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Collapsible Corporations—Probems and Pitfalls

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THE EVOLUTION of Code section 341, the present Collapsible Corporation statute, can best be described as the story of what happens when Congress does too thorough a job of closing a loophole. Subsections (a) through (d) of the statute constitute the embodiment of provisions in three separate revenue acts—1950, 1951 and 1954—intended to forestall practices that seriously threatened the revenue. Subsection (e), which was added by the Revenue Act of 1958, represents the opposite—a strenuous attempt to mitigate penalties that turned out to be harsher than intended, without reopening the loophole. Subsection (e) sets some sort of a record for verbosity and complexity, and in sheer volume of printed pages outweighs the rest of the statute by more than two to one. Fortunately for me, Mr. Reinhardt has agreed to tackle subsection (e), and I might add that he is welcome to it. I can, therefore, limit myself to the less abstruse parts of the statute which deal with its basic loophole-closing aspects.

LOOPHOLE-CLOSING PURPOSES OF STATUTE

I realize most of you are familiar with the type of tax avoidance that section 341 was designed to correct and, therefore, I shall not dwell at any great length on the background that gave rise to the enactment of this statute. Suffice it to say the tax avoidance with which Congress was concerned was the conversion to capital gain, by means of a corporate liquidation or sale of stock, of what would otherwise have been ordinary income in the form of rentals, compensation for personal services, or profits from sale of stock in trade. The principal penalty imposed by section 341 consists of a denial of long-term capital gain treatment on liquidation of, or sale of stock in, a corporation formed or availed of for this type of tax avoidance.

I am not here overly concerned with the application of section 341 to corporations engaged in construction, real estate development, or motion picture production. All of us are at least aware of the possibility of having collapsible corporation sanctions imposed against such corporations and their shareholders. In fact the taxpayers them-

selves may have had reason to entertain serious doubts about whether capital gain treatment would be appropriate at the time they organized such corporations or became shareholders thereof. I am more concerned here with the possibility of section 341 being used as a trap to ensnare unwary stockholders in the event of liquidation, or sale of stock in, a more conventional corporation. I am concerned about this because of the prevalent misconception that section 341 applies only to specific types of businesses or to stockholders who lack purity of motive. On the contrary, the statute is broad enough to include corporations in practically every business category and provides no exception for any particular type or types of business or corporation. Of course by express provision shareholders owning 5 per cent or less of the outstanding stock are for the most part exempt from section 341 penalties. Therefore, the ordinary investor is reasonably well insulated and need not be concerned with collapsible status of the corporation.

I wish I could say categorically that section 341 applies only to corporations engaged in real estate development, building construction, or motion picture production and that it does not apply to mercantile or manufacturing corporations. Unfortunately I can make no such general statement.

MANUFACTURING AND MERCANTILE CORPORATIONS

It is conceivable that the collapsible-corporation penalties could apply to a mercantile or manufacturing company by reason of an increase in the value of its inventories. The problem would be most likely to occur with manufacturers' finished-goods inventories, the value of which is substantially in excess of cost of raw materials, direct labor, etc. The problem could also arise for retailers and wholesalers using LIFO inventories where current costs are considerably higher than LIFO costs. Of course a distribution of LIFO inventories would result in the realization of ordinary income to the corporation under section 311 (b) measured by the difference between LIFO and current costs. As a corporation is collapsible only by reason of failure to realize substantial income from collapsible assets, it may be that the problem in the case of a liquidation is merely academic. Nevertheless, where there is a sale of stock rather than a liquidation, the question is of something more than academic interest. Moreover, there will be other cases where the gain attributable to inventories

results from bargain purchases or a rise in market values. In any event there is nothing in section 341 that would expressly exempt a manufacturing or mercantile corporation from collapsible sanctions.

The Regulations insofar as they may deal with this subject are something less than explicit. They indicate that a corporation will not be considered collapsible if the amount of inventories (both in quantity and in value) is not in excess of the amount that is normal, provided the corporation has a substantial prior history including the use of such inventories. Presumably this means that at least in most cases the collapsible corporation penalties will not apply so long as the corporation does not acquire or accumulate inventory for the purposes of the proscribed tax avoidance.

As far as I can determine the Service has had only one occasion to express its views concerning collapsible classification of a mercantile corporation. This was in a ruling issued in 1956 (Rev. Rul. 56-244, 1956-1 CB 176) relating to a corporation engaged in the sale of oil drilling equipment. The corporation was liquidated after about ten years of operation, and the business was thereafter continued on a smaller scale by a partnership composed of former stockholders. The Internal Revenue Service found that the liquidation was compelled by curtailment of business activities caused by market saturation. In holding that the corporation was not collapsible the Service emphasized the fact that the inventory at the date of liquidation was normal for the volume of sales and no greater than the average inventory over the previous several years. It is not clear whether the ruling was predicated on this fact alone or on the fact that liquidation was compelled by factors unforeseeable at the time the corporation was organized.

