respect to *all* section 341(b)(1) property. See H.R. Rep. No. 2319, 81st Cong., 2d Sess. 99 (1950).

65. Cf. Axelrad, *supra* note 16, at 858.

66. See p. 217 *supra*.

67. 1956-1 CUM. BULL. 178.

68. See also *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958); *Weil v. Commissioner*, 252 F.2d 805 (2d Cir. 1958). *But cf.* *Maxwell Temkin*, 35 T.C. 906 (1961).

After the last tenant had secured occupancy, the corporation expended during 1959, 1960, and 1961, the sums of 30x, 40x, and 45x dollars, respectively, in making minor alterations and corrections in the existing structure. The minor alterations and corrections included a change in the decor of the interior of the building, the removal of an obstruction for the convenience of the tenants (which removal did not increase the capacity of the area available for rental), and the installation of additional rest room facilities. Further alterations were made in order to make an office suitable for a new tenant's use and occupancy. As a result of the alterations and corrections, there was no change in the character of the structure in any respect. Moreover, there was no appreciable change in the fair market value of the building.<sup>69</sup>

After stating that whether particular activities constitute "construction" is a question of fact which must be resolved on the basis of all relevant circumstances, the Ruling held that "the minor alterations and corrections here involved will not be considered 'construction' within the meaning of section 341." In so holding, it emphasized the following circumstances:

In the instant situation, the alterations did not increase the area available for rentals and did not change the character of the structure. Moreover, the alterations did not appreciably increase the fair market value of the structure or the net income that could be realized from the building.<sup>70</sup>

Despite the favorable conclusion that the section 341(d)(3) period commenced on December 31, 1958, the negative implications of the last two quoted sentences should be borne in mind.

2) What is the significance of the grouping of assets under section 341(d)(3)?

Under the project approach of Treas. Reg. § 1.341-2(a)(4),<sup>71</sup> the three-year period of section 341(d)(3) would not commence to run until the integrated project is completed. Many difficult problems will arise; for example, consider a corporation whose principal asset is a community antenna television system. Where the basic system has been complete for more than three years, will more recently built "spurs" bar relief under (d)(3)? Even in the instant hypothetical, can the Washington and Jefferson units be separately considered for purpose of the three-year test?<sup>72</sup>

3) Can the holding period of a prior constructor, manufacturer or purchaser be "tacked" for purposes of section 341(d)(3)?

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69. Rev. Rul. 63-114, 1963-1 CUM. BULL. 74.

70. *Ibid.*

71. See p. 222 *supra*.

72. See p. 230 *supra*.

Paragraph (b) (3) of section 341, quoted in note 8 *supra*, provides that, for purposes of *such paragraph*, section 1223 shall apply. Although commentators accordingly expressed doubt as to whether the holding period rules of such section apply to paragraph (d)(3) — which contains no similar cross-reference<sup>73</sup> — the Service had no difficulty in reaching an affirmative conclusion. In Revenue Ruling 57-491,<sup>74</sup> it held that a corporation incorporated in 1956 which had received assets from a partnership in a section 351 transaction was not collapsible by reason of section 341(d)(3) where the last collapsible activity by either the corporation or partnership occurred in 1952.<sup>75</sup> By way of reasoning, the ruling simply refers to paragraph (b)(3) and concludes that “on the basis of the foregoing” tacking is permitted under (d)(3).<sup>76</sup>

4) How does section 341(d)(3) apply to gain attributable to accumulated earnings and noncollapsible property?

Gain attributable to accumulated earnings derived from collapsible property whose manufacture, etc. was completed more than three years before qualifies for the benefits of section 341(d)(3).<sup>77</sup> On the other hand, gain attributable to earnings derived from section 341(b)(1) property of insufficient age does not benefit from such limitation. Earnings attributable to noncollapsible property are treated like other noncollapsible assets. See below.

If a corporation's only section 341(b)(1) property is more than three years old, the entire gain upon a sale or liquidation, including that attributable to noncollapsible property, is exempt from section 341(a) by reason of section 341(d)(3).<sup>78</sup> If the only section 341(b)(1) property, per contra, is less than three years old, the example in Treas.

73. See Axelrad, *supra* note 16, at 857.

74. 1957-2 CUM. BULL. 232.

75. Although section 341(d)(3) may be applied on a pro tanto basis (see p. 235 *supra*), its applicability to *all* of a corporation's assets may be important if a section 333 liquidation is involved. Unlike section 337, which does not apply to collapsible corporations “as defined in section 341(b),” section 333 applies to corporations “other than a corporation to which section 341(a) applies.” Since section 341(a) does not apply if subsection (d) does, paragraph (d)(3), as well as (d)(2), may be helpful in qualifying a liquidation for section 333 treatment. Rev. Rul. 57-491 and 63-114, *supra* note 56, have so held.

76. 1957-2 CUM. BULL. 233.

77. Just which accumulated earnings are attributable to which property where dividends have been paid, etc., is, of course, a perplexing problem. Axelrad suggests that gain realized on reinvested earnings, mortgage proceeds or the depreciation reserve of three-year old property could logically be attributed to it. Axelrad, *supra* note 44, at 906.

78. Although the language of section 341(d)(3) seems to require this result because the *only relevant* manufacture, etc., was completed more than 3 years before the “collapse,” this conclusion has been certain only since the second sentence was added to Treas. Reg. § 1.341-4(d) *supra*, by amendment dated June 15, 1964. Previously, even in the case where *all* collapsible property was fully “seasoned,” such regulation could have been interpreted to mean that the benefit of section 341(d)(3) is limited to the “portion” of the total gain attributable to the 3-year old collapsible assets — unless, perhaps, gain attributable to noncollapsible assets independently qualified for exemption thereunder.



Reg. § 1.341(c)(4) indicates that section 341(d)(3) is of no help with respect to gain attributable to noncollapsible property; *i.e.*, in the example, the shareholder was held to realize only ordinary income despite the fact that \$100,000 of his gain was attributable to after-tax earnings from a clean project.<sup>79</sup>

Where a corporation owns section 341(b)(1) properties which are both more and less than three years old, there are no rules as to the proper treatment under section 341(d)(3) of gain attributable to noncollapsible property. While the first sentence in Treas. Reg. § 1.341-4(d) arguably suggests that the applicability of such section might turn upon whether the noncollapsible property itself was purchased three years before or constituted earnings derived from manufacture, etc. three years before. This approach would seem to conflict with the above-described treatment of situations where all section 341(b)(1) property is on the same side of the three-year line;<sup>80</sup> *i.e.*, in those situations, the treatment of gain attributable to noncollapsible property follows that of the gain derived from collapsible property.

