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Federal Income Tax-Definition of Collapsible Corporation

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FEDERAL INCOME TAX—DEFINITION OF COLLAPSIBLE CORPORATION —In 1948 petitioner and several other taxpayers, who had previously been active in constructing homes, formed two corporations to build apartment houses.[1] As a result of decreases in the price of building materials and savings on labor and architectural costs, each corporation was left, after completion of construction, with borrowed funds which exceeded costs of construction.[2] In the year following completion of construction the taxpayers distributed the excess borrowed funds of the two corporations and then sold their stock in each at a substantial profit. Petitioner reported his receipts from the distribution of the loan funds and the profit on the sale of his stock as long term capital gain. The Tax Court,[3] one judge dissenting, upheld the Commissioner's assertion that these were collapsible corporations under section 117(m) of the Internal Revenue Code of 1939[4]

1 The project was financed under § 608 of the National Housing Act, 56 Stat. 301 (1942), as amended, 12 U.S.C. § 1743(b) (1958), and the Federal Housing Administration guaranteed mortgage loans to the two corporations.

2 Instead of contracting out the carpentry and plumbing work, the taxpayers had their own men do the work, saving $85,000 on plumbing and heating. A decline in the cost of lumber resulted in a saving of $50,000. In addition, other savings amounted to $90,000 in title and recording expenses and legal organizational expenses, and petitioner acted as architect for the project, thus saving nearly $600,000 more. Consequently, the mortgage loan proceeds exceeded cash expenditures by more than $150,000. Braunstein v. Commissioner, 305 F.2d 949, 953 (2d Cir. 1962).

3 Benjamin Braunstein, 36 T.C. 22 (1961). The issue confronting the circuit court and the Supreme Court was not raised during the hearing of the case by the Tax Court. An explanation for this may be that the Tax Court decision was handed down prior to the decision in United States v. Ivey, 294 F.2d 799 (5th Cir. 1961).

4 Int. Rev. Code of 1939, § 117(m) (now substantially INT. REV. CODE OF 1954, § 341):

"(1) Treatment of gain to shareholders. Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it

and that taxpayer's gains were therefore ordinary income. On appeal, the Court of Appeals for the Second Circuit affirmed the Tax Court's opinion, holding that section 117(m) applies to the collapse of a corporation regardless of whether a shareholder might have received capital gains treatment on his receipts if he were doing business as an individual proprietorship. On certiorari, *held*, affirmed, one Justice dissenting. Congress, in enacting section 117(m), intended to define what it believed to be a tax avoidance device rather than leave the question of the presence of tax avoidance to the courts to be determined on the facts of each case; thus the provision applies to all corporations falling within its definition, regardless of what tax consequences might have resulted had another form of enterprise been used. *Braunstein v. Commissioner*, 374 U.S. 65 (1963).

In 1950 Congress singled out the so-called "collapsible corporation" as a tax avoidance device.[5] This scheme, originally used primarily by movie producers[6] and real estate builders,[7] involved forming a corporation to construct or produce a single property. Typically, the corporation's capital structure was highly levered,[8] and the shareholders contributed significant personal services to the production of the property in return for nominal compensation.[9] Consequently, production costs were often less than the loan funds obtained to finance the enterprise. Upon completion of production the shareholders distributed the excess loan funds and liquidated the

would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

"(2) Definitions.—

"(A) For the purposes of this subsection, the term 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, . . . or for the holding of stock in a corporation so formed or availed of, with a view to—

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

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

"(3) Limitations on application of subsection.—In the case of gain realized by a shareholder upon his stock in a collapsible corporation— . . .

"(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, production, or purchase. . . ."

5 See H.R. REP. No. 2319, 81st Cong., 2d Sess. 96 (1950); S. REP. No. 2375, 81st Cong., 2d Sess. 88 (1950). See also H.R. REP. No. 586, 82d Cong., 1st Sess. 25 (1951); S. REP. No. 781, 82d Cong., 1st Sess. 45 (1951).

6 *E.g.*, Pat O'Brien, 25 T.C. 376 (1955); Fred MacMurray, 21 T.C. 15 (1953).

7 S. REP. No. 2375, 81st Cong., 2d Sess. 88 (1950); see Note, *Legislative Response to the Collapsible Corporation*, 51 COLUM. L. REV. 361, 363 & n.15 (1951).

8 A high percentage of the corporate capital structure was in the form of borrowed funds. Consequently, the stockholders risked very little capital, while enjoying an opportunity to realize large gain if the project prospered. In the principal case the total paid-in capital of the stockholders was $260 on a project involving $6,000,000 in expenditures.

