

Collapsible Corporations in a Nutshell

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INTRODUCTION

SECTION 331(a)(1) of the Internal Revenue Code provides that a complete liquidation of a corporation is to be treated by a shareholder as a sale of his stock, and section 334(a) provides that a shareholder's basis for property acquired on a liquidation is its fair market value at the time of distribution. These long-established rules led to the tax avoidance device known as the "collapsible corporation" with which the Treasury Department has long been concerned.¹ In 1950, Congress enacted a provision designed to deal with this form of tax avoidance,² the predecessor of section 341 of the Internal Revenue Code of 1954. This article will examine the device known as the "collapsible corporation," the manner in which section 341 has been used to prevent the conversion of ordinary income into capital gain, and the problems flowing from this provision.

As will be seen, section 341 reaches a good many corporations besides those at which it was aimed; and its application is not limited either to "temporary" corporations or to corporate liquidations.³ Although section 341 has thus come to encompass a wide

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¹ *Hearings on Revenue Revision Before the House Committee on Ways and Means*, 81st Cong., 2d Sess. 20 (1950).

² I.R.C. § 117(m) (1939).

³ See *Burge v. Comm'r*, 253 F.2d 765, 767 (4th Cir. 1958):

The word "collapsible" considered apart from its context would be somewhat misleading; but there can be no question, we think, as to what Congress meant by a "collapsible corporation" as used in [section 341]. That term was used to describe a corporation which is made use of to give the appearance of a long term investment to what is in reality a mere venture or project in manufacture, production or construction of property, with the view of making the gains from the venture or project taxable, not as ordinary income, as they should be taxed, but as long term capital gains. Because the basic type of transaction which gave rise to the legislation involved the use of temporary corporations which were dissolved and their proceeds distributed after tax avoid-

range of corporations and transactions, it can be understood best after the "classic" collapsible corporation is examined.

The collapsible corporation first attracted attention in the motion picture industry. A producer, director, and leading actors would organize a corporation for the production of a single motion picture. They would invest small amounts of cash and agree to work for modest salaries, and the corporation would finance the production with borrowed funds. When the motion picture was completed, but before it was released for public exhibition, the corporation would be liquidated. The stockholders would report the difference between the cost of their stock and the value of their proportionate shares in the completed film (established on the basis of previews) as long-term capital gain under section 331(a)(1). For example, if their investment in the stock was \$100,000 and the value of the film was \$1,100,000, the shareholders' profit would be \$1,000,000, on which the capital gains tax would be \$250,000. Under section 334(a), the basis of the film in the hands of the shareholders would be \$1,100,000; and if the net rentals received thereafter equalled that amount, they would have no further gain or loss, since the fair market value of the film could be amortized against the rentals.⁴ In effect, the exhibition profit, which would have been taxed as ordinary income to the corporation had it not been liquidated (or to the producers if they had operated in noncorporate form from the outset) was converted into capital gain. Moreover, instead of two taxes (a corporate tax on the exhibition income and an individual tax at the capital gain rate on ultimate sale or liquidation of the corporation), there would be only one.

The collapsible corporation was also used by builders and investors for the construction of homes in residential subdivisions. A corporation would be created to construct the houses, but it would be liquidated before the houses were sold. The stockholders

ance had been accomplished, the term "collapsible corporation" was employed to describe the corporations used for this form of tax avoidance; but the statute was drawn in broad general terms to reach the abuse which had arisen, whatever form it might take.

See also *Braunstein v. Comm'r*, 374 U.S. 65 (1963). Both *Burge* and *Braunstein* were decided under section 117(m) of the 1939 Code. This interpretation of section 117(m) is the basis for the broad application of section 341.

⁴ If the proceeds exceeded, or fell short of, the estimated fair market value, the shareholders would have additional income or deductible loss. In *Pat O'Brien*, 25 T.C. 376 (1955), *acq.*, 1957-1 CUM. BULL. 4, it was held that income in excess of the film's basis was taxable as ordinary income. But see *Brodsky & King, Tax Savings Through Distributions in Liquidation of Corporate Contracts*, 27 TAXES 806 (1949); *Farer, Corporate Liquidations: Transmuting Ordinary Income Into Capital Gains*, 75 HARV. L. REV. 517 (1962).

would report as long-term capital gain the difference between the cost of their stock and the value of the completed houses. The houses, which thus acquired a "stepped-up" basis under section 334(a) equal to their fair market value at the time of distribution, would then be sold, ordinarily with no further gain or loss to be accounted for. Here again, only one tax would be paid instead of two, and that one would be computed at the capital gain rate.

NONSTATUTORY WEAPONS AGAINST THE COLLAPSIBLE CORPORATION

Even without specific statutory authority, the Treasury was not entirely helpless in the face of the collapsible corporation. If the promoters receive inadequate salaries, something could be said for treating the stock of the corporation as additional compensation taxable as ordinary income. Another possibility would be to treat the whole transaction as an ineffective anticipatory assignment of income, relying on the principle of *Lucas v. Earl*⁵ that the federal income tax cannot "be escaped by anticipatory arrangements and contracts however skillfully devised." Another argument open to the Treasury was that the collapsible corporation lacks substance and that the arrangement should be taxed as a joint venture of the alleged stockholders.

So far, however, the Treasury has been unsuccessful in two efforts to attack the collapsible corporation with these nonstatutory weapons. One of these cases, *Herbert v. Riddell*,⁶ was not an entirely fair test of the cogency of the nonstatutory arguments, since the liquidation of the motion picture corporation there involved was not prearranged, but resulted from a change in plans after one film had been completed. But when the Tax Court came to pass on a collapsible corporation whose liquidation was apparently contemplated from its inception, it described *Herbert v. Riddell* as "almost identical," and similarly held for the taxpayers.⁷ While these initial set-backs would not have entirely foreclosed the development of a nonstatutory weapon against the collapsible corporation, the Treasury quite naturally shifted in 1950 to its newly enacted statutory weapon, and evidently gave up

⁵ 281 U.S. 111 (1930).

⁶ 103 F. Supp. 369 (S.D. Calif. 1952).

⁷ Pat O'Brien, 25 T.C. 376 (1955); see also *Gross v. Comm'r*, 236 F.2d 612, 618 (2d Cir. 1956), upholding the Tax Court's refusal to impute a salary to corporate officers who preferred to take their profits on a business venture in the form of capital gains distributions on their stock. For further discussion of possible nonstatutory weapons, see Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 439-48 (1950).

on pre-1950 transactions after its losses in the *Herbert* and *O'Brien* cases.⁸

THE FRAMEWORK OF SECTION 341

Although the details of section 341 are quite intricate, its basic principle is simple: a shareholder who disposes of his stock in a collapsible corporation in a transaction that would ordinarily produce long-term capital gain must instead report the gain as ordinary income. As applied to the Hollywood collapsible corporation described earlier, section 341(a) would compel the shareholders to report their \$1,000,000 gain on the corporation's complete liquidation as ordinary income, a result which may well be more costly than allowing the corporation to remain alive to realize the income from the film with a view to ultimate sale or liquidation of the corporation. If section 341(a) were applicable only to complete liquidations, however, the shareholders would be able to escape by means of one of the following devices:

1. A corporate distribution of the property without a surrender of stock, since under section 301(e)(3)(A) the excess of the value of the property over the shareholders' basis for their stock would ordinarily be taxed as long-term capital gain if the distribution occurred before the corporation had realized any earnings and profits.
2. A sale or exchange of the stock.⁹
3. A partial liquidation of the corporation, if the criteria of section 346 could be satisfied.

In recognition of the fact that the above arrangements might be used as a substitute for a complete liquidation, section 341(a) provides that gain realized by a shareholder in any of these ways shall, to the extent that it would otherwise be long-term capital gain, be considered as gain from the sale or exchange of a non-capital asset.¹⁰

⁸ But see *Jacobs v. Comm'r*, 224 F.2d 412 (9th Cir. 1955).

⁹ The new shareholders would, of course, be concerned about the corporation's low basis for its assets, but they could liquidate the corporation without tax cost since the value of the liquidating distribution would presumably be equal to the price paid for the stock. The property would thereupon take on a new basis equal to its value, either under section 334(a), or, if the buyer was a corporation, under section 334(b)(2).

¹⁰ There is a curious omission from this pattern: a distribution in redemption of stock that is treated as long-term capital gain under section 302(a). The omission, which probably stems from carrying forward the pre-1954 reference to "partial liquidations" without noting that this term in the 1954 Code no longer includes redemptions, may be neutralized by the fact that most distributions by collapsible corporations will reflect a "corporate contraction" so as to constitute partial liquidations, which are covered by section 341(a)(2). In an effort to bring distributions by collapsible corporations

Section 341(a) is applicable only if the shareholder's gain would otherwise be long-term capital gain.¹¹ The omission of short-term capital gain from section 341(a) is surprising, since it permits the collapsible corporation to retain its old advantages for the shareholder who has capital losses that can be offset against any short-term capital gain realized on the liquidation or sale.¹² Section 341(a) is also inapplicable to losses. Finally, section 341(a) applies to gain that otherwise "would be considered" as long-term capital gain, but it does not of its own force make gain taxable, with the result that it will have no effect upon a tax-free exchange of stock in a collapsible corporation (*e.g.*, under section 351 or section 1036).