5) Can "realization" of gain upon a stock sale be delayed for purposes of section 341(d)(3) by various deferred-payment techniques?

The most obvious technique — electing installment-sale treatment under section 453 — has been held ineffective for this purpose in Revenue Ruling 60-68.<sup>81</sup> The Service stated that section 453 does not postpone the date of realization of income but serves merely to postpone the taxation thereof.<sup>82</sup> It held that determinations as to the *character* of gain under section 341(a) are to be made as if the sale in question were wholly for cash. If ordinary income results, it may, however, be reported in accordance with the installment method.

Another technique is suggested by Robert J. McDonald, who writes:

If the obligations of the vendee at the time of the sale are a mere contract to pay and the cash and market values of other property received are less than the vendor's basis for the property

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79. In the example, the clean project was completed less than three years before collapse, and it is thus arguable that section 341(d)(3) would have applied if the accumulated earnings were appropriately "seasoned." Such an approach would, however, conflict with the rule, suggested by the amendment to Treas. Reg. § 1.341-4(d) that where all collapsible property is on the same side of the 3-year line, the treatment of gain attributable to noncollapsible property should follow that derived from collapsible property. Furthermore, this approach would lend credence to the suggestion of the first sentence in Treas. Reg. § 1.341-4(d) that "portions" of gain may be attributable to the manufacture or purchase of property other than section 341(b)(1) property.

80. Despite the theoretical objections expressed to this last-suggested approach, it will be seen below that it may be the only way to derive some benefit from section 341(d)(3) in certain situations. See p. 240 *infra*.

81. 1960-2 CUM. BULL. 151.

82. Citing *In re Rogers' Estate*, 143 F.2d 695, 696-97 (2d Cir. 1944), *cert. denied*, 323 U.S. 780 (1944).

sold, gain is not realized until such time as the total of the collections on the vendee's obligations exceed the vendor's basis for the property sold.<sup>83</sup> Such gain should be outside the scope of the 'collapsible' provision if the collections occur more than three years following completion of production or purchase. The seller's position should be stronger if the payments are indeterminate and subject to contingencies, rather than fixed and dependent only upon the buyer's solvency.<sup>84</sup>

These possibilities should not be overlooked in planning particular transactions.

### C. *The Hypothetical*

The extent to which Messrs. First and Second could benefit from section 341(d)(3) upon the liquidation of Land Co. is highly conjectural. Since (d)(3) follows (d)(2) and refers to "such manufacture, construction, production or purchase", it is reasonable to assume that it means the manufacture, etc. of the same section 341(b)(1) property which gave rise to more than 70 per cent of the shareholder's gain under the preceding clause. Such an assumption makes sense because unless (d)(2) were inapplicable by reason of such gain from such property, there would be no need to consider (d)(3). It also makes sense because, without such an assumption, we would again be faced with *all* the problems relating to the allocation of particular elements of gain among the various shareholders.<sup>85</sup> It should be remembered, however, that the regulations offer no guidance on this question.

Since the prognosis under section 341(d)(2) indicates that only Mr. Second would remain subject to section 341(a), let us consider his situation under section 341(d)(3). Of his total gain of \$385,000, \$270,000 would be deemed attributable to Apartment Co. stock and \$115,000 to earnings from various completed projects. As to the first element, since we are assuming that it is proper to look through the corporate shell of Apartment Co.,<sup>86</sup> the application of section 341(d)(3) will depend upon whether the Washington unit of the Delux Apartments may be considered a separate section 341(b)(1) property. If so, the portion of the \$270,000 properly attributable to such unit would be capital gain.

As to the remaining \$115,000, uncharted confusion confronts us once again. While such sum is comprised solely of earnings from com-

83. See, *e.g.*, Rev. Rul. 58-402, 1958-2 CUM. BULL. 15; *cf.* *Burnet v. Logan*, 283 U.S. 404 (1931).

84. CORPORATIONS AND CORPORATE DISTRIBUTIONS 126 (P.L.I. 1962).

85. See pp. 226-32 *supra*, dealing with the composition of each shareholder's numerator under section 341(d)(2). That some of these problems remain in any event will be seen below.

86. See p. 235 *supra*.

pleted projects engaged in by Land Co. over ten years, a total of \$350,000 of such earnings would be distributed to the four shareholders in the liquidation. On the assumption that Apartment Co. has paid no dividends, no part of such \$350,000 would be in any way attributable to the only relevant section 341(b)(1) property — *i.e.*, the Washington and Jefferson units. For this reason, the age of such “property” does not provide a very sound basis for allocating the gain attributable to unrelated earnings.<sup>87</sup>

Rather than concede that *all* the accumulated earnings lead to ordinary income, we might adopt the approach suggested by the first sentence in Treas. Reg. § 1.341-4(d) and recommend that Mr. Second claim capital gain with respect to that portion of the accumulated earnings which is attributable to Land Co. projects that were in fact completed more than three years before liquidation. But, in view of the fact that such corporation has paid dividends on its preferred stock, how could we tell how much of the \$350,000 represents such retained earnings? Moreover, even if this could be done, how would we compute the portion of such portion received by Mr. Second? We saw above that, for purposes of section 341(d)(2), clean gain is, in effect, first allocated to preferred shareholders and then applied against the total basis of the common shareholders before it benefits a particular common shareholder;<sup>88</sup> there is no such rule, nor indeed any rule, for similarly allocating (d)(3) gain. Presumably, Mr. Second would be advised to use some sort of proportional approach and hope for the best.<sup>89</sup>

#### D. *Planning under Sections 341(d)(2) and (3)*

There can be no doubt that these provisions and the regulations thereunder are riddled with doubts and inequities. The example in Treas. Reg. § 1.341-4(c)(4) is a prime illustration in that the sole shareholder realized \$500,000 of ordinary income despite the fact that \$160,000 of his gain was attributable to corporate earnings which had already been subjected to income tax. If the facts are right and the steps well timed, however, section 341(d) may still prove a valuable planning tool.

For example, assume that a sole shareholder has a zero basis for his stock in a corporation with the following assets: Project *Q* worth \$60,000 (one year old); Project *R* worth \$50,000 (two years old); \$10,000 of earnings from Project *Q* and \$30,000 of clean earnings

87. If, of course, the construction of the *entire* Delux Apartments was completed more than three years prior to liquidation, Mr. Second's *entire* gain would be capital. Treas. Reg. § 1.341-4(d).

88. See Treas. Reg. § 1.341-4(c)(2) and p. 227 *supra*.

89. It will be seen that a very slight change in the figures will raise all these perplexing problems for Mr. First as well as Mr. Second.

