Denver Law Review

Volume 58 | Issue 3 Article 2

February 2021

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THE UNITED STATES INTERNAL REVENUE CODE SECTION 341 AND MINING CORPORATIONS

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INTRODUCTION

The application of the collapsible corporation provisions of the Internal Revenue Code[1] to mining corporations is an example of a failure to fully allow for the inherent differences between mining operations and other kinds of business ventures. As has been noted elsewhere,[2] the strict application of section 341 to mining corporations will often have the unfortunate result of causing such corporations to be treated as collapsible even though the abuses at which section 341 is directed are not present. This problem was recognized by Congress[3] and remedied to some extent with the enactment of the escape provisions of section 341(e). The problem, however, still exists.

The purposes of this article will be to describe generally the application of section 341 to mining corporations, and to provide guidance in dealing with section 341 problems. It should be noted that there has not been much of a history involving this problem, so there are often no definitive interpretational answers. A probable reason for the lack of decisions in this area is that mining ventures are not often incorporated. The individuals involved are likely to be more interested in taking individual advantage of items such as exploration and development expenditure deductions and depletion allowances than they are in such corporate advantages as flexibility, limited liability, and free transferability. Consideration of possible section 341 problems themselves may be still another strong factor discouraging the use of corporations.

Nonetheless, there will be situations calling for the use of corporations, and at such times the tax advisor must carefully consider the possible impact of section 341.

I. THE COLLAPSIBLE CORPORATION ABUSE

The abuse at which section 341 is directed can be illustrated as follows. Some individuals purchase undeveloped real estate for $100,000, and they put the real estate into a real estate development corporation in return for the corporation's stock. Next, the real estate is subdivided and fully developed. As developed, the real estate now has a fair market value of

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1. I.R.C. § 341. All references to regulations are to the Income Tax Regulations.

2. *See* Hambrick, *Collapsible Corporations in Oil and Gas: Does the 1958 Act Afford Any Relief?*, 28 GEO. WASH. L. REV. 815 (1960); Cruickshank & Tomlin, 108-2d T.M., *Oil and Gas Transactions and Subchapter C* (1950), at A-44 ff.

3. *See* S. REP. NO. 1983, 85th Cong., 2d Sess. 32 (1958).

$1,000,000. If the corporation proceeds to sell lots, the corporation will be taxed on its income from the sales at ordinary income tax rates.[4] Subsequent distributions of income to the individuals will be taxed a second time as dividends or salary. Even if the shareholders individually develop and sell lots, their gains will be ordinary income.[5]

To avoid both the ordinary income tax rates and the double taxation possibility, in the absence of section 341, the corporation might liquidate by distributing the real estate to the individuals in return for their stock. Assuming the corporation has been in existence for twelve months, the individuals now have a long-term capital gain of $900,000 under section 331(a)(1). They also obtain a basis in the real estate of the full $1,000,000, so that when they sell the lots they will not have any additional income unless the sales bring in more than $1,000,000. In effect, these individuals have converted what would have been a large amount of ordinary income into long-term capital gains.

To eliminate this conversion possibility, section 341 was enacted. In the above example, section 341 would have the effect of causing the $900,000 gain on the liquidation to be treated as ordinary income.[6] Thus, section 341 clearly eliminates the abuses at which it was aimed. As will be seen from the discussion below, however, section 341 has such wide applicability that it operates more as a bludgeon than as a scalpel.

II. General Applicability To Mining Corporations

Basically, section 341 sets forth fairly complicated rules for determining when a corporation is "collapsible," and provides that shareholder gains from disposing of their interests in a collapsible corporation will be treated as ordinary income regardless of the capital gain treatment that would otherwise be available. Because of the broad coverage of the basic definition of "collapsible corporation," Congress has provided a number of possible escape routes in section 341. It is the escape routes that create most of section 341's complexity, but without the escapes the scope of section 341 would probably be intolerable.

To make the following discussion more concrete, assume the following hypothetical fact situation. *A* has purchased a working interest entitling him to three-fourths of all the uranium extracted from Tract *X*. *B* holds the remaining one-fourth interest. Tract *X* is completely unexplored and undeveloped. To obtain funds for mining the uranium they expect to find, *A* and *B* form the Uranium Mining Corporation (Uranium), which will issue 100 shares of stock. *A* takes 45 shares in return for his interest, while *B* takes 15 shares. The remaining 40 shares are sold for $1,000 per share to *C* (20 shares), *D* (15 shares), and *E* (5 shares). *A*, *B*, *C*, *D*, and *E* are all individuals. Rich uranium deposits are located, development is completed, and ura-

4. The lots would be "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" under either I.R.C. § 1221(1) or § 1231(b)(1)(B), so that the corporation is a "dealer."