Aside from the basic rules of section 341(a), the statute consists of (a) a definition of the term "collapsible corporation"; (b) a statutory presumption in aid of the definition; and (c) three sets of limitations that moderate the rules of section 341(a) in certain circumstances. These aspects of section 341 will be examined in the remaining sections of this article.¹³ Two other disadvantages of

within section 341(a)(2), the government may have to construe the term "partial liquidation" expansively, contrary to its usual position.

It is also possible that a section 302(a) redemption could be brought within section 341(a)(1), as a "sale or exchange" of stock, though this theory would be open to the objection that the regulations require an "actual" sale or exchange. Reg. Sec. 1.341-1. Moreover, it would render the inclusion of partial liquidations in section 341(a)(2) redundant, since if a section 302(a) redemption is covered by section 341(a)(1), so would be a section 346 redemption. Note, however, that the term "sale or exchange" is used in section 341(c) to include partial and complete liquidations—or at least so the regulations assume. Reg. Sec. 1.341-3(a). See also section 341(f)(1).

Prior to 1954, the statute did not explicitly reach distributions that were not accompanied by a surrender of stock, but they were held subject to the statute anyway in *Pomponio v. Commissioner*, 288 F.2d 827 (4th Cir. 1961).

¹¹ Thus, if a corporate distribution of money or property would be treated as dividend income to its shareholders under section 301, section 341 would not apply. Similarly, if the stock is not a capital asset because the shareholder holds it as "dealer property," ordinary gain would result on its sale without resort to the provisions of section 341(a).

The special earnings and profits rule of section 312(j) bears special mention in this context. Prior to the enactment of section 341 in 1950, a corporation having no earnings and profits could distribute the "excess" mortgage proceeds from government guaranteed loans and its shareholders would receive return of capital, and hence capital gain, treatment thereon. From 1950 through 1954, however, these transactions were subject to the collapsible corporation provisions of section 117(m) of the 1939 Code (the predecessor of section 341). But for years covered by the 1954 Code, such distributions are taxable as dividend income to the shareholders, since earnings and profits are specifically created for this purpose by section 312(j), thus eliminating this type of transaction from the coverage of section 341. Note that "conventional" mortgage bailouts are still subject to section 341, however, since section 312(j) applies only to federally insured mortgages.

¹² Note also that section 333 apparently could be used in this situation since the shareholders would not be subject to section 341 treatment because of the short-term holding period of their stock.

¹³ For an exhaustive examination of section 341 as amended in 1958, but prior to the

collapsible corporation status are: (a) section 337 (nonrecognition of corporate gain or loss on certain sales in conjunction with a complete liquidation) is ordinarily inapplicable to collapsible corporations; and, (b) section 333 (nonrecognition of shareholder gain on elective one month liquidations) is also ordinarily inapplicable to collapsible corporations.¹⁴

As noted earlier, the penalty of section 341 (ordinary gain treatment to shareholders of a collapsible corporation) may be more severe than if the parties had realized the entire gain at the corporate level and then liquidated their corporation at a capital gain. This results from the fact that the top bracket for individuals is 70 per cent (1966 rates), while the total effective rate if the profit is taxed once at the corporate level (as ordinary gain) and then at the shareholder level (as capital gain) would not exceed 61 per cent. This disparity may be reduced if the shareholder's gain on a sale of the stock of a collapsible corporation is reported on the installment basis under section 453, or if the averaging relief

enactment of section 341(f) in 1964, see Axelrad, *Collapsible Corporations and Collapsible Partnerships*, U. So. CAL. 1960 TAX INST. 269.

Other post-1958 discussions are: Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 COLUM. L. REV. 1146 (1958); Donaldson, *Collapsible Corporations*, 36 TAXES 777 (1958); Odell, *Collapsible Corporations—Some "Softspots" in Section 341*, 18 U. MIAMI L. REV. 645 (1964); Pelletier, *Shareholder Intent and Congressional Purpose in the Collapsible Corporation Morass*, 20 TAX L. REV. 699 (1965); Note, *Collapsible Corporations—Application to Real Estate Transactions*, 15 TAX L. REV. 121 (1959).

Earlier discussions are: Axelrad & Kostas, *A Re-Examination of Collapsible Corporations "With a View To" Coexisting with Section 341*, U. So. CAL. 1956 TAX INST. 549; Boland, *Practical Problems of the Collapsible Corporation*, PROCEEDINGS OF NEW YORK UNIVERSITY TENTH ANNUAL INSTITUTE ON FEDERAL TAXATION 537 (1952); DeWind & Anthoine, *Collapsible Corporations*, 56 COLUM. L. REV. 475 (1956); Freeman, *Collapsible Corporations*, PROCEEDINGS OF NEW YORK UNIVERSITY ELEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION 407 (1953); MacLean, *Collapsible Corporations—The Statute and Regulations*, 67 HARV. L. REV. 55 (1953); Weyher & Bolton, *Collapsible Corporations as Affected by the 1954 Code—Inventory and Unrealized Receivables*, PROCEEDINGS OF NEW YORK UNIVERSITY THIRTEENTH ANNUAL INSTITUTE ON FEDERAL TAXATION 657 (1955).

See also Dauber, *Use of Reorganization Techniques to Avoid Collapsible Treatment*, 49 A.B.A.J. 1214 (1963).

¹⁴ There are, however, certain differences in the treatment of liquidating collapsible corporations under section 337 and section 333. If a corporation is "collapsible" within the meaning of section 341(b), its assets cannot be sold tax-free under section 337, but this fact in turn cures its collapsible status by compelling realization of gain at the corporate level; see Rev. Rul. 63-125, 1963-2 CUM. BULL. 146 (and this result obtains even though its shareholders are protected from ordinary gain treatment by one of the exceptions of section 341(d)). In the case of section 333 liquidations, on the other hand, if the shareholders are protected from collapsible treatment by section 341(d), section 333 can be used, notwithstanding the collapsible character of the corporation; Rev. Rul. 63-114, 1963-1 CUM. BULL. 74. See note 40 *infra*.

of section 1301 applies. It bears noting, however, that there is no doctrine of "partial collapsibility," permitting the shareholder's gain under section 341 to be fragmented between capital gain and ordinary income depending on the "mix" of collapsible and non-collapsible assets involved; this all-or-nothing aspect of section 341 makes it difficult to settle close cases with the Service.

THE DEFINITION OF "COLLAPSIBLE CORPORATION"

The term "collapsible corporation" is defined by section 341(b) to mean a corporation that is formed or availed of:

1. Principally for the "production" of property (or for certain other activities to be discussed below);

2. With a view to (a) a sale, liquidation, or distribution before it has realized a substantial part of the taxable income to be derived from the property, and (b) a realization by the shareholders of the gain attributable to the property.

If we take the extreme case of a corporation that is organized solely to produce one motion picture and that, by agreement among the shareholders at the time of its creation, is to be liquidated as soon as the film is completed and before any income is received by the corporation, the applicability of section 341(b) is indisputable. Moreover, the use of an existing corporation for these purposes will not escape section 341(b), since it is applicable whether the corporation is "formed" or "availed of" for the specified purpose. Finally, although the collapsible corporation provisions are aimed primarily at attempts to convert untaxed corporate ordinary income into shareholder level capital gain, the Supreme Court has held that there is no implied exception in section 341 for profits that would have been taxed as capital gain if the corporate assets had been sold by the shareholders as individuals.¹⁵ Accordingly, the operation of section 341 may serve to convert what would otherwise be capital gain into ordinary income solely because of the use of a corporation, a result which was largely responsible for the adoption in 1958 of the "amnesty" of section 341(e).

¹⁵ *Braunstein v. Comm'r*, 374 U.S. 65 (1963), rejecting the restrictive theory of *Ivey v. United States*, 294 F.2d 799 (5th Cir. 1961). See also *Bailey v. United States*, 360 F.2d 113 (9th Cir. 1966), refusing to find an implied exception in section 341 for shareholders whose intent had been to liquidate the corporation in a tax-free liquidation under the 1939 Code version of section 333. (The liquidation failed to qualify for such nonrecognition, however, because of a failure to file a proper election). Prior to 1954, the "one-month" liquidation rules of section 112(b)(7) (1939) did not prohibit their use by a collapsible corporation; hence the taxpayer's argument in *Bailey* that the prohibited view did not exist because of the intent to effect a tax-free liquidation had considerable merit. See also Rev. Rul. 56-160, 1956-1 CUM. BULL. 633.

The "collapsible corporation" definition (which should be examined with a lively appreciation of the fact that the term is not confined to such classic collapsible patterns as the use of temporary corporations in the motion picture or construction industries) contains these elements:

1. *Formed or availed of.* Because section 341 reaches corporations that are either "formed" or "availed of" for the proscribed purposes, it is not confined to a corporation that is specially created for the purpose or that is dissolved as soon as the purpose has been achieved.¹⁶ Temporary corporations may be especially vulnerable, but a long life does not insure immunity.

2. *Principally for the manufacture, construction or production of property (to any extent).* Early debate on this aspect of the definition in section 341(b) centered on whether the word "principally" modified the language "manufacture, construction or production," or whether it referred only to the collapsible "view" test; if the latter was the correct interpretation, the statute would have been appreciably narrowed in scope. The regulations adopted the former construction from the outset, and courts soon agreed.¹⁷ The result of these cases is that the corporation need only be formed or availed of principally for the manufacture, etc. of property, a condition present in the case of most if not all ordinary business corporations, and the forbidden "view" need not be the principal reason for formation or use of the corporation.