The question of the application of section 341 to a mercantile corporation was also raised in a California District Court case, (*Levenson* v. *U.S.*), one of the few cases, if not the only one, dealing with a corporation engaged in something other than real estate development, construction, or motion picture production. The corporation in this case had entered into a contract to purchase 4,000 house trailers at a price that, as it developed, was something of a bargain. The shareholders disposed of their stock in this corporation at a time when the corporation had sold somewhat less than 50 per cent of the trailers. However, the trailers were made available to the corporation by its vendor only as and when they were released by the occupants, and on the date the stock was sold the corporation had

only about 100 of these in inventory. The Court held that the gain was largely attributable, not to property manufactured, constructed, produced, or purchased, but to a non-collapsible asset, the purchase contract. You will recall that under one of the limitations in section 341 a shareholder will not be deprived of capital gain unless more than 70 per cent of the gain is attributable to collapsible assets. Although collapsible stigma was avoided, the case does bear witness to the fact that a mercantile corporation can be subject to collapsible penalties by reason of its inventories.

EFFECT OF LIFO INVENTORIES

It is most difficult to predict at this time whether the Commissioner will attempt to apply section 341 where the gain on sale of stock is due in large measure to low LIFO base inventories. To do so he would have to overcome the argument almost certain to be raised by the taxpayer that a substantial part of the income from the property has been realized by reason of previous sales. This argument would negate collapsibility because the statute by its express terms does not apply unless the sale or liquidation occurs prior to the time the corporation has realized substantial income from the collapsible assets. To overcome this argument the Commissioner would have to contend that each item of inventory is a separate property. This contention in turn could be countered by carrying the contention to its logical conclusion. If each inventory item is a separate property, hasn't the property been held for more than three years, assuming of course that the LIFO base goes back this far? If so, then the shareholders could avoid ordinary income treatment under the exception dealing with corporations that hold the collapsible asset for more than three years. This line of reasoning would seem at least to be consistent with the literal meaning of last-in, first-out.

CORPORATIONS ENGAGED IN AGRICULTURE OR TIMBER RAISING

I wish I could also categorically state that section 341 does not apply to corporations engaged in agriculture, the operation of fruit orchards, growing of timber, and the like. Unfortunately again I can provide no such assurance. The statute can apply to any corporation engaged in *manufacture, construction, or production of property.* Neither

the statute nor the regulations attempt to define these terms. The Service did rule, however, that the drilling and equipment of oil wells on unproved leases constituted *construction or production of property* (Rev. Rul. 57-346, 1957-1 CB 236). This interpretation was later confirmed by a District Court (*Honaker Drilling Inc.* v. *Koehler*, 7 AFTR 2d 416 (DC Kan. 1961)). Neither the Service nor the District Court seemed concerned with the fact that the statute does not use the word *development,* a term invariably referred to in connection with exploitation of mineral properties. The question has yet to be answered about whether the raising of crops constitutes the production of property. Probably, the drafters of the Collapsible Corporation statute were thinking of motion pictures when they used the term *production* as the terms *manufacture* and *construction* could hardly be appropriate to motion pictures. Nevertheless, taxpayers and tax advisers can ill afford to ignore one of the dictionary definitions of the word *produce* which reads as follows: *To bring forth as a mature product or growth ... as, the earth produces grass, trees produce fruit.*

Thus, literally interpreted, section 341 could apply to a corporation engaged in farming, ranching, raising timber, etc. Moreover, on the sale of a farm the entire gain, or at least more than 70 per cent, may very well be attributable to unharvested crops, a collapsible asset, and, therefore, the possible application of section 341 should not be overlooked. I might add that if section 341 can properly be interpreted as applying to a farm corporation, we have an instance of the congressional left hand not knowing what the congressional right is doing. This will be apparent when it is recalled that Congress went out of its way in the 1951 Act to permit capital gain treatment for sales of unharvested crops sold with the land by adding the 1939 Code equivalent of Section 1231 (b) (4). The 1951 Act, as you will recall, was the same Act that tightened up the collapsible-corporation loophole.

LIMITATIONS ON STOCKHOLDER PENALTIES

Before concluding this part of the discussion I should like to make brief mention of the three limitations on the application of section 341. I refer, of course, to the 70 per cent rule, the three-year rule, and the 5 per cent stock-ownership rule, to all three of which I have previously referred. Under the 70 per cent rule, section 341 penalties can be avoided by showing that at least 30 per cent of the gain on

sale or liquidation is attributable to non-collapsible assets. Thus, where the value of corporate goodwill, trademarks or tradenames, and possibly copyrights and patents, is substantial, it may be that the 70 per cent rule provides a convenient mechanical criterion for proving the shareholder's right to capital gain. As to copyrights and patents this presupposes that these items are neither *manufactured nor produced* within the meaning of the statute, an assumption that cannot safely be made at this time.