5. I.R.C. §§ 1221(1), 1231(b)(1)(B).

6. *Id.* § 341(a)(2).

nium is now being produced. The Giant Uranium Mining Corporation (Giant) now comes along and offers to buy out Uranium's shareholders at a breathtaking profit.

Assuming that none of the shareholders are dealers in uranium leases, there does not appear to be any reason why these shareholders should be denied capital gains treatment in this situation. If any of them had individually owned for twelve months, developed, and then sold the Tract *X* lease, they would clearly have been entitled to treat any gain as long-term capital gain. Thus, there would be no abuse in allowing the shareholders capital gain treatment on a sale of their stock or in a liquidation.

Section 341, however, is applied literally regardless of whether there is any apparent abuse. It has been specifically held to apply to situations, such as that described above, in which the shareholders would have had capital gains treatment if they had not incorporated.[7] In effect, then, a provision intended to prevent turning ordinary income into capital gains can come full circle and turn capital gains into ordinary income.

In analyzing whether section 341 applies to Uranium it becomes apparent that section 341 will apply to most mining corporations in which the shareholders are contemplating selling out. Section 341(b)(1) defines "collapsible corporation" as "a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of [section 341 assets], or for the holding of stock in a corporation so formed or availed of, with a view to [collapsing the corporation]." Collapsing the corporation basically consists of a disposition of stock by shareholders before the corporation realizes "a substantial part of the taxable income to be derived from such property."[8] At first blush this definition may appear to be quite broad. It is.

The phrase "formed or availed of" indicates that collapsibility does not depend on having had the proscribed purposes at the inception of the corporation. It is sufficient if the corporation is "availed of" at any time for those purposes. The fact that a corporation might have been formed with no intention of constructing or producing property will not affect the determination of whether it is later "availed of" for such purposes.[9]

"Principally" has been held to modify "the manufacture, etc."[10] At the same time, "manufacture, etc." can be interpreted to apply to nearly any kind of corporate activity. To make the definition even more all-inclusive, section 341(b)(2)(A) provides that a corporation is deemed to have manufactured, etc., property if "it engaged in the manufacture, construction, or pro-

7. Braunstein v. Commissioner, 374 U.S. 65 (1963).

8. It should be noted that this discussion is not intended to exhaustively analyze § 341. Therefore, in some cases generalizations are made, and in some cases certain of the rules of § 341 are not discussed at all. *See* Revenue Act of 1950, Pub. L. No. 64-994 § 212(a), 64 Stat. 935 (1950).

9. *See* Weil v. Commissioner, 252 F.2d 805, 806-07 (2d Cir. 1958); H. REP. NO. 2319, 81st Cong., 2d Sess. 99 (1950).

10. *See* Mintz v. Commissioner, 284 F.2d 554 (2d Cir. 1960); Burge v. Commissioner, 253 F.2d 765 (4th Cir. 1958); Weil v. Commissioner, 252 F.2d 805 (2d Cir. 1958).

duction of such property *to any extent*."[11]

Has Uranium principally engaged in any of these activities? The answer to this question illustrates the difficulty in applying section 341 to mining corporations. Such corporations ordinarily do not manufacture anything, but what about construction or production? The Internal Revenue Service has ruled that drilling dry holes or conducting unsuccessful exploration activities do not constitute "construction or production."[12] The negative implication of this ruling is that successful exploration and development activities do constitute "construction or production."[13] As a result, it appears that Uranium had engaged in construction or production as soon as any of its exploration activities revealed the existence of recoverable uranium ore.

This analysis raises a few questions in the mining area. The first question involves the fact that section 341 refers to the construction or production of "property." In the usual case it will be fairly clear whether any "property" is being constructed. For instance, in the example of the real estate developer used above it is clear that once lots have been developed or houses have been built on the lots, "property" has been constructed. Suppose, however, that the Uranium shareholders sold out the corporation after successful exploration but before any development. Where is the "property" that has been constructed or produced? To find that property has been constructed or produced the argument must be that because successful exploration activities necessarily increase the value of the relevant mineral interests, there must be some kind of "property" representing the increased value. Surely this is a case of the tail wagging the dog.