(unrelated to any collapsible project but only one year old). An immediate complete liquidation would result in \$150,000 of ordinary income. But, if Project *Q* and all the cash are distributed in one year, section 341(d)(2) will apply to the gain; and if the distribution of Project *R* in the subsequent year is delayed until three years after collapsible activity ceased, section 341(d)(3) will complete the realization of capital gain. Many more examples could, of course, be given.<sup>90</sup>

## V.

## SECTION 341(e)

Since we have just seen that neither section 341(d)(2) nor (d)(3) is likely to afford either certain or complete relief from ordinary income tax in the hypothetical, it is advisable to consider the potential benefits from section 341(e) which was added to the Code in 1958. The method of capitalizing on section 341(e) would be to adopt a plan of liquidation under section 337, sell all of Land Co.'s assets,<sup>91</sup> and complete the liquidation within 12 months of the adoption of the plan. This technique has at least two potential advantages over the section 331 liquidation considered above: (1) non-inventory assets (*e.g.*, Lot *A*), as well as inventory (if sold to one person in one transaction), could be sold tax-free after the adoption of the plan; (2) failure to qualify for section 337 treatment via section 341(e)(4) will result only in two capital gains taxes on the gain attributable to Apartment Co. stock, one at the corporate level and one on the shareholders,<sup>92</sup> rather than ordinary income tax on the shareholders as would obtain if a section 331 liquidation failed to qualify under section 341(d)(2).<sup>93</sup>

90. See, *e.g.*, Axelrad, *supra* note 16, at 869.

91. If the prospective purchaser of the Delux Apartments insists on buying assets rather than Apartment Co. stock, some new problems may arise. Apartment Co. could, of course, be liquidated under section 332 and its assets sold pursuant to the section 337 plan, but there would be some danger that the apartments would be considered to be inventory in the hands of Land Co. — *i.e.*, because they were never used in its trade or business. *Cf.* Acro Mfg. Co., 39 T.C. 377 (1962), *aff'd*, 64-2 U.S. Tax Cas. ¶ 9604 (6th Cir. 1964). *But see* section 341(b)(2)(B) which may suggest that property acquired in tax-free transactions retains all of its tax attributes.

It will be observed that a section 337 liquidation of Apartment Co. is not the answer since section 337(c)(2)(A) renders such section inapplicable to liquidation of controlled subsidiaries. On the other hand, a change in the character of the apartments lacks significance under a plan based on sections 331 and 341(d)(2). *I.e.*, if the purchaser of the apartments wants assets, Apartment Co. can be liquidated immediately after its stock is distributed by Land Co., and the arguable status of the apartments as inventory will not matter because no gain will be realized on their sale.

92. See Rev. Rul. 58-241, 1958-1 CUM. BULL. 179. The reason, of course, is that once a corporation has made a taxable sale of all of its assets, it has realized sufficient income to be no longer collapsible at the time of the liquidating distribution.

93. It will be seen below, however, that even if section 341(e)(4) does apply to bar taxation at the corporate level, certain shareholders may realize ordinary income by reason of section 341(e)(2).

It would be physically impossible to deal with all the absurdities and complexities of section 341(e) in this paper, particularly if an effort were made to cover in detail questions pertaining to dealership status and the various stock attribution rules prescribed by such section. Other authors have striven manfully to accomplish this task and their work is recommended for leisure-time reading.<sup>94</sup> For present purposes, it should suffice merely to review the myriad of problems presented by the application of section 341(e) to a section 337 liquidation in the relatively simple hypothetical outlined above.<sup>95</sup>

#### A. Section 341(e)(4)

Since we have assumed, for safety's sake, that Land Co. would be covered by the section 341(b)(1) definition of a collapsible corporation, section 337 will apply to make the Apartment Co. stock sale tax-free only if section 341(e)(4) is satisfied. Such section provides:

(4) GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS. — For purposes of section 337, a corporation shall not be considered to be a collapsible corporation with respect to any sale or exchange by it of property within the 12-month period beginning on the date of the adoption of a plan of complete liquidation, if—

(A) at all times after the adoption of such plan, the net unrealized appreciation in subsection (e) assets of the corporation (as defined in paragraph (5)(A)) does not exceed an amount equal to 15 percent of the net worth of the corporation,

(B) within the 12-month period beginning on the date of the adoption of such plan, the corporation sells substantially all of the properties held by it on such date, and

(C) following the adoption of such plan, no distribution is made of any property which in the hands of the corporation or in the hands of the distributee is property in respect of which a deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion is allowable.

This paragraph shall not apply with respect to any sale or exchange of property by the corporation to any shareholder who owns more than 20 percent in value of the outstanding stock of the corporation or to any person related to such shareholder (within the

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94. See, e.g., BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 313-20 (1959); Axelrad, *supra* note 44, at 909-18; Boland, *Collapsible Corporations Under the 1958 Amendments*, 17 TAX L. REV. 203, 209-34; Modrall, *Collapsible Corporations and Subsection (e)*, 37 TAXES 895 (1959).

95. At the outset it should be noted that there are at this writing neither final regulations, cases nor rulings to guide us in this inquiry, although proposed regulations under section 341(e) were, at long last, published on November 11, 1964.

meaning of paragraph (8)), if such property in the hands of the corporation or in the hands of such shareholder or related person is property in respect of which a deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion is allowable.

Taking the various subparagraphs in turn, our first inquiry is necessarily devoted to the fraction:

$$\frac{\text{net unrealized appreciation in subsection (e) assets}}{\text{net worth}}$$

1) *Subsection (e) assets*

Although all the problems raised by the paragraph (5)(A) definition will not be here considered, it will be quoted for reference purposes:

(A) For purposes of paragraphs (1), (2), and (4), the term "subsection (e) asset" means, with respect to property held by any corporation—

(i) property (except property used in the trade or business, as defined in paragraph (9)) which in the hands of the corporation is, or, in the hands of a shareholder who owns more than 20 percent in value of the outstanding stock of the corporation, 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 of property which is neither a capital asset nor property described in section 1231(b);

(ii) property used in the trade or business (as defined in paragraph (9)), but only if the unrealized depreciation on all such property on which there is unrealized depreciation exceeds the unrealized appreciation on all such property on which there is unrealized appreciation;

(iii) if there is net unrealized appreciation on all property used in the trade or business (as defined in paragraph (9)), property used in the trade or business (as defined in paragraph (9)) which, in the hands of a shareholder who owns more than 20 percent in value of the outstanding stock of the corporation, 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 of property which is neither a capital asset nor property described in section 1231(b); and

(iv) property (unless included under clause (i), (ii), or (iii)) which consists of a copyright, a literary, musical, or artistic composition, or similar property, or any interest in any such property, if the property was created in whole or in part by the personal efforts of any individual who owns more than 5 percent in value of the stock of the corporation.