Similarly, the definition of "manufacture, construction or production" has received an expansive interpretation by courts and the Service. This definition has two distinct elements: (1) whether the questioned activity itself constitutes "production"; and (2) the duration of the activity (since its duration has significance in connection with the "view" requirement, as well as in applying the three year rule of section 341(d)(3)). The earlier opinions and rulings on this question suggested that practically any corporate activity that is materially related to a property creating transaction would satisfy the statutory test,¹⁸ but the pendulum may be

¹⁶ Reg. Sec. 1.341-2(a); *Glickman v. Comm'r*, 256 F.2d 108 (2d Cir. 1958); *Burgo v. Comm'r*, 253 F.2d 765 (4th Cir. 1958).

¹⁷ Reg. Sec. 1.341-2(a)(2); *Mintz v. Comm'r*, 284 F.2d 554 (2d Cir. 1960); *Burgo v. Comm'r*, *supra* note 16; *Weil v. Comm'r*, 252 F.2d 805 (2d Cir. 1958).

¹⁸ *E.g.*: *Farber v. Comm'r*, 312 F.2d 729 (2d Cir. 1963) (filing of applications for zoning permits and mortgage guarantees, payment of fees, and payments for utility and water connections held construction); *Glickman v. Comm'r*, 256 F.2d 108 (2d Cir. 1958) (construction period extended beyond issuance of final certificate of occupancy, and included landscaping and obtaining of FHA inspector's final approval); *Sterner v. Comm'r*, 32 T.C. 1144 (1959) (hiring mortgage broker and architect, application for

swinging back to a limited extent. Thus, it has been held that the term "construction" does not include: minor alterations and corrections of an existing structure that did not change its character or increase its fair market value; the drilling of dry holes and unsuccessful exploration activities; or various preliminary activities by a real estate construction corporation.¹⁹ If the corporation goes beyond distinctly preliminary activities or mere maintenance of existing assets, however, it may be engaged in "construction"; it should not be forgotten that to do so "to any extent" suffices under section 341(b)(2)(A). Although the cases and rulings have not said so explicitly, it may be that the distinction between deductible expenses and capital outlays that has developed under section 162 and section 263 will afford a useful analogy.

It would seem that any type of property which a corporation is capable of producing will meet the requirements of the statutory definition. Although the vast majority of transactions which run afoul of section 341 involve the construction or production of tangible property (buildings, motion pictures, etc.), the creation of such intangibles as good will, secret formulas, industrial know-how, and the like, even by a service business, may also be within the reach of the section, although as yet there seem to be no reported cases in point.

3. *Purchase of "section 341 assets."* Even if the corporation does not engage in the "manufacture, construction, or production of property," it may fall within section 341 by engaging in the "purchase" of "section 341 assets," provided this is done with a "view" to a sale, liquidation, or distribution before it has realized a substantial part of the taxable income to be derived from such property. This portion of the definition was originally enacted in 1951 and expanded in 1954. It is primarily aimed at the use of collapsible corporations to convert the profit on inventory property and stock in trade into capital gain:

The procedure used was to transfer a commodity to a new or dormant corporation, the stock of which is then sold to the prospective purchaser of the commodity who would thereupon liquidate the corporation. In this manner

FHA mortgage insurance, and negotiation of sales contract held construction); *Abbott v. Comm'r*, 28 T.C. 795 (1957), *aff'd*, 258 F.2d 537 (3rd Cir. 1958) (corporation owning unimproved land held to have engaged in construction by contracting to install streets, obtaining FHA mortgage commitment, and depositing funds in escrow to insure that improvements would be installed); Rev. Rul. 56-137, 1956-1 CUM. BULL. 178 (rezoning of land from residential to commercial use held construction).

¹⁹ *Morris Cohen v. Comm'r*, 39 T.C. 886 (1963); *V. W. McPherson*, 21 COH T.C. MEM. DEC. 583 (1962); Rev. Rul. 64-125, 1964-1 CUM. BULL. 131; Rev. Rul. 63-114, 1963-1 CUM. BULL. 74.

the accretion in the value of the commodity, which in most of the actual cases was whiskey, would be converted into a gain realized on the sale of stock in a corporation, thus opening the possibility that it would be taxed as a long-term capital gain.²⁰

If the transaction described by this committee report was sufficiently blatant, the formation of the corporation and sale of its stock might be treated as a single transaction by which the taxpayer sold the property itself in the ordinary course of business, as in *Jacobs v. Commissioner*;²¹ or the repeated use of the device might lead to the conclusion that the corporate stock was held for sale to customers in the ordinary course of business, which would make the capital gain provisions inapplicable.²² It was evidently thought, however, that a statutory tool would be preferable to the "single transaction" approach of the *Jacobs case*.²³ Under section 341 as amended, every corporation holding appreciated inventory or stock in trade would be a potential target for section 341, and its fate would depend on whether the elusive "view" was present; but the regulations cut down the scope of the statute by conferring immunity on the corporation if its inventory property—more precisely, the property described in section 341(b)(3)(A) and (B)—is normal in amount and if it has a substantial prior business history involving the use of such property.²⁴

²⁰ H.R. REP. NO. 586, 82d Cong., 1st Sess. 25 (1951).

²¹ 224 F.2d 412 (9th Cir. 1955).

²² For a decision adopting this approach in an extreme case, see *Herman Katz*, 19 CCH T.C. MEM. DEC. 1035 (1960).

For other applications of the *Jacobs* approach, see *Margolis v. Comm'r*, 337 F.2d 1001 (9th Cir. 1964); *Willett v. Comm'r*, 277 F.2d 586 (6th Cir. 1960); *Thomas F. Abbott Jr.*, 23 CCH T.C. MEM. DEC. 445 (1964).

²³ The language employed by section 341(b) to reach the device described in the text is somewhat awkward; it might be argued that the corporation was not formed or availed of for the purchase of stock in trade, inventory property, or property held for sale to customers—as required by section 341(b)(3)(A) and (B)—since the whiskey in question was *not* to be sold by the corporation. The regulations, in accord with the obvious legislative intent, state that the status of the property is to be determined without regard to the collapsibility of the corporation, *i.e.*, if the whiskey would be inventory in the hands of a "normal" corporation, it will have the same status in the hands of the collapsible corporation.

For an application of section 341(b)(3) to a one shot purchase and sale of a single parcel of real estate, see *Guy A. Van Heusden*, 44 T.C. 491 (1965), *aff'd*, 66-2 U.S.T.C. ¶ 9751 (5th Cir. 1966).

On the troublesome question of "dual purpose" property, held for either investment or sale, see *Malat v. Riddell*, 383 U.S. 569 (1966).

²⁴ Reg. Sec. 1.341-5(c)(1); see also Rev. Rul. 56-244, 1956-1 CUM. BULL. 176, where inventory, though appreciated in value, was normal in amount for volume of sales and not in excess of average inventory over the preceding several years. The corporation was held not to be collapsible in that instance.

The 1951 amendment reached inventory property, stock in trade, and property held primarily for sale to customers in the ordinary course of trade or business—the categories now found in section 341(b)(3)(A) and (B). In 1954, section 341 was expanded, to reach a purchase of “unrealized receivables or fees” and certain property described in section 1231(b), by the addition of section 341(b)(3)(C) and (D). At the same time, the generic label “section 341 assets” was created for the property reached by both the 1951 and the 1954 legislation.

Although the Senate Report on the 1954 Code does not explain the extension of section 341 to cover a purchase of “unrealized receivables or fees,”²⁵ presumably Congress sought thereby to prevent an individual on the cash basis of accounting from transferring uncollected claims for services or goods to a corporation in order to sell the stock at the capital gains rate, since in the absence of a corporation the taxpayer would have to report the collections as ordinary income.

The 1954 inclusion of section 1231(b) property in the category of “section 341 assets” is less clear, since capital gain can ordinarily be realized on the sale of such property without resort to the use of a collapsible corporation. The change may have been intended to prevent dealers in apartment houses or other rental property from converting ordinary income into capital gain through the use of a separate corporation for each parcel of property. This device might have been defeated without amending section 341, by treating the corporate stock as held for sale to customers in the ordinary course of business and hence, under section 1221(1), as a non-capital asset. The remedy that was adopted by Congress, however, was more drastic; the result of treating section 1231(b) property as “section 341 assets” is that the typical real estate holding corporation, formed to purchase an apartment house or other rental property, may be collapsible if the requisite view is present, even though the shareholders are investors rather than dealers and would have been entitled to report their profit on the building as capital gain under section 1231 in the absence of a cor-

²⁵ Despite the definition of “unrealized receivables or fees” in section 341(b)(4)—or perhaps because of it—the term is most ambiguous, especially as concerns the status of rights under long term contracts. For some of the difficulties, see DeWind & Anthoine, *supra* note 13, at 496–502. Note also that the “unrealized receivables or fees” must have been “purchased” by the corporation. This implies the acquisition of a chose in action from a third party, but it is essential to the statutory purpose to include untaxed accounts receivable resulting from the corporation’s sales of its own merchandise or performance of services. *But cf.* Reg. Sec. 1.341-3(b) (accrued rents not a section 341 asset).

poration. The collapsible corporation provisions have thus come full circle: designed to prevent the transmutation of ordinary income into capital gain, they may now convert capital gain into ordinary income. In recognition of this possibility, Congress in 1958 enacted section 341(e) to provide an escape from collapsibility in cases, roughly speaking, where the taxpayers would have enjoyed capital gains had they not used the corporate form. This amendment is discussed in the text *infra* following note 48.