The second problem involves the question of whether the production of minerals should be treated as section 341 "production." Looking at the classic section 341 abuse in which ordinary income is converted into capital gains, it does not appear that such an abuse would normally occur in a mining corporation. In Uranium's case, any uranium recovered has most likely been sold and the twenty-two percent depletion allowance claimed. When Uranium is sold out, therefore, there will be no conversion of ordinary income unless there has been an intentional stockpiling of recovered ore. Moreover, an Internal Revenue Service ruling[14] suggests that the recovery of minerals will not be treated as "production" since that ruling holds that construction or production are completed once a producing well is completed.

The problem becomes more complex if the mining corporation engages in processing or refining the extracted minerals prior to sale. In theory, it can be argued that extraction itself is not "production" because the minerals being extracted are already in existence. Further processing, however, raises the question of whether something new is not manufactured or produced at some point. Again, it is likely that even if there is further processing, any ore

11. Emphasis supplied.

12. Rev. Rul. 64-125, 1964-1 C.B. 131.

13. Rev. Rul. 57-346, 1957-2 C.B. 236, specifically holds that the drilling and equipping of wells constitutes construction or production under § 341.

14. Rev. Rul. 64-125, 1964-1 C.B. 131.

extracted and processed will be sold rather than stockpiled so that there will not be an intent to convert ordinary income into capital gains.

Despite these underlying problems of logic or policy, it is relatively clear that Uranium will be treated as a corporation formed or availed of principally for the construction or production of property. Thus, we come to the final definitional question which is whether there is a "view" to collapse the corporation before a substantial part of the income is realized. Here again the test is difficult to avoid. In almost any case where a corporation is sold or liquidated before it has realized a substantial part of the income from its property, the "view" can and will be found to exist.[15] The key in most situations lies in showing that a substantial part of the income has been realized, since where there has not been such substantial realization there tends to be a presumption that there was a "view."[16]

When is a substantial part of the income from the property realized? It is generally accepted that realization of at least one-third of the total income to be realized is "substantial."[17] Where mining corporations are concerned, the problem is to determine what is meant by the "income to be derived from such property." This determination is relatively easy in the case of a housing project in which it can be assumed that once one-third of the houses are sold, one-third of the total possible income has been realized.

In Uranium's case, however, the first theoretical problem to resolve is to determine what the relevant income is. In the real estate example, the relevant income is clearly the income from the sale of improved lots, where the improved lots are the property that was constructed or produced. Where a mining corporation is concerned, it is not entirely clear what the property constructed or produced is, but it is clear that the income to be derived from such property cannot be anticipated income from the sale of the leases themselves.

Evidently the relevant income must be the anticipated income from the sale of minerals, even though the minerals are arguably not the section 341 "property" that was constructed or produced so that arguably such income is not "derived from such property." Uranium, then, would need to estimate the projected amount of extractable ore in order to determine whether one-third of the income from such ore has already been realized. This required estimate would usually not pose a great problem since Uranium would already need to have made such an estimate for purposes of computing its possible cost depletion.

A further problem may arise out of an argument raised by the Service in the case of *Honaker Drlg., Inc. v. Koehler*.[18] In that case, the Internal Revenue Service argued that items that had been expensed in advance[19] should be subtracted from income received in determining the percentage of total

15. *See* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 12-14, 12-15 (4th ed. 1979) (discussion of when the "view" can be avoided).

16. *Id.*

17. Rev. Rul. 72-48, 1972-1 C.B. 102.

18. 190 F. Supp. 287 (D. Kan. 1960).

19. An example of such items would be intangible drilling costs which the corporation elected to deduct currently.

expected income that had been realized.[20] Although this theory was rejected in *Honaker*, the Service may not have abandoned it.

A policy-oriented objection can be raised with regard to treating potential income from mineral sales as the income "derived from such property." If the idea of section 341 is to prevent revenue losses resulting from conversion of ordinary income into capital gains, the objection in the mining area is that in many cases there would be no revenue loss even without the application of section 341. In Uranium's case, if the shareholders sell their shares to Giant and can treat the gains as a capital gain they must then pay taxes at capital gains rates. The income "derived from such property" is still going to be derived and taxed as it would have been, except that now Giant is the taxpayer. The only way for a revenue loss to result is for Giant's available cost depletion to exceed percentage depletion, because cost depletion is only available to the extent of basis and Giant may be able to obtain a greater basis than Uranium had in the leasehold.[21] Percentage depletion, however, is available without regard to basis, and in many, if not most, cases percentage depletion will exceed cost depletion.

Nonetheless, it appears from this analysis that Uranium, and many mining corporations, will fall under the section 341 definition of "collapsible corporation." Thus, Uranium was (1) formed or availed of, (2) principally to construct and produce property, (3) with a view, (4) to collapse before a substantial part of the income from such property has been realized.