It is most important to note that these three limitations merely relieve the individual shareholders in certain cases from ordinary income treatment on liquidation or sale of their stock. Unlike the exceptions provided in subsection (e) to be discussed by Mr. Reinhardt, these limitations do not affect the corporation's collapsible status. The corporation may still be collapsible even though, because of the limitations, none of the stockholders will be denied capital gain benefits. This is important because the corporation, being collapsible, will under section 337 be denied the privilege of making tax-free liquidating sales during a 12-month period. Presumably, however, to gain the corporation by reason of liquidating sales can be avoided under the *Cumberland Public Service* case if the post-liquidation sales are actually made by the shareholders.

AVOIDANCE OF COLLAPSIBLE STATUS

I should like to point out that a corporation might avoid collapsible status simply by realizing the income to be derived from the collapsible assets. Moreover, collapsibility does not deprive the corporation of long-term capital gain benefits on sale of the collapsible assets if these are in fact *capital assets*. Thus, in some cases it might be advisable for the corporation to dispose of the collapsible assets prior to liquidation. It may be that the effect of two capital gains taxes —to the corporation on sale of the assets and again to the stockholder—may be less burdensome than one tax at ordinary rates to the stockholder on liquidation or sale of the stock.

It may be possible to avoid both the collapsibility problem and the problem of two capital gains taxes by means of a Sub-Chapter S election. In this connection it is important to note that a Sub-Chapter S Corporation is not by that reason alone exempt from collapsible-corporation classification. Nor is there anything in the Code that would deprive a collapsible corporation of the privilege of

making a Sub-Chapter S election, provided, of course, that it otherwise meets the requirements of Sub-Chapter S. The sale of a collapsible Sub-Chapter S Corporation's stock or the liquidation of such a corporation may result in ordinary income the same as for a conventional corporation. Therefore, in order to avail themselves of capital gain, shareholders must make it a point to have the *corporation* sell the collapsible asset. It is apparent that lack of planning in this area can be costly.

It has been suggested that a potentially collapsible corporation whose collapsible assets are also capital assets, should prepare for the worst by disposing of its assets in connection with a plan of liquidation under Section 337. The reasoning goes something like this: If the corporation is successful in contesting collapsible stigma nothing has been lost, and the corporation has had the benefit of tax-free liquidating sales. On the other hand, if the corporation loses the argument and it is held to be collapsible, the worse that can happen is that it will have to pay a tax at capital gain rates on sale of its assets. However, as the corporation has now realized a substantial part of the income to be derived from the collapsible assets, capital gain will not be denied the shareholders. We have no less an authority than the Internal Revenue Service itself, in the form of a published ruling, for this suggested method of avoiding collapsible status (Rev. Rul. 58-241, 1958-1 CB 179).

One final possibility for avoiding collapsible-corporation stigma is suggested by a provision in the Regulations to the effect that the corporation will not be considered collapsible if the sale or liquidation is attributable solely to circumstances that arose after manufacture, construction, etc. The Regulations are quick to add, however, that this exception does not apply to circumstances that could reasonably be anticipated at the time of manufacture, construction, etc. In a series of recent decisions the courts have shown a willingness to rely on this provision of the Regulations as a means of saving deserving taxpayers from collapsible-corporation sanctions. In most of these cases, the unanticipated circumstance that compelled the sale was the ill health of a major stockholder. See *Maxwell Temkin,* 35 TC 906 (1961); *Elliott* v. *U.S.,* 9 AFTR 2d 1418 (DC Ore. 1962); *Charles J. Riley,* 35 TC 848 (1961). Despite the generosity of the courts in this area, I should not like to go on record as recommending a heart attack as a means of avoiding collapsible-corporation penalties.

At one time it was thought that collapsible status could be avoided

by having the corporation realize prior to liquidation or sale of the stock a substantial part of the income to be derived from the collapsible asset. In those days it was believed that the only problem was to determine what percentage constituted a substantial amount. Unfortunately, however, the Commissioner, with some court support, has construed the statute to mean that the *unrealized* gain must not be substantial. Thus assuming that 33 per cent is substantial, as one court has held, the Commissioner would insist that at least 67 per cent of the gain must have been realized if collapsible status is to be avoided (*Comm.* v. *James B. Kelley,* 8 AFTR 2d 5232, 293 F. 2d 904 (CA-5 1961)).