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.

The most important Land Co. asset to be tested is, of course, the Apartment Co. stock. If gain from its *sale* by Land Co., or a more-than-twenty-per cent shareholder of Land Co., would result in *any* ordinary income, such stock would be a subsection (e) asset; if, however, only *part* of the gain was ordinary income by reason of section 341(d)(3), only such part would be included in the numerator of the paragraph (4)(A) fraction.<sup>96</sup> In determining whether the gain upon these hypothetical sales of Land Co. stock would result in ordinary income, all of the limitations and exceptions to section 341(a) would apply — *i.e.*, sections 341(d)(2), (d)(3) and (e)(1).<sup>97</sup> Since all of Apartment Co.'s assets are collapsible, (d)(2) would not be helpful and partial relief under (d)(3), even if available,<sup>98</sup> would not suffice. Subsection (e)(1) would, therefore, be determinative.

Section 341(e)(1) is also based upon a 15 per cent test, but it includes two additional categories of net unrealized appreciation in the numerator of the crucial fraction and does not apply to redemptions or to sales by a more-than-twenty per cent shareholder to certain related persons.<sup>99</sup> The two additional categories are: (a) in the case of a five-to-twenty per cent shareholder, net unrealized appreciation on those corporate assets (other than subsection (e) assets) described in clauses (i) and (iii) of paragraph (5)(A) which would be subsection (e) assets if such shareholder owned more than twenty per cent in value of such corporation's stock;<sup>100</sup> and (b) in the case of a more-than-twenty per cent shareholder, net unrealized appreciation on those assets (other than subsection (e) assets) described in clauses (i) and (iii) of paragraph (5)(A) which would be subsection (e) assets if

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96. See INT. REV. CODE OF 1964, § 341(e)(6)(D). The fact that all or part of the gain upon the sale of a particular asset would be ordinary income by reason of section 1245 or 1250 does not make such asset a subsection (e) asset. See section 341(e)(12).

97. See Axelrad, *supra* note 44, at 903; Modrall, *supra* note 94, at 914.

98. See p. 239 *supra*.

99. *I.e.*, the persons listed in paragraph (8) of subsection (e). In testing the ordinary income status of stock in a subsidiary such as Apartment Co., it may, apparently, be presumed that the hypothetical sale is not to a "related person." Otherwise section 341(e)(1) could never affect collapsible status.

100. INT. REV. CODE OF 1964, § 341(e)(1)(B).

such shareholder were deemed to have sold certain assets belonging to certain *other* corporations within the three years preceding the sale in question.<sup>101</sup> The statutory provision which creates this last category of appreciation is the so-called hypothetical dealer test; its vast complexities will not be considered further.<sup>102</sup>

In applying section 341(e)(1) to Apartment Co., we shall assume that neither that corporation, its actual sole shareholder nor any constructive more-than-twenty per cent shareholder<sup>103</sup> would be considered an actual or hypothetical dealer in property like the Delux Apartments. This is not a farfetched assumption despite the fact that Land Co. is in the business of constructing and selling real property since it is well established that a dealer in a general class of property may nevertheless have the requisite investment attitude with respect to any item within that class.<sup>104</sup> Apartment Co.'s only appreciated assets are the Washington and Jefferson units. These are not clause (i) subsection (e) assets because they are "property used in the trade or business";<sup>105</sup> and they are not clause (iii) assets because we have assumed that their sale by any more-than-twenty per cent shareholder would not give rise to ordinary income.<sup>106</sup> Because Apartment Co. thus has no subsection

101. INT. REV. CODE OF 1964, § 341(e)(1)(C).

102. For a full discussion, see Boland, *supra* note 94, at 213-15; Modrall, *supra* note 94, at 900-02.

103. Subsection (e)(10) provides that for purposes of determining percentage ownership under subsection (e)(5), the attribution rules of subsection (d) [a liberalized version of section 544(a)] shall apply. This is in contrast to the restrictive rules of subsection (e)(8) which are applied for certain purposes under subsections (e)(1) and (4). One consequence of this hodge-podge is that although Mr. First's brother would be deemed a more-than-twenty per cent shareholder of Apartment Co. whose dealer status would accordingly be crucial under subsection (e)(5), he would not be a "related person" for purposes of sales of stock or assets under subsection (e)(1) or (4). See generally, Modrall, *supra* note 94, at 907-10.

104. See, e.g., the cases cited in Boland, *supra* note 94, at 216 n.30. The Conference Committee made this clear with respect to securities dealers [H.R. Rep. No. 2632, 85th Cong., 2d Sess. 23 (1958)], and a similar rule should apply to real estate dealers. For examples of the many ways in which Congress' announced intention to distinguish between dealers and investors under section 341(e) is frustrated by the language of such section, see *id.* at 216-24.

105. See INT. REV. CODE OF 1964, § 341(e)(9).

106. It should be noted that while net unrealized *depreciation* on all section 1231(b) property will reduce the numerator of the crucial fraction by reason of clause (ii) of subsection (e)(5), *all* net unrealized appreciation on such property which would be dealership property in a more-than-twenty per cent shareholder's hands will, under clause (iii), be included in the numerator without any adjustment for net unrealized *depreciation* on *other* section 1231(b) property (unless, of course, such depreciation exceeds such appreciation). Modrall, *supra* note 94, at 897-98, illustrates the peculiar consequences of this rule as follows:

For example, suppose that a corporation's only assets are construction equipment with a basis of \$2,000 and a value of \$1,000 and an apartment house with a basis of \$13,000 and a value of \$15,000. The sole shareholder is a contractor in whose hands the apartment house would be an ordinary-income asset. Unrealized appreciation (\$2,000) exceeds unrealized depreciation (\$1,000), but only the apartment is a subsection (e) asset. Assuming no liabilities, the unrealized appreciation (\$2,000) is 16.7 per cent of the corporation's net worth (\$16,000). If



(e) assets, a hypothetical sale of its stock by Land Co. or a more-than-twenty per cent shareholder of Land Co. would be covered by section 341(e)(1); accordingly, such stock is not a subsection (e) asset of Land Co. for purposes of the contemplated section 337 liquidation and section 341(e)(4).