Another unexplained 1954 change is that the term "section 341 assets" embraces only property held for a period of less than 3 years. Because of this limitation, if a commodity is held by the corporation for 3 years or more (including the holding period of certain predecessors) after manufacture, construction, production, or purchase has been completed, the shareholders may be able to sell their stock or liquidate the corporation without running afoul of section 341(a). This escape is limited, however, by the possibility that a transfer of the property to a corporation for the sole purpose of obtaining capital gain on the sale or liquidation could be attacked as a sham without resort to section 341, as in the *Jacobs* case. Or, if the "aging" process enhanced the value of the property, it might constitute the "manufacture, construction, or production" of property, and thus prevent the running of the 3-year period.

4. *With a "view" (to "collapse")*. Since many, if not most, ordinary business corporations are formed or availed of principally for the production or purchase of property (especially since these terms are broadly defined by section 341), the major issue in a section 341(b) case is usually the existence of the requisite "view" on the part of the shareholders to effect a sale, liquidation, or distribution before the corporation has realized a substantial part of the income to be derived from its property. The classic collapsible corporation was one whose shareholders planned at the very outset to liquidate it before corporate income was realized. The regulations, however, say that section 341(b) is satisfied if a sale, liquidation, or distribution before the corporation has realized a substantial part of the gain from the property "was contemplated, unconditionally, conditionally, or as a recognized possibility."²⁶ This seems to imply that the requisite view exists whenever the controlling shareholders can reasonably foresee that they may decide to sell their stock or liquidate the corporation, if the price is "right," before it substantially realizes the income from its

²⁶ Reg. Sec. 1.341-2(a)(2).

collapsible property. If so, the "recognized possibility" test is almost all-embracing, and the courts may be unwilling to go this far, unless the shareholders are experienced professionals in the business at hand.²⁷

The regulations go on to state that the persons whose "view" is crucial are those who are in a position to determine the policies of the corporation, whether by reason of majority stock ownership or "otherwise." This approach may be hard on innocent minority shareholders, but without such a rule section 341 could be too easily avoided by keeping one shareholder in the dark. Finally, the regulations provide that the collapsible view must exist at some time during construction, production, or purchase of the collapsible property. Some courts have felt that the regulations are overly generous in this respect, asserting that the view need only be held when the corporation is "availed of" for the collapsible purpose even if production of the property has been completed by then; other decisions, however, have questioned or rejected such a broad interpretation.²⁸ In any event, determination of the time when the view arose will of necessity be difficult, involving as it does a highly subjective issue of intent, and the chronological breadth of the term "production" makes it difficult to establish that a tainted view, if it existed, did not arise until after production was completed.

It must be concluded, therefore, that the regulations bring within section 341 any corporation that is formed or availed of for the production or purchase of property if the persons in control recognize (before production is completed) the possibility of selling or liquidating the corporation at a profit before it has realized a substantial part of the income from its property (absent compelling facts to the contrary). Moreover, the natural tendency of courts and administrators to assume that what actually did happen was intended is evident in this area, so that self-serving declarations

²⁷ For a willingness to infer the tainted view in cases involving real estate operators, see *Braunstein v. Comm'r*, 305 F.2d 949 (2d Cir. 1962); *Payne v. Comm'r*, 268 F.2d 617 (5th Cir. 1959); *August v. Comm'r*, 267 F.2d 829 (3rd Cir. 1959); *Carl B. Rechner*, 30 T.C. 186 (1958); Nordberg, *Collapsible Corporations and the "View,"* 40 TAXES 372 (1962).

²⁸ Reg. Sec. 341-2(a)(3). Decisions holding or implying that the regulation is too restrictive: *Spangler v. Comm'r*, 278 F.2d 665 (4th Cir. 1960); *Sidney v. Comm'r*, 273 F.2d 928 (2d Cir. 1960); *Glickman v. Comm'r*, 256 F.2d 108 (2d Cir. 1958); *Burge v. Comm'r*, 253 F.2d 765 (4th Cir. 1958). For a view more in accord with the regulation, see *Braunstein v. Comm'r*, *supra* note 27; *Jacobson v. Comm'r*, 281 F.2d 703 (3rd Cir. 1960); *Payne v. Comm'r*, *supra* note 27; see also *Farber v. Comm'r*, 312 F.2d 720 (2d Cir. 1965); *Stanley Stahl*, 25 CCH T.C. MEM. DEC. 505 (1966).

about the shareholders' state of mind are likely to be less persuasive than the actual results. This emphasis on objective considerations is evident in section 1.341-5(b) of the regulations, which states that a corporation "ordinarily" will be considered collapsible if (a) gain attributable to property produced or purchased by the corporation is realized by the shareholder on a sale of his stock or non-dividend distribution; (b) the production or purchase of the property was a substantial corporate activity; and (c) the corporation has not realized a substantial part of the taxable income to be derived from such property.

The regulations do mention one avenue of escape: if the decision to sell, liquidate, or distribute is "attributable solely to circumstances which arose after the production or purchase . . . other than circumstances which could reasonably be anticipated at the time of production or purchase." Among the post-production motives that have been held to qualify are: illness of an active shareholder; unexpected changes in the law; dissension among the shareholders, especially if a minority interest is bought out; unexpected changes in the value of the property; and a shareholder's sudden need for funds to enter or expand another business.²⁹ This exception is less useful than might appear, however, because of the difficulty of proving that the cause of sale could not have been initially anticipated, as well as because the production process may extend well beyond normal concepts of "completion."³⁰

5. *Corporate realization of substantial part of taxable income from the property.* A corporation can escape the taint of collapsibility under section 341(b)(1)(A) by realizing a "substantial" part of the taxable income to be derived from each of its produced or purchased properties. Where such property consists of fungible units in an integrated project (*e.g.*, inventory assets of a single business, separate installments of a television or motion picture

²⁹ Reg. Sec. 1.341-2(a)(3). See Charles J. Riley, 35 T.C. 848 (1961) (illness); Maxwell Temkin, 35 T.C. 906 (1961) (same); Reg. Sec. 1.341-5(d) Ex. 3 (same); Rev. Rul. 57-575, 1957-2 CUM. BULL. 236 (sale of property to United States under statute whose enactment was not anticipated); *Comm'r v. Lowery*, 335 F.2d 680 (3d Cir. 1964) (buy out of minority shareholder who could not make additional investment); see also *Goodwin v. United States*, 320 F.2d 356 (Ct. Cl. 1963); and *Comm'r v. Solow*, 333 F.2d 76 (2d Cir. 1964), for similar decisions; *Jacobson v. Comm'r*, 281 F.2d 703 (3rd Cir. 1960), *aff'd*, 374 U.S. 65 (1963) (change in property's value); *Southwest Properties, Inc.*, 38 T.C. 97 (1962) (same); *Morris Cohen*, 39 T.C. 886 (1963) (same); but see *Braunstein v. Comm'r*, 305 F.2d 949 (2d Cir. 1962), *aff'd*, 374 U.S. 65 (1963) (change in value not controlling); *Jack Saltzman*, 22 COH T.C. MEM. DEC. 336 (1963) (need for funds); *Stanley Stahl*, *supra* note 28 (sale compelled by economic and business factors beyond taxpayer's control).

³⁰ See *Carl Rechner*, 30 T.C. 186 (1958); *Sproul Realty Co.*, 38 T.C. 844 (1962).

series, or individual units in a housing project), the determination of substantial realization is to be made by treating the aggregate of these properties as a single unit. Thus, if a corporation constructs two office buildings, the sale of one building will not protect it from collapsible treatment caused by the second building; on the other hand, if it is engaged in constructing a housing project, the entire project would constitute a "single property" for substantial realization purposes.³¹

Apparently the "taxable income to be derived from the property" means the taxable income that would be realized if the property were sold at the time the shareholder's gain arises.³² This test seems appropriate in the case of property held only for sale (*e.g.*, inventory or residential home units); but where rental property is involved, some courts require an estimate of the projected net rental income to be realized over the economic life of the property, a yardstick which is considerably more difficult to apply.³³ In addition, the fact that the property has produced no net income or is losing money has not precluded a finding of collapsibility where the prohibited view was present.³⁴ In any event, income which has been realized must be attributable to the collapsible property in order to count towards the substantial realization test.

Once the estimated potential taxable income from the property is determined, the question then arises as to what percentage thereof will be "substantial." Although a determination of this amount would at best represent an *ad hoc* judgment, the issue is complicated by a question of statutory interpretation: is collapsibility avoided if a "substantial" part of the potential is realized, or must enough be realized so that the unrealized part is *not* substantial? To illustrate: if 30 per cent of the total is "substantial," must more than 70 per cent be realized, or will 30 per cent suffice? In *Commissioner v. Kelly*,³⁵ the Court of Appeals for the Fifth Circuit held that a realization of about one-third of the potential

³¹ Reg. Sec. 1.341-2(a)(4) and Reg. Sec. 1.341-5(d) Exs. 2, 3 and 4; *but cf.* section 341(d)(2) and Reg. Sec. 1.341-4(e)(3) (recomputation under 70-30 per cent rule).