9 See note 2 *supra;* United States v. Ivey, 294 F.2d 799, 804 (5th Cir. 1961); Pat O'Brien, 25 T.C. 376 (1955).

corporation or sold their stock before realizing any substantial income from the property. The shareholders therefore paid only a twenty-five percent capital gains tax on earnings attributable to personal services and past and future corporate income[10] which, if the collapsible scheme were not used, would have been taxable as ordinary individual[11] and corporate income.[12]

Although use of the collapsible corporation scheme could conceivably have been curtailed by resort to existing provisions of the Code,[13] Congress chose to enact section 117(m) to deal specifically with the problem. However, in at least one important circumstance, the precise application to be given this provision was not clearly indicated by Congress. It was not apparent whether Congress intended the provision to be interpreted as applying only to situations in which the facts involved avoidance, and thus to those receipts which would be taxed as ordinary income under another form of enterprise, or to be interpreted literally as applying to the receipts resulting from the "collapse" of any corporation falling within the provision's definition of a "collapsible corporation." The alternative interpretations present more than an academic question. In a situation where a partnership is formed to produce a single property and is not deemed a "collapsible partnership,"[14] to the extent that the partners do not contribute personal services[15] and the partnership does not sell the product in the "ordinary

10 The problem of undistributed corporate income being taxed at capital gains rates is not peculiar to collapsible corporations, but exists upon the liquidation of all corporations. See Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437 (1950).

11 S. REP. No. 2375, 81st Cong., 2d Sess. 84, 88 (1950). Section 213 of the committee report dealing with collapsible corporations does not explicitly include salaries; however, § 211, dealing with property created through personal effort, states: "The amendments made by this section to Section 117 of the Code do not cover the situation in which the taxpayer contributes a copyright or similar property created through his personal efforts to a newly formed corporation in exchange for its stock and then sells the stock since such situation is dealt with in section 213 of the bill." *Id.* at 84. See generally Hewitt & Randerson, *Shareholder's Capital Gain Status No. 341 Defense; C.A.-2 Conflicts with Ivey*, 17 J. TAXATION 194 (1962).

12 The sale of stock held for more than the requisite six-month period is treated as the sale of a capital asset, providing the sale is not in the ordinary course of the stockholder's business. Int. Rev. Code of 1939, § 117(a)(1)(A) (now INT. REV. CODE OF 1954, § 1221(1)). Capital gains treatment on complete liquidation stems from the fact that liquidations are treated as sales or exchanges of stock. Int. Rev. Code of 1939, § 115(c) (now substantially INT. REV. CODE OF 1954, § 331); see Comment, *Collapsible Corporations: An Analysis of the Past, Present, and Proposed Collapsible Concepts*, 28 GEO. WASH. L. REV. 855, 858 (1960).

13 Various grounds were available to the Commissioner to challenge the transaction in the principal case under the 1939 Internal Revenue Code, such as a claim that the gain represents earned income taxable under § 22(a), that the income is allocable to the corporation under §§ 41 and 45, that the entity of the corporation is to be disregarded, or that the stock is to be held for sale in the ordinary course of the business. Of course, these grounds are available even if § 117(m) does not apply; but courts are less likely to construe them in favor of the Commissioner in light of the existence of a special collapsible corporation provision. See MacLean, *Collapsible Corporations—The Statute and Regulations*, 67 HARV. L. REV. 55, 87 (1953).

14 INT. REV. CODE OF 1954, § 751.

15 Int. Rev. Code of 1939, § 117(a)(1)(C), (now INT. REV. CODE OF 1954, § 1221(3)). This provision was passed in 1950 along with the collapsible corporation provision for

course of business,"[16] sale of the property yields a capital gain. Moreover, an individual partner's sale of his interest in the business may also escape ordinary income tax rates.[17] Thus, under the hypothesis that section 117(m) was intended to apply to all shareholders within its definition regardless of the tax consequences had they not formed a corporation, situations may arise in which a taxpayer will lose the benefit of capital gains treatment solely as a result of adopting the corporate form.

While the congressional committee reports are vague and do not reveal whether the intent of the committees was that section 117(m) be interpreted literally or that it be applied only to fact situations involving tax avoidance, the hearings before the House Committee on Ways and Means indicate that the Treasury Department was interested in having Congress draft a bill which would clearly define a "collapsible corporation"—thus a provision which could be construed literally.[18] It would appear that the objective of Congress in enacting section 117(m) was to satisfy this request, for it drafted a provision much broader in scope than would have been necessary to cover only those situations in which the taxpayer chooses the corporate form in an effort to convert ordinary income into capital gain, *i.e.*, those situations originally thought to constitute tax avoidance.