Turning to Land Co.'s other assets, the improved lots and houses in Projects X and Y are clearly clause (i) subsection (e) assets.<sup>107</sup> Lot A is neither "ordinary income" nor section 1231(b) property and hence cannot be a subsection (e) asset; *i.e.*, it is a "capital asset".<sup>108</sup> The characterization of the equipment and supplies is of no consequence since there is neither unrealized appreciation or depreciation thereon.<sup>109</sup>

## 2) *Net unrealized appreciation*

At the outset it should be noted that the crucial ratio must be kept below 15 per cent throughout the twelve-month period, and thus changes in net unrealized appreciation, as well as in net worth, must be carefully scrutinized.<sup>110</sup> In computing net unrealized appreciation

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the construction equipment were to be included in subsection (e) assets, the net unrealized appreciation (\$1,000) would be only 8.3 per cent of net worth. Boland's example, *supra* note 94, at 211-12, is even more striking.

Assume a corporation with a net worth of \$100 and inventory of \$50 on which there is unrealized appreciation of \$16, *i.e.*, 16 per cent of net worth. If all the assets other than inventory and cash are section 1231(b) assets on which there is a net unrealized depreciation of one dollar, a sale of stock by any shareholder will automatically qualify for capital gains relief under the subsection because the net unrealized appreciation of the collapsible assets will not exceed 15 per cent of net worth. This is the result even though all the shareholders are dealers in section 1231(b) assets held by the corporation. If, on the other hand, there is as much as a one cent over-all net unrealized appreciation on the section 1231(b) assets, then even the investor-shareholders are all disqualified, unless a more than 20 per cent shareholder happens to be a dealer in one class of such section 1231(b) assets and there is a net unrealized depreciation in excess of one dollar on that class of the corporate assets, in which event all of the shareholders, including the dealer, will qualify for the relief.

The "example" in Proposed Treas. Reg. § 1.341-6(b)(2)(iii), Fed. Reg. (1964) specifically confirms such anomalous conclusions.

107. If substantially all inventory assets are sold to one purchaser in one transaction pursuant to a section 337 plan, no gain is recognized by virtue of section 337(b)(2). Since the final sentence in section 341(e)(5) presumes such a sale for purposes of clause (i), it is arguable in the context of a section 337 liquidation, that such a sale is not one which could result in ordinary income "under any provision of this chapter"; *i.e.*, that inventory is not a subsection (e) asset. It would not seem that this argument would prevail, however, since, if section 337 did *not* apply, the sale of inventory would give rise to ordinary income and there is no statutory basis for limiting inquiry to section 337 sales. Furthermore, if a dealer-shareholder sold such inventory in one transaction, section 337 surely would not apply to him.

108. We, of course, continue to assume that no more-than-twenty per cent shareholder of Land Co. is a dealer in property like Lot A.

109. If a corporation is uncertain whether the gain realized upon the sale of a particular asset would be capital or "ordinary," its planning problems under section 341(e) may be seriously complicated. At the outset, for example, it would not know whether such asset was a subsection (e) asset, and it might have to make all computations in the alternative.

110. Another type of change during the twelve-month period which might affect the corporation's ratio, and thus the applicability of section 341(e)(4), is a change

as of April 1, 1965, it will be seen that one of the most difficult problems will be determining "fair market value";<sup>111</sup> *i.e.*, is it the price which might be paid if a certain option is exercised or a certain zoning change is obtained, or the price to be paid in a hurried liquidating sale, or the price which the asset would bring if sold in a "package" to take advantage of section 337(b)(2)?<sup>112</sup> Proposed Treas. Reg. § 1.341-6(h)(3) offers no guidance.

Computations of net unrealized appreciation with respect to each subsection (e) asset are as follows:

*Project X:* Unrealized appreciation would appear to equal \$34,000.<sup>113</sup>

*Project Y:* Should the option price of \$180,000 or the quick-sale price of \$140,000 be used in computing unrealized appreciation?

*The Package:* To complicate matters further, let us assume that an unrelated person would be willing to buy *all* of Projects X and Y after the adoption of the section 337 plan for \$367,200, a price which represents a 20 per cent reduction of the quick-sale profit on each item.

The conclusions to be drawn from the foregoing are as follows: (a) the *maximum* net unrealized appreciation in subsection (e) assets as of April 1, 1965 is \$124,000; (b) the *minimum*, \$67,200;<sup>114</sup> and (c) the *probable*, \$84,000.<sup>115</sup>

The sale of a subsection (e) asset during the twelve-month period will, of course, reduce the numerator since all such assets, in the hypothetical, have unrealized appreciation. Net worth will also be reduced, however, by the amount of taxes and expenses payable with respect to such sale.

Before leaving the subject of "net unrealized appreciation" two aspects of section 341(e) which do not arise in the hypothetical may be briefly mentioned. First, if the corporation sold subsection (e) assets under an installment contract prior to adopting its section 337 plan and, by reason of a section 453 election, has not yet reported all its gain upon such sales, is such gain includible in the numerator of the section 341(e)(4)(A) fraction? The answer, by analogy to Revenue

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in stock ownership. For example, if Mr. First sold one-half of his stock to a dealer in undeveloped land prior to the sale of Lot A, such asset would for the first time come within clause (i). If such purchaser were a dealer in apartment houses, the Apartment Co. stock, if not yet sold, would, by virtue of the attribution rules, become a subsection (e) asset. See Modrall, *supra* note 94, at 903-04.

111. See INT. REV. CODE OF 1964, §§ 341(e)(6)(B)(i) and (C)(ii).

112. Cf. Modrall, *supra* note 94, at 911.

113. See pp. 219 and 233 *supra*. The regulations offer no guidance as to the proper treatment of necessary brokerage fees, transfer taxes and other costs of sale in computing net unrealized appreciation so, for present purposes, we shall assume that \$36,000 is the proper figure, however computed.

114. *I.e.*, assuming that the package price is fair market value.

115. *I.e.*, assuming that the quick-sale prices are fair market value.