³² See *Comm'r v. Kelly*, 293 F.2d 904 (5th Cir. 1961); *Levenson v. United States*, 157 F. Supp. 244 (D. Ala. 1957). See Ryan, *What is Substantial Part of the Taxable Income*, 16 J. TAXATION 246 (1961).

³³ *Mintz v. Comm'r*, 284 F.2d 554 (2d Cir. 1960); *Sidney v. Comm'r*, 273 F.2d 928 (2d Cir. 1960); *Payne v. Comm'r*, 268 F.2d 617 (5th Cir. 1959). The *Mintz* and *Sidney* cases also held that premiums received from a lender with which an FHA mortgage was placed were not part of the net income "to be derived from such property."

³⁴ *Short v. Comm'r*, 302 F.2d 120 (4th Cir. 1962); *Spangler v. Comm'r*, 278 F.2d 665 (4th Cir. 1960).

³⁵ 293 F.2d 904 (5th Cir. 1961).

taxable income was sufficient, a result that seriously impairs the effectiveness of section 341 but finds support in the statutory language. The Court of Appeals for the Third Circuit, by contrast, has upheld the Service's insistence that the corporation is collapsible if there is a substantial amount of *unrealized* income.³⁶

6. *Realization by shareholders of gain attributable to the property.* This last element of the collapsible definition has generated relatively few problems, since, if the other elements are present, it will be satisfied almost automatically if the collapsible property has appreciated in value at the time of collapse.³⁷ Problems in determining whether the shareholder's gain is "attributable to such property" are discussed in the text *infra* at note 42, in connection with the 70 per cent exception of section 341(d)(2).

7. *Additional considerations.* To safeguard its statutory purpose, section 341 provides that a corporation "shall be deemed to have manufactured, constructed, produced, or purchased property" if any of the following conditions are satisfied:

(a) If the corporation engages in manufacture, construction, or production of property "to any extent." By virtue of this provision, the corporation need not have originated or completed the process of manufacture, construction, or production; any contribution to the process is sufficient.

(b) If the corporation holds property having a basis determined by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased it. This provision reaches such devices as the transfer of manufactured property or "section 341 assets" to a corporation by a tax-free exchange under section 351, or the use of a second corporation into which a collapsible corporation is merged.

³⁶ *Abbott v. Comm'r*, 258 F.2d 537 (3d Cir. 1958). See also *Comm'r v. Zongker*, 334 F.2d 44 (10th Cir. 1964) (amount realized, not the amount unrealized, is controlling; the Tax Court had intimated that realization of 24 per cent of potential would suffice); *Heft v. Comm'r*, 294 F.2d 795 (4th Cir. 1961) (17 per cent not "substantial"; later distributions in liquidation subjected to section 341 even though 51 per cent had been realized by then).

The regulations, section 1.341-5(c)(2), are inconclusive on this point, merely stating that a corporation ordinarily will not be deemed collapsible if its unrealized income is not substantial in amount. It is understood that the Service will rule favorably on the status of collapsibility if 85 per cent of the income from collapsible property has been realized. See also Rev. Rul. 62-12, 1962-1 CUM. BULL. 321 (*Abbott* approach).

In theory, the amount *actually* realized is irrelevant, and the amount which the shareholders *intended* the corporation to realize is controlling. But this would make the corporation collapsible even if all the income had in fact been realized by it, provided the shareholders had earlier entertained the "view" that the income should not be realized by the corporation. The regulations, perhaps treating the events as they occur as the best evidence of what was intended, clearly imply that actual—rather than intended—realization is controlling. Reg. Sec. 1.341-2(a)(4) and Reg. Sec. 1.341-5(c)(2). *But see Payne v. Comm'r*, 268 F.2d 617 (5th Cir. 1959).

³⁷ See, for example, *Payne v. Comm'r*, *supra* note 36 (shareholder's view to collapse and realization of gain attributable to collapsible property go hand in hand).

The statute does not state whether the successor corporation inherits not only the collapsible property, but also the transferor's "view."

(c) If the corporation holds property having a basis determined by reference to the cost of property manufactured, constructed, produced, or purchased by it. This provision is designed to prevent an escape from section 341 by a plan under which the corporation would manufacture property and transfer it in a tax-free exchange (*e.g.*, under section 1031), following which the shareholders would liquidate the corporation or sell their stock before the corporation had realized income from the newly acquired property.

A further buttress to section 341 is the inclusion of holding companies in the term "collapsible corporation." If a corporation is employed to hold the stock of a manufacturing corporation, the parent corporation will be a "collapsible corporation" by virtue of section 341(b)(1) if it is formed or availed of with a "view" to a sale, liquidation, or distribution before the manufacturing corporation has realized a substantial part of the taxable income from the property. In Revenue Ruling 56-50³⁸ it was held that the holding company becomes noncollapsible (so as to protect its shareholders) if it sells the stock of the subsidiary and is taxed under section 341(a) on its gain, notwithstanding some difficulty in bringing this result within the literal terms of the statute.

THE REBUTTABLE PRESUMPTION OF COLLAPSIBILITY: SECTION 341(c)

In 1954, section 341 was amended to add a rebuttable presumption of collapsibility if the fair market value of the corporation's "section 341 assets" is (a) 50 per cent or more of the fair market value of its total assets and (b) 120 per cent or more of the adjusted basis of such "section 341 assets." 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 collapsibility on the taxpayer.³⁹ In order to prevent manipulation, section

³⁸ 1956-1 CUM. BULL. 174. See generally, Del Cotto, *The Holding Company As A Collapsible Corporation Under Section 341 Of The Internal Revenue Code*, 15 BUFFALO L. REV. 524 (1966).

³⁹ Even without the presumption of section 341(c), the taxpayer has the burden of overcoming the presumption of correctness that accompanies the Commissioner's action in assessing a deficiency. What weight, if any, section 341(c) adds to this nonstatutory presumption is doubtful. Perhaps it is only "a handkerchief thrown over something covered by a blanket," as Randolph Paul said of an analogous statutory presumption in the federal estate tax law. PAUL, *FEDERAL ESTATE AND GIFT TAXATION* 92 (1946 Supp.).

But note that application of the presumption in section 341(c) will probably serve to poison the atmosphere of the taxpayer's case, and, to this extent, it may occupy a significant role. See, *e.g.*, Max Tobias, 40 T.C. 84 (1963).

341(c)(2) provides that cash, stock, and certain securities are to be disregarded in determining the corporation's "total assets"; otherwise, the shareholders of a corporation whose "section 341 assets" have appreciated substantially in value might attempt to avoid the statutory presumption by contributing liquid assets to the corporation's capital to dilute the "section 341 assets" to less than 50 per cent of the total assets. Perhaps the "business purpose" doctrine could be used by the Commissioner as an alternative weapon against an attempt to drown the corporation's "section 341 assets" in a sea of other assets by contributions to capital having no nontax purpose.

In applying the presumption of section 341(c), the appreciation in "section 341 assets" is measured against their basis, not against the shareholders' investment. Thus, if the shareholders invest \$15,000 in a corporation, and it constructs "section 341 assets" at a cost of \$100,000 (represented by \$15,000 of equity investment and \$85,000 of borrowed funds), the presumption of section 341(c) will not be applicable if the assets increase in value to only \$115,000 (this being less than 120 per cent of their basis), even though the appreciation (\$15,000) represents a profit of 100 per cent on the shareholders' investment. If the assets increased in value to \$120,000, however, section 341(c) would become applicable; and this would be true even if the shareholders had financed the entire cost of construction (\$100,000) with their own funds and had enjoyed a gain of only 20 per cent on their investment.

Since the presumption of section 341(c) is rebuttable, it is open to the taxpayer to establish that the corporation is not "collapsible" because it was not formed or availed of principally for the purposes set out in section 341(b) or because the requisite "view" did not exist. Section 341(c) also provides that its inapplicability shall not give rise to a presumption that the corporation is *not* a collapsible corporation.

THE STATUTORY LIMITATIONS OF SECTION 341(d)

Even though the corporation is "collapsible" under the foregoing principles, section 341(d) makes the punitive rules of section 341 inapplicable to a particular shareholder⁴⁰ if any of the following three conditions are satisfied:

⁴⁰ Section 341(d) provides relief for the shareholder *only*; the corporation remains collapsible as respects such provisions as section 337(c)(1) (nonapplicability of section 337). Rev. Rul. 63-125, 1963-2 CUM. BULL. 146. On the other hand, section 333 can be used by shareholders who are protected from collapsible treatment by section 341(d). Rev. Rul. 63-114, 1963-1 CUM. BULL. 74.

1. *Not more than 5 per cent of stock.* The shareholder is not subject to section 341 unless he owns (a) more than 5 per cent in value of the outstanding stock, or (b) stock that is attributed to another shareholder who owns more than 5 per cent of the stock. The ownership of stock is to be determined under a set of constructive ownership rules,⁴¹ and the specified amount of stock will be fatal if owned when the manufacture, construction, or production of property is begun, when "section 341 assets" are purchased, or at any time thereafter.