In addition to the factors discussed above, there is an excellent chance that Uranium is subject to section 341(c), which simply establishes a rebuttable presumption of collapsible status.[22] The presumption applies if (1) the fair market value of a corporation's section 341 assets equals or exceeds fifty percent of the fair market value of all of its assets, and (2) the fair market value of the section 341 assets also equals or exceeds 120% of the adjusted basis of such section 341 assets.[23] "Section 341 assets" are defined in section 341(b)(3) to include any property held for sale[24] and most property described by section 1231(b) where such property has been held for a period of less than three years.[25] Section 1231(b) defines "property used in a trade or business" and would include items such as the leasehold interests *A* and *B* put into Uranium.[26]

The reason this presumption probably applies to Uranium can be illustrated with the following example. Assume that the leasehold interests put

20. Honaker Drlg., Inc. v. Koehler, 190 F. Supp. 287 (D. Kan. 1960).

21. Giant could obtain a greater basis through application of § 342(b)(2) or by buying Uranium's assets outright, with the Uranium shareholders utilizing a § 337 liquidation. *See* I.R.C. § 611 and appropriate regulations.

22. BITTKER & EUSTICE, *supra* note 15, at 12-17. "The theory of the rebuttable presumption is that if the 'section 341 assets' are substantial in amount and have risen significantly in value above their basis, it is reasonable to place the burden of disproving collapsability on the taxpayer."

23. I.R.C. § 341(c)(A), (B).

24. "[P]roperty held by the corporation for sale to customers in the ordinary course of its trade or business." *Id.* § 341(b)(3)(B).

25. *Id.* § 1231(b). References to § 1231(b) property are used interchangeably with references to property used in a trade or business.

26. We must again assume that Uranium is not a dealer in such interests.

into Uranium by *A* and *B* had a combined basis to *A* and *B* of $60,000 when they exchanged those interests for Uranium stock, and that section 351 applied to the exchange.[27] Because of section 351, neither *A* and *B* nor Uranium recognized any gain or loss on the exchange, and Uranium's basis in the leasehold is $60,000. Next, assume that the fair market value of the leasehold is $200,000 when Giant offers to buy Uranium out. Uranium's non-section 341 assets (mining equipment,[28] and so forth) have a fair market value of $200,000. The section 341(c) presumption applies because (1) the fair market value of Uranium's section 341 assets ($200,000) equals fifty percent of the fair market value of its total assets ($400,000), and (2) the fair market value of the section 341 assets ($200,000) also exceeds 120% of its adjusted basis in such assets ($60,000).[29]

It is submitted that these tests will often be met by mining corporations. Indeed, the above example simply shows what can happen where the fair market value of a leasehold rises sharply as is likely to happen once successful exploration has occurred. Two other typical occurrences will also tend to cause the presumption to apply. One occurrence is the use of depletion allowances which will cause a decrease in the adjusted basis of the leasehold.[30] The second occurrence is the extraction of ore which will have a zero basis to the corporation, and which will also be a section 341 asset.[31]

From the above discussion, it may appear that a mining corporation is doomed to collapsible corporation treatment. Fortunately, however, section 341 provides a number of exceptions to collapsible corporation treatment.

III. SECTION 341(d) EXCEPTIONS

Section 341 generally does not apply to a shareholder who owns five percent or less of the outstanding stock of the corporation.[32] To meet this exception the shareholder must not have owned more than five percent of the stock at the time the construction or production began or at any time thereafter.[33] In addition, the exception will not apply if the shareholder's holdings can be attributed to another shareholder under the constructive ownership rules applicable under section 341(d).[34] In our basic example, only *E* will benefit from this exception, and even *E* will not benefit if *E* is related to one of the other shareholders in such a way as to cause attribution of ownership.

Section 341 also does not apply unless more than seventy percent of the

27. I.R.C. § 351. This section provides for the nonrecognition of gains or losses when property is transferred to a corporation in exchange for securities in situations where the transferor controls the corporation.

28. We must now assume that the mining equipment would be treated under I.R.C. § 341(b)(3)(D) as property described in § 1231(b), since the equipment is used to produce uranium ore. Of course, a similar argument can be made for not classifying the lease itself as a § 341 asset.

29. I.R.C. § 341(c)(A), (B).

30. *Id.* § 1016(a)(2).

31. *Id.* § 341(b)(3).

32. *Id.* § 341(d)(1).