Ruling 60-68,<sup>116</sup> would appear to be no since the gain would have been "realized" at the time of the sales. Second, because subsection (e) assets include such property as section 1232 discount bonds and stock in a collapsible corporation, potential *capital losses* on these assets serve to reduce the crucial fraction. Section 306 stock which may have ordinary income potential even though its basis exceeds its value can give rise to the most surprising results of all.<sup>117</sup>

3) *Net Worth*. As of April 1, 1964, the net worth of Land Co. would appear to be \$964,000 — *i.e.*, book net worth of \$290,000 plus \$590,000 of unrealized appreciation in the value of the Apartment Co. stock and Lot A plus the probable \$84,000 of unrealized appreciation in subsection (e) assets. This net worth figure will, of course, change in the course of the liquidation. First of all, net worth will be reduced by the accrual of a liability or by an expenditure which had not been accrued before the adoption of plan, such as the commission paid on the sale of Lot A. Second, income taxes payable upon the sale of inventory assets, if not sold to one person in one transaction, will further reduce net worth.<sup>118</sup>

Distributions in complete liquidation of assets such as the proceeds of the Apartment Co. stock sale will not reduce net worth during the period of liquidation, however, since section 341(e)(7)(A)(ii) specifically includes such amounts in net worth. On the other hand, it will be seen that dividends paid prior or subsequent to the adoption of the plan of liquidation will reduce net worth and thereby result in an increase in the crucial ratio. This, of course, is an example of the same type of perversity with respect to dividend distributions as exists

116. See p. 238 and note 81 *supra*.

117. Modrall, *supra* note 94, at 911, illustrates the potential problems relating to section 306 stock as follows:

For example, if the stock's fair market value at distribution and its ratable share of earnings and profits were \$100 and the basis were \$50, a present sale for any price between \$100 and \$150 would produce \$100 of ordinary income. However, if the present value is \$120, unrealized appreciation, as defined in subsection (e), would be \$70. A more paradoxical result would occur if the present value dropped below basis; although the entire proceeds on sale would be ordinary income, there would be unrealized depreciation under subsection (e). In order to account for the potential ordinary income in section 306 stock, the definitions in section 341(e)(6)(D) will either have to be stretched or amended.

118. Net worth would also be reduced by any income taxes payable upon the sale of depreciable property to a "related person" since, under the final sentence in section 341(e)(4), such sales do not qualify for the benefits of section 337. See pp. . . . . *infra*. Boland, *supra* note 94, at 230, argues that income tax payable on such sales should not reduce net worth for purposes of section 341(e)(4), but rather should be retained as part of net worth in the same fashion as liquidating distributions under section 341(e)(7)(A)(ii).

The sale of an asset of uncertain tax status can cause problems in calculating the crucial section 341(e) fraction throughout the 12-month period; *i.e.*, if it is a capital or section 1231(b) asset, as distinguished from inventory, there will be no need to reduce net worth by an accrued income tax liability. Compare note 109 *supra*.

under section 341(d)(2); *i.e.*, the corporation will be less likely to be affected by section 341(a) if it withholds rather than distributes dividends.<sup>119</sup>

Again, several aspects of the net worth concept which do not directly apply to the hypothetical may be noted. Section 341(e)(7), in its final sentence, seeks to prevent enlargement of net worth for purposes of section 341(e) through the issuance of stock or contributions to capital prior to a stock sale or the adoption of a plan of liquidation under section 337. Such sentence provides:

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.

It has been argued, however, that the specific one-year cutoff creates a negative inference that courts should not inquire into the business purposes of contributions to capital or the issuance of stock one year and a day before net worth is determined under section 341(e).<sup>120</sup>

Since net worth is affected by the amount of a corporation's indebtedness, the "thin capitalization" doctrine may become relevant in cases under section 341(e); *i.e.*, the *taxpayer* may argue that indebtedness held by shareholders really represents an equity interest with the result that net worth would be increased.<sup>121</sup>

4) *Computation of the crucial percentage.* As of April 1, 1964, the crucial fraction would appear to be \$84,000 over \$964,000, producing an initial ratio of 8.71 per cent. Even if the maximum unrealized appreciation of \$124,000 were used in the initial fraction, the ratio would only be 12.35 per cent. Since subsequent sales of subsection (e) assets would result in a greater reduction in the numerator than the denominator, it appears that the requirement of section 341(e)(4)(A) would be satisfied in the hypothetical.

5) *Section 341(e)(4)(B)* — sale of substantially all properties. This provision, like paragraph (4)(C) and the final sentence in subsection (e)(4), is intended to make sure that the shareholders of a

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119. See pp. 221-22 *supra*. Modrall, *supra* note 94, at 914, 948, believes it desirable, for purposes of section 341(e), to include in the corporation's net worth all distributions which have previously reduced earnings and profits.

120. *Id.* at 910. The problem dealt with by the quoted sentence should be compared with the possibility of obtaining the benefits of section 341(d)(2) by contributing noncollapsible assets with a large amount of unrealized appreciation to a corporation shortly prior to its "collapse." See Axelrad, *supra* note 16, at 869.

121. See Modrall, *supra* note 94, at 912.

collapsible corporation do not, directly or indirectly, obtain a step-up in the basis of depreciable property (or a substantial amount of non-depreciable property) at the cost of only a capital gains tax; *i.e.*, Congress intended that a section 337 liquidation must resemble a sale of stock to an unrelated person if it is to qualify for relief under section 341(e).<sup>122</sup> The question of what may be considered "substantially all" of a corporation's assets is necessarily a tricky one, but one with which practitioners have had considerable experience under section 368 (a)(1)(C). Presumably, it would not be necessary for a company like Land Co. to sell such assets as purchase money mortgages and installment-sale obligations obtained in the ordinary course of its business, although Proposed Treas. Reg. § 1.341-6(g)(1) offers no guidance.

While, for safety's sake, a corporation seeking the benefit of section 341(e)(4) would ordinarily sell *all* of its assets, situations may arise where this may not be desirable. If certain shareholders wish to retain ownership of a particular non-depreciable property, paragraph (4)(C) will not bar its distribution; but if the value of such property might be considered "substantial", paragraph (4)(B) suggests that the interested shareholders should purchase it prior to liquidation. In these circumstances, however, might not the Commissioner argue that the sale to shareholders, followed by a distribution to them of all or part of the cash they paid, actually constituted the distribution, rather than sale, of a substantial asset?<sup>123</sup>

6) *Treatment of depreciable property — section 341(e)(4)(C) and the final sentence in section 341(e)(4)*. We have already seen that the corporation is required to sell "substantially all" of its property within a twelve month period, but, in addition, it must sell *all* of its depreciable property; *i.e.*, Congress made sure that the shareholders of any corporation which obtained the benefits of section 337 via section 341(e)(4) would not be able to achieve a single dollar's worth of basis step-up at the cost of only a capital gains tax on the liquidation. It went even further by providing that if depreciable property is sold, rather than distributed, to a more-than-twenty per cent shareholder or certain related persons,<sup>124</sup> the benefit of section 337 would be withdrawn pro tanto; *i.e.*, any direct or indirect benefit to such a shareholder by reason of a stepped-up basis for depreciation can be realized only at the cost of two capital gains taxes.

122. The purchaser in such hypothetical stock sale must be "unrelated" since he might be able to liquidate the corporation under section 332, obtain a stepped-up basis under section 334(b)(2), and, theoretically, thereby indirectly confer the benefits of increased depreciation deductions upon his spouse, child, etc., who sold him the stock.