2. *Not more than 70 per cent of gain attributable to collapsible property.* Section 341(d)(2) insulates a shareholder's gain on the sale, liquidation, or distribution from collapsible treatment if 70 per cent (or less) of that gain is attributable to the collapsible property. Thus, if 30 per cent or more of his gain can be traced to noncollapsible property, the entire gain will qualify for capital treatment even though the corporation is collapsible.⁴² In computing the gain attributable to the collapsible property for this purpose, the regulations, section 1.341-4(c)(2), adopt a "but for" approach, *i.e.*, it is the excess of the gain recognized by the shareholder over the gain that he would have recognized if the collapsible property had not been produced or purchased. (In the case of a partial liquidation or nonliquidating distribution, this approach must be refined by taking account of the result that would have been reached on a complete liquidation.) It is important to note that income realized by the corporation in respect of its collapsible property remains attributable to such property under the regulations, and thus counts against the shareholder in apply-

⁴¹ The constructive ownership rules applicable to personal holding companies, section 544, are adopted for this purpose, except that the definition of "family" is expanded to include brothers and sisters, and their spouses.

⁴² The 70 per cent rule of section 341(d)(2), which is concerned with the shareholder's gain, should not be confused with the "substantial realization" element of the definition of "collapsible corporation," which is applied solely at the corporate level. A realization of 30 per cent of its potential collapsible income will free the corporation from collapsibility entirely (under the theory of *Comm'r v. Kelly*, 293 F.2d 904 (5th Cir. 1961)), but the shareholder of a corporation that has realized *none* of the income potential from its collapsible property may still escape under section 341(d)(2) if 30 per cent or more of *his* gain is attributable to noncollapsible property.

Nor should the 70 per cent rule be confused with the three-year rule of section 341(d)(3). The fact that the collapsible property has been held by the corporation for more than three years after construction is completed immunizes the shareholder's gain under section 341(d)(3); but if the shareholder is forced to rely on section 341(d)(2), the gain from such a project goes into the collapsible portion of his gain. Rev. Rul. 65-184, 1965-2 CUM. BULL. 91.

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

ing the 70 per cent rule, unless enough of the potential income is realized at the corporate level to make the property noncollapsible. Thus, if the corporation constructs two separate projects, and satisfies the "substantial realization" rule of section 341(b)(1) as to one but not the other, all of the shareholder's gain that is attributable to the former project goes into the noncollapsible fraction in applying section 341(d)(2), while all of his gain attributable to the latter project (reflecting the corporation's realized as well as its unrealized gain) goes into the collapsible fraction. An unintended side effect of the 70-30 per cent rule of section 341(d)(2) is to encourage the retention of corporate income derived from noncollapsible property; in the case of the two project corporation just described, a distribution by the corporation of its profits on the noncollapsible property will make it more difficult for the shareholder to meet the standard of section 341(d)(2) on selling his stock or liquidating the corporation.⁴³

Under the cases and regulations, gain realized by the shareholder is allocated to the collapsible share even if it is only indirectly attributable to the collapsible property. Thus, in the case of real estate improvements, an increase in the value of the land resulting from a building project is treated as "collapsible" gain, as well as the gain on the improvements themselves; and the same is true of an increase in the value of undeveloped land if attributable to improvements constructed on the developed portion.⁴⁴ Similarly, an increase in land value attributable to off site improvements and a refund from a building contractor have been placed on the collapsible side of the equation.⁴⁵

⁴³ See example 2 of section 1.341-5(d) of the regulations, where the shareholder would have been saved from collapsible treatment had the corporation accumulated its profits from the realized project rather than distributing them as a dividend.

Another method of diluting the tainted portion of the shareholder's gain would be to make capital contributions of appreciated noncollapsible assets (*e.g.*, securities). Such an attempt to shelter collapsible activities by contributing "pure" assets to the corporation may be vulnerable to the business purpose doctrine, although mere tax avoidance, while often evoking judicial hostility, is not enough *per se* to vitiate a transaction which otherwise has legal and economic substance. For a useful analogy on this point, see *W.H.B. Simpson*, 43 T.C. 900 (1965); see also section 341(o)(7), discussed in the text at note 50 *infra*.

⁴⁴ Reg. Sec. 1.341-4(c)(3); *Short v. Comm'r*, 302 F.2d 120 (4th Cir. 1962); *Mintz v. Comm'r*, 284 F.2d 554 (2d Cir. 1960); *Payne v. Comm'r*, 268 F.2d 617 (5th Cir. 1959); *August v. Comm'r*, 267 F.2d 829 (3rd Cir. 1959); *Glickman v. Comm'r*, 256 F.2d 108 (2d Cir. 1958).

⁴⁵ *Spangler v. Comm'r*, 278 F.2d 665 (4th Cir. 1960). See generally *Farber v. Comm'r*, 312 F.2d 729 (2d Cir. 1963); *Chodorow & De Castro*, *How to Use the "70-30" Exception to Avoid Collapsible Corporation Treatment*, 21 J. TAXATION 258 (1964).

3. *Gain realized after expiration of 3 years.* Ordinary gain treatment may be avoided by a shareholder if the gain on his collapsible corporation stock is realized more than three years after completion by the corporation⁴⁶ of production or purchase of collapsible property. (The shareholder's holding period for his *stock* is irrelevant; section 341(d)(3) is concerned only with the corporation's holding period for the property.) Although the statute is not crystal clear on this point, it is not necessary for all of the corporation's collapsible property to be held for three years to bring section 341(d)(3) into play; part of the shareholder's gain may qualify for relief under section 341(d)(3) even though the balance is taxable as ordinary income because attributable to collapsible property held for less than three years.⁴⁷

Because the terms "manufacture, construction, and production" have been given such an expansive meaning, the 3-year rule of section 341(d)(3) is a treacherous exception: the waiting period commences only on "completion"—not partial or substantial completion—of the productive process. Moreover, production of "the" property must be completed; if the corporation is engaged in multi-unit construction activities, it may be difficult to say whether there is only a single project, on which work is continuing, or several projects, one or more of which have been completed.

Hopes have sometimes been built on the fact that section 341(d)(3) speaks of gain "realized" after the 3-year period, since this term suggests that a sale of stock on the installment plan or a complete liquidation that is stretched out over a period of time will postpone the date of "realization," at least as to the shareholder's later receipts. The Internal Revenue Service has ruled that gain is realized when stock is sold, rather than when the payments are received, if the shareholder elects under section 453 to report on the installment method,⁴⁸ but the taxpayer's case would be stronger if he does not rely on such an election (*e.g.*, a cash basis taxpayer's sale of stock on a deferred payment plan if he does not receive negotiable promissory notes or other evidences of indebtedness). If the shareholder's gain or loss on a sale or liquidation cannot be computed because a fair market value cannot be assigned to the

⁴⁶ In Rev. Rul. 57-491, 1957-2 CUM. BULL. 232, it was held that the 3-year period of section 341(d)(3) includes the holding period of certain predecessors.

⁴⁷ Reg. Sec. 1.341-4(d). The balance of the gain might qualify under section 341(d)(2), but in applying the 70-30 per cent rule, the gain on the three year property is counted against the shareholder (see note 42 *supra*).

⁴⁸ Rev. Rul. 60-68, 1960-1 CUM. BULL. 151.

property received, his gain is probably not "realized" in applying section 341(d)(3) until it can be computed; but such "open" transactions are rarely encountered. Note, however, that if the Commissioner argues that distribution of potential corporate income rights is a "realization" to the shareholders for purposes of section 341(d)(3), taxpayers then could argue that "realization" of the income potential in those rights also had occurred at the corporate level, which fact could serve to cure collapsible status under the basic definition of section 341(b)(1).

THE AMNESTY OF SECTION 341(e)

Section 341(e), enacted in 1958, ameliorates the rigors of the collapsible corporation provisions in four respects:

1. *Sale or exchange of stock.* If certain conditions are satisfied, a shareholder's gain on the sale or exchange of the stock of an otherwise collapsible corporation is exempted from section 341(a)(1), and hence will be taxed as long-term capital gain.

2. *Complete liquidation.* In certain circumstances, a shareholder's gain on the complete liquidation of an otherwise collapsible corporation is exempted from section 341(a)(2), and hence will be taxed as long-term capital gain.

3. *Eligibility for section 333.* Certain otherwise collapsible corporations are made eligible for the benefits of section 333 (elective nonrecognition of shareholder gain on one month liquidations).

4. *Eligibility for section 337.* Certain otherwise collapsible corporations are made subject to section 337 (nonrecognition of corporate gain or loss on sales within a 12-month period following adoption of plan of complete liquidation).

The exemptions described in categories 1 and 2 above are granted on an individual shareholder basis. Thus, some shareholders of a corporation may qualify while others do not. The exemptions of categories 3 and 4, however, are granted to the corporation itself. Section 341(e), it will be noted, does not apply to gain realized on a partial liquidation or on a distribution in excess of the basis of stock; these transactions continue subject to the unabated vigor of section 341(a)(2) and (3).

Section 341(e) is intended solely as a relief measure: it establishes a zone of safety, and any shareholder who can bring himself within this zone is protected against the collapsible corporation provisions, regardless of the nature of the corporation. Section 341(e)(11) also provides that the failure to meet its requirements shall not be taken into account in determining whether a corporation is a collapsible corporation under the statutory definition of

section 341(b), and that this determination shall be made as if section 341(e) had not been enacted.