33. *Id.*

34. *Id.*

recognized gain during a taxable year is attributable to property that was constructed or produced.[35] This exception is not likely to help in our example because virtually all of the gain to be recognized will be attributable to the constructed or produced property.

Finally, section 341(d)(3) provides that section 341 does not apply to gains realized more than three years after the completion of the construction or production. This exception is also likely to have little usefulness for the mining corporation. The Internal Revenue Service has ruled that construction or production is completed once the developmental phase is done.[36] There can be, however, problems in determining when development ends and production begins. Moreover, the typical mining corporation will be involved in a number of interests such that development on some interests is continually taking place.

IV. SECTION 341(e)

The greatest potential for Uranium's escape from section 341 treatment is found in section 341(e). If the conditions of section 341(e) are met then the following four avenues of escape from collapsible corporation treatment are available:

1. The shareholders can sell their stock and be taxed at capital gains rates.
2. The corporation will be eligible for nonrecognition of gain treatment under the twelve-month liquidation provisions of section 337.
3. The corporation can be liquidated with the shareholders' gains taxed at capital gains rates.
4. The shareholders can make use of the nonrecognition of gain treatment allowed for thirty-day liquidations under section 333.[37]

To determine whether the subsection (e) exceptions apply, it is necessary to go through some complex analysis. First, it must be determined whether the corporation in question has any "subsection (e) assets" as defined by section 341(e)(5). Generally, the presence of subsection (e) assets will reduce the possibility of obtaining relief under section 341(e). It should be noted that constructive ownership rules apply throughout subsection (e) in determining percentage of ownership.

The first kind of subsection (e) asset consists basically of property, not used in the trade or business, which could not be sold at capital gains rates either by the corporation or by a more-than-twenty-percent shareholder.[38] This category will primarily include inventory and items held for sale to customers in the ordinary course of business. The key point is that to classify an item properly one must look both to the item's status in the hands of the corporation and to the item's status in the hands of all more-than-twenty-

35. *Id.* § 341(d)(2).
36. Rev. Rul. 64-125, 1964-1 C.B. 131.
37. BITTKER & EUSTICE, *supra* note 15, at 12-22.
38. I.R.C. § 341(e)(5)(A)(i).

percent shareholders.[39] In the example of the real estate development, the improved lots would fall under this category because the corporation is holding the lots for sale to customers in the ordinary course of business.

This category of subsection (e) assets will be one of two key categories for Uranium and other mining corporations. Clearly, Uranium's major asset is its leasehold interest in Tract *X*. To determine if that leasehold is a first category subsection (e) asset we must determine whether Uranium is a dealer[40] in uranium leases and whether the lease is used in Uranium's trade or business. Uranium is not likely to be classified as a dealer where it has never sold uranium leases before. Further, Uranium is in the business of exploring, developing, and extracting minerals; so that the uranium lease is clearly used in Uranium's business.

Another question would be involved if Uranium held nonworking mineral interests. Strictly speaking, such interests are not used in Uranium's trade or business since Uranium would take no part in exploring, developing, or mining such interests other than by investing cash. These interests would nonetheless be capital assets held for investment to Uranium, so long as Uranium is not a dealer. At this point, however, we need to examine whether any more-than-twenty-percent shareholder is a dealer in such interests. If so, these interests are subsection (e) assets even though the corporation would be entitled to capital gains treatment on their sale.[41]

As will be seen in the discussion below, the question of dealer status is often crucial in determining the applicability of subsection (e).[42] Most frequently the key to resolving dealer status has been to look to the number and frequency of prior sales. In the case of Uranium and *A*, we would look then to their prior histories of sales of nonworking mineral interests. Uranium has no prior history and is therefore unlikely to be classified as a dealer. Suppose, however, that *A* has an extensive background of investing in and disposing of mineral interests. Now there is a dealer problem, even though in some cases there probably should not be.[43]

The problem arises because of the number of sales *A* has made. If we assume, however, that *A* is in the business of exploring for minerals and developing mineral interests, it can be expected that *A* will have bought and sold numerous interests. This situation differs from the real estate development example, because there the whole idea of development is to make lots salable while here the idea of development is to facilitate ore extraction. *A* may have had any number of reasons for prior sales such as the need for capital to develop retained interests, an inability to finance further operations, or an unsolicited offer so large he felt compelled to accept. Thus, the

39. Goldstein, *Section 341(d) and (e)—A Journey Into Never-Never Land*, 10 VILL. L. REV. 215, 245 (1965).

40. The term "dealer" is used to denote a person or corporation holding assets for sale to customers in the ordinary course of a trade or business.