123. Cf. BITTKER, *op. cit. supra* note 94, at 320.

124. See INT. REV. CODE OF 1964, § 341(e)(8).

Because the sales which may fail to qualify for section 337 treatment by reason of the final sentence in section 341(e)(4) are not limited to sales to shareholders or their relatives which give rise to a gain, some unusual results may obtain. For example, it seems quite clear that depreciable property could be sold at a *loss* which would be recognized by reason of such sentence despite the fact that sales of other property at a gain to unrelated persons would not be taxable by reason of section 337.<sup>125</sup> While it can be argued that this result is not altogether unfair because the shareholder or his relative will have a reduced depreciation basis, this would be true no matter who the purchaser was, and the regulations prohibiting the straddling of section 337 by selling depreciated property prior to the adoption of the plan would be frustrated.<sup>126</sup> Moreover, because of the operation of the statutory sentence in question, it might even be worth-while in certain circumstances for a more-than-twenty per cent shareholder to purchase *appreciated* depreciable property since the step-up in basis could be more valuable than net cost of the additional corporate capital gains tax.<sup>127</sup>

#### B. Section 341(e)(2)

Assuming that section 341(e)(4) would apply to a section 337 liquidation in the hypothetical with the effect that the gain on the sale of the Apartment Co. stock and Lot A would not be recognized, we must next consider the applicability of section 341(e)(2) to the shareholders' gain on the liquidation. Such section provides:

DISTRIBUTIONS IN LIQUIDATION.—For purposes of subsection (a)(2), a corporation shall not be considered to be a collapsible corporation with respect to any distribution to a shareholder pursuant to a plan of complete liquidation if, by reason of the application of paragraph (4) of this subsection, section 337(a) applies to sales or exchanges of property by the corporation within the 12-month period beginning on the date of the adoption of such plan, and if, at all times after the adoption of the plan of liquidation, the sum of—

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125. See Proposed Treas. Reg. § 1.341-6(g)(2), 29 Fed. Reg. 15209 (1964). Such a loss will not be deductible by reason of section 267, however, if the purchaser was an individual who owned, actually or constructively, more than 50 per cent in value of the corporation's stock or was another corporation more than 50 per cent in value of whose stock was owned, actually or constructively, by or for the same individual who owned a similar interest in the selling corporation. INT. REV. CODE OF 1964, § 267(b)(2) and (3).

126. See note 124 *supra*; BITTKER, *op. cit. supra* note 94, at 320.

127. The corporation's gain would, of course, be ordinary income under section 1239(a)(2) if such purchaser was an individual shareholder who, together with his spouse, minor children and minor grandchildren, owned more than 80 per cent in value of the corporation's outstanding stock. All or part of the gain on *any* sale pursuant to a section 337 plan may, of course, be taxed as ordinary income under section 1245 or 1250.

(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 described in paragraph (1)(B) (other than assets described in subparagraph (A) of this paragraph), 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 described in paragraph (1)(C) (other than assets described in subparagraph (A) of this paragraph),

does not exceed an amount equal to 15 percent of the net worth of the corporation.

The various views on what this section means differ considerably. For example, Axelrad maintains that the section is a nullity since if substantially all of a corporation's assets are sold pursuant to the plan as required by section 341(e)(4)(B), all of the corporation's gain will have been "realized", though not recognized, and the corporation would thus not be "collapsible" at the time of its liquidation.<sup>128</sup> This view, while arguably consistent with Revenue Ruling 58-241,<sup>129</sup> seems unacceptable as a matter of statutory interpretation. This is because Congress clearly intended, through subparagraphs (B) and (C) of subsection (e)(2), to make section 341(a) applicable to certain actual and hypothetical dealer-shareholders even though the corporation realized no gain upon the sale of its assets and other shareholders realized capital gain under section 341(e)(2).<sup>130</sup>

One trouble with literal acceptance of the statute, however, is that a five-to-twenty per cent dealer-shareholder or a more-than-twenty per cent hypothetical dealer-shareholder may have ordinary income under section 341(a) by reason of subsection (e)(2) whereas, if he were an

128. Axelrad, *supra* note 44, at 917.

129. See note 92 *supra*.

130. See Proposed Treas. Reg. § 1.341-6(e)(1)(iii), 29 Fed. Reg. 15209 (1964).

actual dealer who owned more than twenty per cent of the corporation's stock, he would only have to bear the burden of two capital gains taxes under Revenue Ruling 58-241 — as would, of course, all the other shareholders. Under these circumstances, such a shareholder might employ various stratagems to cause the liquidation to fail to qualify under section 341(e)(4); *i.e.*, a five-to-twenty per cent dealer-shareholder might attempt to acquire enough shares prior to the termination of the liquidation to make him a more-than-twenty per cent shareholder; a hypothetical dealer might seek to become an actual dealer;<sup>131</sup> or either of such gentlemen might bring a suit against the corporation in hopes that the legal expenses involved would reduce the corporation's net worth sufficiently to cause it to fail the 15 per cent test.

Another area of doubt under section 341(e)(2) is whether there must actually be at least one sale of property which qualifies for section 337 treatment by reason of section 341(e)(4). Axelrad says that the preferable interpretation is that a liquidation qualifies under (e)(2) if such a sale *could* have been made by reason of (e)(4), although he concedes that the Finance Committee Report indicates that a sale at the corporate level under the latter provision is a prerequisite for qualification under (e)(2).<sup>132</sup> Boland, in contrast to Axelrad, flatly states that section 337(a) must be applicable to at least one sale or exchange made during the twelve month period beginning with the adoption of the plan of liquidation.<sup>133</sup> A third conceivable reading of section 341(e)(2), of course, is that section 337(a) must apply to *all* relevant sales or exchanges of property by reason of subsection (e)(4) before subsection (e)(2) can apply.<sup>134</sup> Proposed Treas. Reg. § 1.341-6(e)(1)(i) simply repeats the statutory language without explanation.

Because we have assumed that no five-to-twenty per cent shareholders of Land Co. are dealers in a relevant class of assets, that no more-than-twenty per cent shareholder is a hypothetical dealer in such assets, that a sale of Apartment Co. stock under section 337(a) will take place and that no sales of depreciable property will be made to a

131. This and the preceding stratagem would, of course, succeed only if the conversion of the class of property in which such shareholders are dealers to subsection (e) assets would raise the crucial ratio under section 341(e)(4)(A) to more than 15 per cent.