In 1958 Congress, cognizant of the difficulties encountered in the application of section 117(m), amended the provision by placing four limitations upon it;[19] it was explained that the broad wording of the provision

the purpose of removing property created through personal efforts from the capital asset category. See generally DeWind & Anthoine, *Collapsible Corporations*, 56 COLUM. L. REV. 475, 519 (1956).

16 See Int. Rev. Code of 1939, § 117(a)(1)(A) (now INT. REV. CODE OF 1954, § 1221(1)); Victory Housing No. 2 v. Commissioner, 205 F.2d 371 (10th Cir. 1953). See also Friend v. Commissioner, 198 F.2d 285 (10th Cir. 1952). However, if the partners collectively sell all of the assets of the partnership, the sale may be commuted into its fragments and ordinary income realized to the extent that the sale price represents the value held for sale by the partnership. See Watson v. Commissioner, 345 U.S. 544 (1953); Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945). *But see* Hatch's Estate v. Commissioner, 198 F.2d 26 (9th Cir. 1952). What purports to be a simultaneous sale of the individual interests of the partners is not likely to be treated differently for tax purposes. See MacLean, *supra* note 13, at 86.

17 Swiren v. Commissioner, 183 F.2d 656 (7th Cir. 1950).

18 *Hearings on the Revenue Revision of 1950 Before the House Committee on Ways and Means*, 81st Cong., 2d Sess. 140-41 (1950). Mr. Lynch, speaking for the Treasury Department, testified as follows:

"Mr. Mills: Should the legislation be specific and include definite standards, or should it be rather general and permissive of great discretion in the internal-revenue service?

"Mr. Lynch: We would not like to ask for great discretion. On the other hand, we would like to be assured that the legislation does not place in jeopardy the normal liquidation of corporations, corporations which are organized and carried on regularly to conduct a business. . . .

"Mr. Jenkins: What I am coming to: Is the relief you are asking for a change in the law, or is it an increase of personnel in order to have more inspectors so as to prevent the evasion?

"Mr. Lynch: We want the law to define what this is and not to leave it to the discretion of the Commissioner. . . ."

19 INT. REV. CODE OF 1954, § 341(e); see S. REP. No. 1983, 85th Cong., 2d Sess. 31, 32 (1958).

had defeated the original intent of Congress, which was to treat the "collapse" as if the shareholders had sold the corporate assets themselves.[20] Thus it would appear that Congress narrowed the scope of section 117(m), now section 341 of the Internal Revenue Code of 1954, to be more in keeping with coverage of those fact situations which originally were thought to constitute tax avoidance.

The circuit courts have divided on the question of whether the original provision should be interpreted literally or only with reference to elimination of avoidance. Although the 1958 amendment was inapplicable,[21] the Fifth Circuit, in *United States v. Ivey*,[22] relied on the amended provision and the Senate subcommittee reports which preceded it, basing its decision on a determination of congressional purpose and intent. The court, unwilling to construe the provision literally, refused to apply it to a situation which would have invoked capital gains treatment in the setting of a partnership or individual proprietorship. The Second Circuit, however, took the position in its decision in the principal case that section 117(m) must be construed literally.

The Supreme Court's affirmance in the principal case resolves this conflict by declaring that, because Congress intended to define what it believed to be a tax avoidance device, any corporation covered by a literal interpretation of this definition is considered to be a "collapsible corporation."[23] Indeed, the Court's decision is in keeping with what seems to have been the original objective of Congress. That purpose appears to have been the clear definition of a "collapsible corporation," notwithstanding an expression in the committee reports preceding the 1958 amendment that the provision was drafted more broadly than it should have been merely to cover those fact situations originally thought to constitute tax avoidance. Nevertheless, whatever the objective of Congress may appear to have been, it was not clearly expressed at the time section 117(m) was passed; and it would seem that, absent a clear and specific expression of purpose by an enacting Congress, the courts should interpret the provision literally.

However, there may still be an avenue of relief open to a taxpayer who finds himself burdened by a "collapsed" corporation, yet not excluded from the operation of section 341[24] by one of the limitations placed upon its application by the 1958 amendment.[25] Section 341 requires that the Commissioner show a "view" on the part of the shareholders to "collapse" the corporation prior to realizing a substantial part of the income which the produced property would yield. The courts, in defining the substantiality

20 *Ibid.*

21 Section 341(e), the 1958 amendment, was not applicable in *Ivey*, since the operative facts had taken place before its enactment. The Fifth Circuit noted that its decision was not affected by the amendment.