41. Goldstein, *supra* note 39, at 245.

42. For a more detailed discussion of the dealer problem in the mineral area see Smith, *Dispositions of Oil and Gas Properties - Dealer vs. Investor*, 1965 TUL. TAX INST. 485.

43. Goldstein, *supra* note 39, at 245. *See also*, H. REP. NO. 2632, 85th Cong., 2d Sess. 23 (1958).

number of prior sales may not constitute sufficient evidence in itself for classifying *A* as a dealer.[44]

Nonetheless, where *A* has had numerous prior sales it is probable that the dealer question will be raised. If he is a dealer, then Uranium's nonworking mineral interest is a first category subsection (e) asset.

The second category of subsection (e) assets includes certain property that is used in the trade or business. As noted above, "property used in the trade or business" includes the uranium lease unless that lease is considered held for sale to customers in the ordinary course of trade or business. This property is a second category subsection (e) asset only if the unrealized depreciation on such property exceeds the unrealized appreciation on such property; or in other words, if there is a net unrealized depreciation.[45] This situation is unlikely to arise in the mining corporation.

Under the third category, if there is net unrealized appreciation in all property used in the trade or business, then any such property will be considered a subsection (e) asset to the extent that any such property would not be a capital or section 1231(b) asset in the hands of a more-than-twenty-percent shareholder.[46] This category is the second key category for most mining corporations.

As discussed above, Uranium's uranium lease was not picked up under the first category of subsection (e) assets where (1) the lease is used in Uranium's business and (2) Uranium is not a dealer in such leases, even if (3) a more-than-twenty-percent shareholder is a dealer in such leases. Under the third category, however, the lease can be a subsection (e) asset if a more-than-twenty-percent shareholder is a dealer in such leases. To make the determination, a calculation must be made of the total fair market value and total basis of all assets used in the trade or business. If basis is exceeded by fair market value then the third category applies, and every business asset must be examined to see if any more-than-twenty-percent shareholder is a dealer in such assets. If so, then such assets are subsection (e) assets even if the particular asset actually had a higher basis than fair market value.[47]

As in the first category, it can be seen that the key question is likely to be whether any more-than-twenty-percent shareholder is a dealer in uranium leases. Thus, it is probable that the fair market value of Uranium's section 1231(b) assets exceeds Uranium's basis in such assets because (1) Uranium probably has a low basis as compared to fair market value in its uranium lease, and (2) that lease is likely to represent the greatest part of Uranium's section 1231(b) assets. The fourth category of subsection (e) assets involves copyrights and the like,[48] and is not relevant to this discussion.

The conclusion is that if the corporation, a more-than-twenty-percent shareholder, or two related shareholders who together own more than twenty percent of the stock, are dealers in mineral leases then the corpora-

44. This problem is specifically discussed by Smith, *supra* note 42.
45. I.R.C. § 341(e)(5)(A)(ii).
46. *Id.* § 341(e)(5)(A)(iii).
47. *Id.*
48. *Id.* § 341(e)(5)(A)(iv).

tion's leases are subsection (e) assets. Because such leases are likely to be a mining corporation's major assets, such classification may prevent the corporation from making use of the relief provisions of subsection (e).

Generally, no relief is available under subsection (e) unless the net unrealized appreciation in the corporation's subsection (e) assets is less than fifteen percent of the corporation's net worth.[49] Thus, the problem of having a mining corporation's mineral leases classified as subsection (e) assets becomes apparent. Because the mineral leases are (1) likely to be the corporation's major assets and (2) likely to have greatly appreciated in value while the basis has been greatly reduced, then classification as subsection (e) assets makes it unlikely that subsection (e) relief can be obtained. Moreover, further rules under subsection (e) can cause problems even where there are no subsection (e) assets under the basic categories described above.

Section 341(e)(1) permits capital gains treatment on the sale of shares by a shareholder. The principal additional rule introduced under section 341(e)(1) is that in addition to computing net unrealized appreciation on the basic subsection (e) assets, if the shareholder in question is a more-than-five-percent shareholder, it is also necessary to compute the net unrealized appreciation on assets that would have been subsection (e) assets if that shareholder had been a more-than-twenty-percent shareholder.[50]