132. Axelrad, *supra* note 44, at 916.

133. Boland, *supra* note 94, at 224. Under this view, if a corporation's only assets other than inventory are depreciable property and such property is sold to more-than-twenty per cent shareholders, the liquidation would not qualify under section 341(e)(2) despite the fact that the corporation sold substantially all of its assets and distributed no depreciable property.

134. Such a rule would presumably not prevent the sale of inventory at a recognized gain because section 337(a) only applies to sales of "property" defined in section 337(b) in any event. Rather, its impact would be felt if any "depreciable property" were sold to a more-than-twenty per cent shareholder or his relative. See note 137 *supra*.



more-than-twenty per cent shareholder or a "related person", section 341(e)(2) would apply to the section 337 liquidation of Land Co. As a consequence, it would be possible for all shareholders to realize capital gain upon such liquidation and to achieve the desired goal of placing the proceeds of the Apartment Co. stock sale in the hands of such shareholders at the sole cost of a single capital gains tax.

### C. *Interaction of Subsections (d) and (e)*

The two relief provisions considered in this article will occasionally interact for planning purposes with beneficial effect. In such event, a careful analysis of each and a keen sense of timing is required to achieve maximum benefits.

For example, consider the case of a hypothetical dealer who would be barred from capital gain treatment by section 341(e)(2)(C) even though corporate sales after the adoption of the plan of liquidation would be tax-free under section 341(e)(4). Such shareholder might be able to achieve capital gain treatment via section 341(d)(2), or perhaps through a combination of section 341(d)(2) and (3),<sup>135</sup> if the timing of distributions to him was properly handled;<sup>136</sup> *i.e.*, the corporation might distribute all gain attributable to dirty assets to those shareholders who could qualify under section 341(e)(2) in the year of the adoption of the plan and then make a distribution of clean assets to the hypothetical dealer in the following year.<sup>137</sup>

It is possible that a corporation might wish to delay the adoption of a section 337 plan until it had made sufficient sales of subsection (e) assets to bring its initial ratio under section 341(e)(4)(A) safely below 15 per cent. Similarly, if the possibility of liquidating under section 331 and claiming the benefit of section 341(d)(2) were under consideration, the corporation might wish to proceed with the sale of collapsible assets in order to render the proceeds of such sales clean assets and thereby improve its ratio under the 70-30 test. Actually, it is quite likely that a corporation would want to proceed with certain sales before deciding whether it would rely on subsection (e)(4) or (d)(2).<sup>138</sup>

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135. See pp. 240-41 *supra*.

136. See pp. 231-32 *supra*.

137. Such latter distribution would, of course, have to be made within 12 months of the adoption of the plan.

138. It will be seen that it would not be possible to obtain the benefit of both subsections in the hypothetical if the corporation is to be liquidated since subsection (e)(4) will only apply in the case of a section 337 liquidation to which subsection (d) cannot apply. Thus, if there must be a separate sale of the Apartment Co. stock or assets, the corporation must eventually choose one route or the other. If, however, a purchaser could be found for the Land Co. stock, its sale could potentially be covered by both subsections.

In cleaning up collapsible projects by selling subsection (e) assets, a high profit would be desirable under both subsection (e)(4) and (d)(2) since clean gain would be maximized and a high net worth substantiated. The reduction of net worth by reason of the accrual of an income tax liability with respect to such sales would, of course, be more than offset by the removal of the taxable appreciation from the numerator of the subsection (e) fraction. In the case of collapsible property which is not a subsection (e) asset, a high profit on "cleaning up" would again be beneficial although if subsection (e)(4) is ultimately to be employed, it would be preferable to obviate the capital gains tax with respect to such property by delaying its sale until after the adoption of the section 337 plan. Since noncollapsible section 1231(b) and capital assets do not have to be cleaned up, the opportunity to avoid tax upon their sale via section 337 would seem to outweigh any possible benefit from substantiating their high value prior to a decision whether or not to liquidate under such section; and if reliance is not ultimately placed upon section 341(e)(4), the double capital gains tax on noncollapsible assets can be avoided by simply distributing them in the section 331 liquidation.

## VI.

### ALTERNATIVE SOLUTIONS

A good many commentators have suggested that the shareholders of collapsible corporations should not place their reliance upon either section 341(d) or (e) in view of all the above described uncertainties and inequities, but rather, if possible, should seek relief outside of the context of section 341. The most popular alternative technique is to make an election under Subchapter S and then sell section 1231(b) property at a capital gain.<sup>139</sup> This technique would appear particularly advantageous if the corporation could not benefit from section 341(e) because its principal shareholders were dealers in the type of property in question or if it was desirable to sell such property to a "related person" within the meaning of section 341(e)(8). Although Boland writes that "it seems apparent that the draftsmen of . . . [Subchapter S and section 341(e)] were not acquainted with each other's work," the Treasury has attempted to partially close any resulting "loophole" through the following regulation:

*Level for determining character of gain.* Ordinarily, for purposes of determining whether gain on the sale or exchange of an asset by an electing small business corporation is capital gain, the

139. See, e.g., Axelrad, *supra* note 44, at 906-09; Boland, *supra* note 94, at 231-33.

character of the asset is determined at the corporate level. However, if an electing small business corporation is availed of by any shareholder or group of shareholders owning a substantial portion of the stock of such corporation for the purpose of selling property which in the hands of such shareholder or shareholders would not have been an asset, gain from the sale of which would be capital gain, then the gain on the sale of such property by the corporation shall not be treated as a capital gain. For this purpose, in determining the character of the asset in the hands of the shareholder, the activities of other electing small business corporations in which he is a shareholder shall be taken into consideration.<sup>140</sup>

Another oft-suggested technique is to terminate the existence of the collapsible corporation via a tax-free reorganization.<sup>141</sup> While no attempt will be made here to discuss the possibilities in this area, it should be noted that the difficulties which would be encountered by the acquiring corporation in obtaining a cost basis for the acquired assets might prove a stumbling block to any such plan.

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140. Treas. Reg. § 1.1375-1(d). There may, of course, be a great many other obstacles to the employment of the Subchapter S technique. *E.g.*, Land Co. would have the following problems: preferred stock; a trust as a shareholder; and an active subsidiary. Section 1372(e)(5) which provides that the Subchapter S election is not available to any corporation which receives over 20 per cent of its gross receipts, from rents, royalties, etc., will prove troublesome to many other collapsible corporations. But see Boland, *supra* note 143, at 232.

141. See, *e.g.*, Axelrad, *supra* note 16, at 872; Donaldson & Hobbet, *Three Techniques for Getting Capital Gain Despite Section 341*, 12 J. TAXATION 194, 196 (1960).