22 United States v. Ivey, 294 F.2d 799, 801-04 (5th Cir. 1961).

23 Principal case at 71.

24 See note 4 *supra*.

25 See note 19 *supra*. The 1958 amendment merely places four quantitative limitations upon the application of the provision.

of the "view" required, and in determining the time at which it must be formed, retain some discretion in applying this provision. In this regard, it would seem that two possible arguments are available to a taxpayer. First, courts may be persuaded that the provision is inapplicable because the intention or "view" to collapse was not substantial. Second, they may be persuaded that, although a substantial "view" did develop, it was not formed prior to completion of production; therefore it was not the requisite "view."

Although there has been some disagreement among the commentators,[26] the courts have accepted the interpretation that the words "formed or availed of principally," refer directly to "the manufacture, construction or production of property," and not to the words "with a view to."[27] Consequently, the view to "collapse" is not required to be the principal objective of the taxpayer. The regulations give "with a view to" the broadest meaning possible, requiring only that the action required in the provision be contemplated as a "recognized possibility."[28] Such an interpretation appears to be too broad. It would seem to include all corporations formed by knowledgeable enterprisers who from past experience are aware of the many possible occurrences which may give rise to a need to collapse the corporation. It appears that a fairer construction "would require that the chance of taking the action contemplated be regarded as substantial."[29]

In addition to having formed a "view" to "collapse" the corporation, the shareholder must have done so within the time period suggested by the provision. The courts and commentators have not been able to agree as to the definition of the suggested period and have proposed three different points in time: when the corporation was formed,[30] before completion of construction,[31] or any time within the three-year holding period.[32] Although adopting the first interpretation would effectuate the word "formed," it would attach little significance to the words "availed of." As long as the construction of the property is incomplete, the opportunity apparently exists to channel a portion of the taxpayer's constructive effort through the corporate device; thus the corporation may be "availed of" as a tax avoidance scheme.[33]

Adopting the third interpretation would eliminate the need for the use of the word "view." Since the "view" may be formed at any point within

26 See Altman, *Collapsible Corporations*, 28 TAXES 1013, 1015 (1950); MacLean, *supra* note 13, at 59; Note, 51 COLUM. L. REV. 361, 364 (1951).

27 Burge v. Commissioner, 253 F.2d 765, 768 n.2 (4th Cir. 1958); Honaker Drlg., Inc. v. Koehler, 190 F. Supp. 287, 292 (D. Kan. 1960); see August v. Commissioner, 267 F.2d 829 (3d Cir. 1959).

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

29 MacLean, *supra* note 26, at 60.

30 *Id.* at 61.

31 Jacobson v. Commissioner, 281 F.2d 703 (3d Cir. 1960).

32 Burge v. Commissioner, 253 F.2d 765, 768-69 (4th Cir. 1958); Glickman v. Commissioner, 256 F.2d 108 (2d Cir. 1958) (dictum).

33 See United States v. Ivey, 294 F.2d 799, 806 (5th Cir. 1961).

the three-year holding period, including the moment of collapse, in all instances the circumstances leading to collapse will be contemplated when the "view" is formed. Since Congress included the word "view" it would seem that the courts should give some effect to it.

Therefore, the logical limit on the reach of the collapsible corporation provision is the point at which the construction of the property is completed. Such an interpretation gives consideration to the use by Congress of the word "view" in the provision, without permitting the taxpayer's constructive efforts to be channeled through the unfinished property.

However, one possible argument which is no longer available to a taxpayer is that involved in *Honaker Drlg., Inc. v. Koehler*.[34] The court in *Honaker*, seizing upon the view requirement, determined that the "requisite view" is one of tax avoidance and is therefore lacking when capital gains treatment is available under another form of enterprise. This rationale is analogous to that used in *United States v. Ivey*, which was rejected by the Supreme Court in the principal case. The provision does not require that the view of the taxpayer be one of tax avoidance, but merely that it be a view to take that action which constitutes a "collapse" of the corporation. Consequently, in analyzing the view requirement, there is no longer a need to inquire into a taxpayer's tax avoidance motives in using the corporate form. He is presumed to be using the corporation for tax avoidance if the enterprise falls within the definition of section 341. Thus the rationale of *Honaker*, as well as that of *Ivey*, is overturned.

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[34] 190 F. Supp. 287 (D. Kan. 1960).