To explain, suppose that in the case of the Uranium Corporation neither the corporation nor *A* is a dealer in mineral leases, and none of the shareholders are related in a way that would bring the constructive ownership rules into play. Suppose further that the net unrealized appreciation of the uranium lease exceeds fifteen percent of the corporation's net worth. From these facts the lease is not a subsection (e) asset because the corporation and its only more-than-twenty-percent shareholder are not dealers. On a sale of shares, however, every more-than-five-percent shareholder, which includes everyone except *E*, must separately compute the net unrealized appreciation on subsection (e) assets as if such shareholder were a more-than-twenty-percent shareholder. Thus, if any of them are dealers in mineral leases, they will not be entitled to capital gains treatment on a sale of their shares. This provision applies on an individual basis, so that it is possible for some shareholders to obtain capital gains treatment while others cannot.[51]

Corporations can make use of the nonrecognition of gain on sales of property in a twelve-month liquidation[52] if the requirements of section 341(e)(4) are met. The basic requirement is that the net unrealized appreciation of the subsection (e) assets not exceed fifteen percent of net worth at any time during the twelve-month period.[53] Here we are not concerned with anyone who is not a more-than-twenty-percent shareholder. This provision, however, only deals with the tax treatment of the corporation.

To determine the tax treatment of the shareholders on receipt of liqui-

49. *Id.* § 341(e)(1)(C).
50. *Id.*
51. Goldstein, *supra* note 39, at 234.
52. I.R.C. § 337.
53. *Id.* § 341(e)(4)(A), (B).

dating distributions in a twelve-month liquidation, we need to examine section 341(e)(2). Under section 341(e)(2) we must once again consider each more-than-five-percent shareholder separately, and determine the net unrealized appreciation of basic subsection (e) assets plus the net unrealized appreciation of assets that would be subsection (e) assets if such shareholders were more-than-twenty-percent shareholders. Those shareholders meeting the fifteen-percent-of-net-worth test are entitled to capital gains treatment on receipt of liquidating distributions.[54] Here again, it is possible for some shareholders to obtain capital gains treatment on the liquidating distributions while others cannot.

Finally, section 341(e)(3) permits nonrecognition of gain treatment in thirty-day liquidations pursuant to section 333. Again the basic condition for such treatment is that the net unrealized appreciation of subsection (e) assets not exceed fifteen percent of net worth. For purposes of this provision, however, "subsection (e) asset" is defined to include all assets that would be subsection (e) assets for more-than-five-percent shareholders. In other words, here the basic definition of "subsection (e) asset" is broadened, and if one shareholder cannot obtain nonrecognition treatment none of them can.

V. WHAT TO DO

From the above analysis it is possible to reach the following generalized conclusions:

1. A typical mining corporation is likely to come under the basic section 341 definition of "collapsible corporation."
2. If a mining corporation is classified as a collapsible corporation, it must primarily look to subsection (e) for relief.
3. If the corporation or any of its more-than-twenty-percent shareholders are dealers in mineral interests, subsection (e) relief is probably unavailable.
4. If any more-than-five-percent shareholder is a dealer in mineral interests, subsection (e) relief is probably unavailable to that shareholder and thirty-day liquidation treatment is probably unavailable to any shareholder.
5. Any corporation or shareholder that has engaged in a significant number of mineral lease transactions must face the possibility that the Service will want to treat them as dealers.

What do these conclusions suggest in terms of the proposed buy out of Uranium by Giant?

First, Uranium ought to consider whether it can meet the subsection (e) requirements. If so, it is irrelevant whether Uranium is a collapsible corporation or not so long as the buy out is structured either as a stock sale or as a twelve-month liquidation in accordance with the section 341(e) rules.

The key question for this purpose will be to determine whether any of the relevant parties are dealers in uranium leases. If no one has had a significant number of prior dealings in such leases, no one should be classified as a

54. Note that this discussion only discusses the basic rules. Other requirements must be met under both §§ 341(e)(2) and 341(e)(4).

dealer. Unfortunately, it is the nature of a mining corporation that at least some of the shareholders, and the corporation itself if the corporation has been in existence a significant period of time, will have had a significant number of prior dealings.

If a dealer problem is foreseen, the next step is to make the relevant subsection (e) percentage calculations. Of course, in making the calculations there is room for planning in setting the various fair market values and determining net worth. Thus, the best evidence of fair market value of corporate assets will be the price assigned to the assets after negotiation between buyer and seller. Where the seller is a corporation disposing of its assets in a twelve-month liquidation, it is obviously to the shareholder's advantage to have most of the purchase price allocated to assets that cannot be classified as subsection (e) assets. Such an allocation serves to reduce the amount of unrealized net appreciation on such assets.