The provisions of section 341(e) were thought necessary largely because of the 1954 changes in section 341, under which a corporation formed or availed of to purchase rental property (*e.g.*, an apartment house) may be a collapsible corporation by virtue of section 341(b)(3)(D), although the shareholders could in the alternative have acquired the property as individuals and reported their gain on a sale as long-term capital gain unless they were dealers in such property.⁴⁹ It is perilous to summarize the fearfully intricate conditions of section 341(e), but its underlying theory is that the collapsible corporation provisions should not be applicable if the net unrealized appreciation in the corporation's "subsection (e) assets" (roughly speaking, property held by the corporation which would produce ordinary income if sold by the corporation itself or by its principal shareholders) amounts to less than 15 per cent of the corporation's net worth.⁵⁰ This theory is applied with important variations to each of the four events listed above.

Before turning to these conditions and variations, we must first examine the term "subsection (e) assets," a new phrase employed throughout section 341(e) as the means of determining if there has been a significant appreciation in the value of the corporation's ordinary income assets. This term is defined by section 341(e)(5)-(A) to include the following categories of property held by the corporation:

1. *Property not used in the trade or business.* Any such property is a

⁴⁹ In *Braunstein v. Commissioner*, 374 U.S. 65 (1963), the Supreme Court refused to provide a *judicial* escape for property that would have constituted a capital asset in the shareholders' hands, but this decision came after the enactment of section 341(e) and relied in part on the existence of this *statutory* escape.

For a special problem in the determination of "a substantial part of the taxable income to be derived from such property" as it arises in the oil and gas business, which may have contributed to the enactment of section 341(e), see *Honaker Drlg., Inc. v. Koehler*, 190 F. Supp. 287 (D. Kan. 1960); *Hambriek, Collapsible Corporations in Oil and Gas: Does the 1958 Act Afford Any Relief?*, 28 GEO. WASH. L. REV. 815 (1960).

Section 341(e) is discussed in Boland, *Collapsible Corporations Under the 1958 Amendments*, 17 TAX L. REV. 203 (1962); Goldstein, *supra* note 42.

⁵⁰ The terms "net unrealized appreciation" and "net worth" are defined by section 341(e)(6) and (7). In computing the corporation's "net worth," section 341(e)(7) provides for the exclusion of increases in net worth during the preceding one-year period resulting from transfers for stock or as contributions to capital or 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." Compare the handling of a similar problem under section 341(c)(2).

“subsection (e) asset” if the corporation’s gain on a sale would be taxed as ordinary income—*i.e.*, if the property is neither a capital asset nor section 1231(b) property. Moreover—and this is section 341(e)’s unique innovation—property held by the corporation is brought into this category *if in the hands of any shareholder owning (directly or constructively)*⁵¹ *more than 20 per cent in value of the corporation’s stock* it would not be a capital asset or section 1231(b) property. Thus, property held by the corporation constitutes a “subsection (e) asset” if it is stock in trade, inventory property, or property held for sale to customers in the ordinary course of trade or business in the hands of the corporation, or *if it would have this status were it held by any shareholder owning more than 20 per cent of the corporation’s stock*. In other words, if any shareholder who holds more than 20 per cent of the outstanding stock is a dealer,⁵² his status taints the corporation’s property.

2. *Property used in the trade or business—net unrealized depreciation.* If there is a net unrealized depreciation on assets used in the trade or business, they constitute “subsection (e) assets.”⁵³

3. *Property used in the trade or business—net unrealized appreciation.* If there is a net unrealized appreciation on such assets, they constitute “subsection (e) assets” if they would be neither capital assets nor section 1231(b) assets in the hands of a more-than-20-per cent shareholder. This provision is crucial to the purpose of section 341(e). If a corporation’s sole property is an apartment house or other rental property that has appreciated in value, the property will constitute a “subsection (e) asset” only if a more-than-20-per cent shareholder is a dealer in such property.

Although the status of short term trade or business property is not entirely clear, it would seem that it constitutes a “subsection (e) asset”; in the case of trade or business property with a “split” holding period (*i.e.*, property held for more than 6 months with improvements or additions held for six months or less), the property evidently constitutes a “subsec-

⁵¹ Throughout section 341(e), constructive ownership rules are applicable. See section 341(e)(8) and (10). Note also Reg. Sec. 1.341-6(a)(4) stating that dealer status of a more than 20 per cent *constructive* shareholder will be attributed to the corporation in determining whether its property constitutes “subsection (e) assets.”

⁵² The term “dealer” is not used in the statute; it is employed here and in the text to denote a person who would treat gain from the sale or exchange of the property as in whole or in part gain from a noncapital and non-section 1231(b) asset.

On the status of “dual purpose” property, held for investment or sale, see *Malat v. Riddell*, 383 U.S. 569 (1966).

See Reg. Sec. 1.341-6(b)(4) stating that if a corporation holds property *similar* to that held by a more than 20 per cent shareholder-dealer, such property will constitute dealer property in the hands of the corporation (“segregation” is allowed, however, by Reg. Sec. 1.341-6(b)(5) in the case of corporate securities).

⁵³ The Senate Report on section 341(e), S. REP. No. 1983, 85th Cong., 2d Sess. (1958), does not state why depreciated property used in the trade or business is included if there is net unrealized depreciation in such assets. Since such assets would ordinarily qualify for the hotchpot of section 1231(b), and give rise to ordinary losses if the net result of the hotchpot were a loss, it may have been thought appropriate to include them in the section 341(e) calculation in order to counterbalance appreciation in inventory and similar property.

tion (e) asset" in its entirety, but only the short-term gain is taken into account in computing "net unrealized appreciation."⁵⁴

4. *Copyrights and similar property.* A copyright, literary composition, or similar property is a "subsection (e) asset" if it was created in whole or in part by the personal efforts of an individual owning directly or constructively more than 5 per cent of the corporation's stock. By virtue of this provision, a motion picture will be a "subsection (e) asset" if created by the personal efforts of a more-than-5-per cent shareholder.

The function of the new category of "subsection (e) assets" is to permit a determination of whether there has been a significant increase in the value of the assets which would produce ordinary income upon sale by either the corporation or a more-than-20-per cent shareholder,⁵⁵ since in the absence of such an increase in the value of the ordinary income assets, there is to be relief from the collapsible corporation restrictions. As stated earlier, however, this test is applied with variations to each of the four situations to which section 341(e) is applicable, and we now turn to these variations.

1. *Sale or exchange of stock.* Section 341(e)(1) makes section 341(a)(1) inapplicable to a sale or exchange of stock if the net unrealized appreciation in the corporation's "subsection (e) assets" does not exceed 15 per cent of the corporation's net worth and if the shareholder does not own more than 5 per cent of the corporation's stock.⁵⁶ If the shareholder owns between 5 and 20 per cent of the stock, a similar calculation is made, but it must take into account not only the corporation's "subsection (e) assets" but also any corporate assets which would produce ordinary income if held by the particular shareholder for whom the calculation is made.⁵⁷ And if the shareholder owns more than 20 per cent of the stock, *his* calculation must also take into account any corporate assets which would have produced ordinary income (a) if he owned them and (b) *if he had held in his individual capacity the property of certain other corporations of which he owned more than 20 per cent of the stock in the preceding 3 years.*⁵⁸

Thus, the corporate assets will be tainted by the dealer status of any shareholder owning more than 20 per cent of the stock of the

⁵⁴ See sections 341(e)(6)(D) and 341(e)(9).

⁵⁵ Five per cent in the case of a copyright, literary composition, or similar property.

⁵⁶ Such a shareholder might find it simpler to take refuge in section 341(d)(1), which makes section 341(a) inapplicable to certain not-more-than-5-per cent shareholders, but that sanctuary is closed to a shareholder who owned more than 5 per cent of the stock at any time after manufacturer, etc., commenced, as well as to a shareholder (*c.g.*, an estate or trust) whose shares are attributed to a more-than-5-per cent shareholder. Section 341(e)(1) is not quite so exclusive.

⁵⁷ I.R.C. § 341(e)(1)(B).

⁵⁸ I.R.C. § 341(e)(1)(C).

corporation—and this “taint” will affect all shareholders of the corporation, regardless of the size of their shareholdings. In addition, a shareholder owning more than 5 per cent of the stock must take into account any other corporate assets which would be ordinary income assets if he held them in his personal capacity—but this “taint” will affect only him. Finally, as to a more-than-20-per cent shareholder, any corporate assets will be tainted by the hypothetical dealer status he would have attained if he had engaged in certain transactions as an individual rather than in corporate form, during the preceding 3 years.

The net result of these extraordinary statutory gyrations is that profit on the sale of stock of an otherwise collapsible corporation will qualify as long-term capital gain unless the assets of the corporation reflect a significant amount of unrealized ordinary income—the corporate veil being pierced for the purpose of determining the amount of unrealized ordinary income, in order to take account of assets that might have changed their character by the interposition of a corporation between the shareholders and the assets.

To illustrate the operation of section 341(e)(1), assume that a corporation has three stockholders, unrelated to each other, whose holdings by value are as follows:

A	5 per cent
B	15 per cent
C	80 per cent.

Assume also that the corporation's assets fall into four categories, as follows:

<i>Class</i>	<i>Net unrealized appreciation</i>	<i>Nature of asset</i>
W	\$10,000	Stock in trade in hands of corporation.
X	\$10,000	Capital asset to corporation; but would be stock in trade if held by C, though not if held by A or B.
Y	\$10,000	Capital asset to corporation; but would be stock in trade if held by B, though not if held by A or C.
Z	\$20,000	Capital asset to corporation; but would be stock in trade if held by C, but only if sales by certain corporations in which C was interested during preceding 3 years were treated as sales by C or if sales by C of stock in such corporations were treated as sales by him of his share of assets.