If it is determined that the subsection (e) percentage tests cannot be met, it is time to consider other defenses. The weight of such defenses must then be compared to the risk that they will fail.

The most immediate defense will be that the relevant parties should not be classified as dealers. As suggested above, this defense can be a strong one because of analytical problems involved in applying normal "dealer" principles in the mineral area.

Beyond the dealer question, it will be necessary to go back to the other section 341 exceptions and to the collapsible corporation definition to determine if there is another escape. As analyzed above, however, the other escapes will probably be of little help.

What then can Uranium do if it makes the required analysis and determines that it cannot presently escape section 341 treatment?

1. It can cease all activity that might constitute construction or production and wait three years to liquidate. This solution may be unacceptable for a number of reasons.
2. It can continue to operate until one-third of the estimated uranium ore on Tract *X* has been extracted and sold, and then liquidate. This solution is more palatable although it means that additional leases should not be acquired. Also, this plan will not work well if additional ore deposits are located on Tract *X*. There may even be a problem in determining when one-third of the income has been recognized in light of the position taken by the Service in *Honaker Drlg*.[55]
3. Uranium can go through a tax-free reorganization with Giant. The drawback here is that Uranium's shareholders may not want simply to trade their Uranium shares for Giant shares.
4. The corporation can make an election under section 341(f) which would permit the shareholders to obtain capital gains treatment on a sale of their shares.[56] There are two difficulties with this approach. First, it is often difficult in general to convince a buyer to buy stock rather than assets. Second, this difficulty is com-

55. 190 F. Supp. 287 (D. Kan. 1960).
56. I.R.C. § 341(f)(2).

pounded by the fact that a 341(f) election has been made, because the election can cause detrimental tax treatment to the subsequent buyer.[57]

5. The shareholders can sell their shares under the installment method.[58] In this way, if they are ultimately subjected to ordinary income treatment, they will at least spread out such income. Here again, however, it may be difficult to convince a buyer to buy shares, especially since he may be buying a collapsible corporation.

There are some other possibilities, but these are the major ones. As indicated, there are problems with all of the solutions such that once shareholders find themselves in a collapsible corporation situation there simply may not be a satisfactory way out. It should be noted in this connection that there is little hope of obtaining advance assurance through a private letter ruling from the Internal Revenue Service because it does not ordinarily issue rulings either as to collapsible corporation status or as to dealer status.[59]

This analysis leads to the most important point of all. There must be sound planning at the outset to determine whether a corporation should be used at all. If a partnership is used, there will obviously not be a collapsible corporation problem. There will still be a dealer problem, but the dealer problem is only exacerbated when combined with a collapsible corporation problem. Thus, when the initial decision on whether to incorporate is made, the possibility of section 341 treatment must be weighed.

Another possibility in early planning is to elect Subchapter S treatment.[60] This approach may be desirable because capital gains retain their nature when passed through to Subchapter S corporation shareholders, and section 341 does not apply to such gains. The reason early planning is called for is that under section 1378 the capital gains pass-through benefit may be severely restricted if a Subchapter S election has not been in effect for a corporation's previous three taxable years.[61] It should be noted that the regulations indicate that the Service may not allow a capital gains pass-through where a sale of the assets involved would generate ordinary income in the hands of a substantial shareholder.[62] This regulation's validity, however, is at least open to question.[63]

A final alternative where a corporation is otherwise desirable is to go ahead and use a corporation to do the actual exploration, development, and mining, but keep the mineral leases out of the corporation. In this way corporate advantages such as limited liability can be utilized, while the major assets that might trigger section 341 treatment are kept out of the corporation. Again, there will still be a dealer problem if the leases are sold, but the problem will not involve section 341 at the same time.

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57. *Id.*
58. I.R.C. § 453.
59. Rev. Proc. 80-22, 1980-26 I.R.B. 26.
60. *See* Boland, *Collapsible Corporations Under the 1958 Amendment*, 17 TAX L. REV. 203, 231 (1962).
61. I.R.C. § 1378(c)(1).
62. Treas. Reg. § 1.1375-1(d), T.D. 6432, 1960-1 C.B. 317.
63. *See* BITTKER & EUSTICE, *supra* note 15, at 6-26 n.58.

CONCLUSION

There are clearly both analytical and policy problems in applying section 341 to mining corporations. Nonetheless, it appears to be well established that section 341 will be applied to such corporations with the result of severely discouraging the use of the corporate form in many mining operations. Where use of a corporation is desirable despite section 341 risks, the best that can be done is to seek competent advance tax counseling and hope that the Service will ultimately not see fit to invoke section 341.