Under section 341(e)(5)(A), the corporation's “subsection (e) assets” would include Classes W and X. Consequently, on a sale of stock by A the net unrealized appreciation of the corporation would be \$20,000, and if

this does not exceed 15 per cent of the corporation's net worth, the corporation could not be collapsible as to A. On a sale of stock by B, however, the net unrealized appreciation would be \$30,000, since section 341(e)(1)(A) and (B) require him to take into account not only the corporation's "subsection (e) assets" (Classes W and X), but also any corporate assets which would be "subsection (e) assets" if he held more than 20 per cent of the stock (Class Y). B, therefore, can take advantage of section 341(e)(1) only if \$30,000 does not exceed 15 per cent of the corporation's net worth. Finally, if C invokes section 341(e)(1), he must take into account Classes W, X, and Z (but not Class Y) in determining the net unrealized appreciation.⁵⁹ For him, section 341(e)(1) will be applicable only if \$40,000 does not exceed 15 per cent of the corporation's net worth.

For another example, which is both simpler and more typical of section 341(e)'s intended operation, assume a corporation (Smith-Jones, Inc.) owned equally by Smith and Jones (who are unrelated), the sole asset of which is an appreciated apartment house. Assume also that neither Smith nor Jones is a dealer in such property, but that Jones has owned more than 20 per cent of the stock of certain other real estate corporations during the preceding 3 years. In these circumstances, Smith-Jones, Inc. owns no "subsection (e) assets," either in its own right or by attribution from Smith or Jones. As to Smith, the net unrealized appreciation under section 341(e)(1) is zero, so a sale or exchange of his stock (except to the issuing corporation or to a "related person") is exempt from the operation of section 341(a)(1). As to Jones, it is necessary to determine whether more than 70 per cent in value of the assets of any of the other corporations are similar or related in use or service to the property held by Smith-Jones, Inc. If so, Jones is to be treated (a) as though any sale or exchange by him of stock in such other corporation (while he owned more than 20 per cent of its stock) had been a sale by him of his proportionate share of the corporation's assets, and (b) as though any sale or exchange by such other corporation (while he owned more than 20 per cent of its stock) which was subject to section 337(a) had been a sale by Jones of his proportionate share of the property. If, taking into account these hypothetical sales or exchanges by Jones, he would have been a dealer in the type of property held by Smith-Jones, Inc.,⁶⁰ he can make use of section 341(e)(1) only if the net unreal-

⁵⁹ I.R.C. § 341(e)(1)(A) and (C).

⁶⁰ When section 341(e)(1)(C) is applicable, the shareholder is treated as though he had sold his proportionate share of property held by the other corporations during the preceding 3-year period. The mere fact that these corporations were or were not dealers in the property in question is not relevant; the purpose of imputing sales to the shareholder is to determine his status, based on both these hypothetical sales and any actual

ized appreciation in the apartment building owned by Smith-Jones, Inc., does not exceed 15 per cent of its net worth.

Section 341(e)(1) cannot be invoked if the stock is sold to the issuing corporation,⁶¹ nor does it apply to a more-than-20-per cent shareholder if the stock is sold to a "related person" as defined by section 341(e)(8).

2. *Complete liquidations.* A shareholder's gain on a complete liquidation is exempted by section 341(e)(2) from section 341(a)-(2)—and hence can enjoy long-term capital gain treatment—if two conditions are met. The first is that the net unrealized appreciation in the corporation's assets must meet the same test as is imposed by section 341(e)(1), *i.e.*, the appreciation in the corporation's "subsection (e) assets" plus, in the case of shareholders owning more than 5 or 20 per cent of the stock, the appreciation in certain other assets held by the corporation, may not exceed 15 per cent of the corporation's net worth. The second condition is that section 337(a) applies to the corporation by reason of section 341(e)(4). This condition, as will be seen *infra*, cannot be satisfied unless the corporation sells substantially all of its property before the liquidation; its purpose is to prevent a liquidation in kind of assets subject to depreciation or depletion, which if permitted would give the shareholders a stepped-up basis for such assets (which could thereafter be written off against ordinary income) at the capital gain rate, the classic situation covered by section 341.

3. *Elective one-month liquidations under section 333.* Ordinarily, the shareholders of a collapsible corporation are excluded from section 333 (elective nonrecognition of shareholder gain on a complete liquidation within one calendar month). Section 341(e)(3) provides that a corporation shall not be considered collapsible for this purpose, however, if the unrealized appreciation in its "subsection (e) assets" does not exceed 15 per cent of the corporation's net worth. The term "subsection (e) assets" is modified in applying section 341(e)(3), so as to reduce from 20 per cent to 5 per cent

sales by him of similar properties held in his individual capacity. The number and frequency of sales are usually only two of the factors determining whether the taxpayer is a dealer, however, and it is not clear whether section 341(e)(1)(C) attributes to the shareholder not only his proportionate share of the corporations' assets, but also his share of any corporate activity (use of agents, advertising, etc.) that might have resulted in the sales.

⁶¹ This restriction may reflect an excess of caution, since section 341(e)(1) is an exception to section 341(a)(1), which embraces sales and exchanges of stock, but not partial or complete liquidations. As to section 302(b) redemptions, however, see note 10 *supra*.

the stock ownership that will impose the shareholder's dealer status on the corporate assets. If the corporation can meet the test of section 341(e) (3), all shareholders may take advantage of section 333; otherwise, section 333(a) remains in full force and no shareholders may do so.⁶²

4. *Use of section 337 by a collapsible corporation.* Generally speaking, section 337 (nonrecognition of corporate gain or loss on certain sales within the one-year period following the adoption of a plan of complete liquidation) is not applicable to a collapsible corporation. Section 341(e) (4), however, lifts this barrier to a limited extent, making an otherwise collapsible corporation subject to section 337 if:

(a) At all times following the adoption of the plan of complete liquidation, the net unrealized appreciation in its "subsection (e) assets" does not exceed 15 per cent of its net worth;

(b) It sells substantially all the property owned by it on the date the plan of liquidation was adopted within the 12-month period following that date; and

(c) Following the adoption of the plan, it does not distribute any depreciable or similar property.

The first of the foregoing conditions (with variations noted above) is common to section 341(e) (1), (2), (3), and (4)—relief from the collapsible corporation provisions is granted only to corporations whose ordinary income assets have not appreciated significantly in value. Thus, the shareholders of a corporation holding substantially appreciated assets that in its hands are (or in the hands of any more-than-20-per cent shareholder would be) inventory property or stock in trade may not employ section 337 to obtain capital gain on a sale by having the corporation sell the property and distribute the proceeds in liquidation. The second and third conditions have a different purpose: even if the corporation's ordinary income assets have not appreciated substantially in value, the corporation is not permitted to distribute some of its assets in kind to its shareholders in order to give them a stepped-up basis at the lenient long-term capital gain rate. Thus, the second condition requires the corporation to sell substantially all of its assets if it wishes to come under section 337; it may not sell some, and transfer the rest by a liquidating distribution in kind to its shareholders. The third condition overlaps the second to a considerable degree:

⁶² Unless a particular shareholder is protected from section 341 treatment by one of the exceptions in section 341(d). Rev. Rul. 63-114, 1963-1 *CUM. BULL.* 74.

it forbids the distribution of corporate property that is depreciable (or subject to amortization or depletion) in the hands of either the corporation or the distributee. Since the second condition requires "substantially all of the properties" held by the corporation when the plan of liquidation is adopted to be sold within the 12-month period thereafter, the third condition would be automatically satisfied as to such properties, but it has the additional effect of preventing the distribution of any depreciable, amortizable, and depletable properties that fall outside the "substantially all" clause or that were not held by the corporation when the plan of liquidation was adopted. If property is distributed before the plan is *formally* adopted in an effort to avoid the impact of these conditions, the plan may be "pre-dated."

A final restriction in section 341(e)(4) makes it inapplicable to any sale to a more-than-20-per cent shareholder, or to a person related to such a shareholder, if the property so sold is subject to depreciation, depletion, or amortization in the hands of either the corporation or the buyer. By virtue of this restriction, section 341(e)(4) and hence section 337 may be applicable to some of the corporation's sales but not to others, so that an otherwise collapsible corporation may employ section 337 to ward off gain on some sales, while avoiding section 337 on sales producing losses (by selling to a more-than-20-per cent shareholder), an ironic result in view of the effort to prevent corporations from straddling section 337. The irony will be heightened by the fact that the shareholder, not the government, will be seeking to establish that the corporation is collapsible. Another problem in this final restriction on section 341(e)(4) is whether a "sale" of appreciated corporate property to shareholders pro rata (*e.g.*, if two 50 per cent shareholders each "purchase" a 50 per cent interest in depreciable assets) will be treated as a true sale. If so, the corporation will be subject to tax on the sale (probably under section 1231(a), at the capital gain rate), but the shareholders will obtain a stepped-up basis for the property; at the same time, the other sales by the corporation will be subject to section 337, and the liquidation will produce capital gain for the shareholders by virtue of section 341(e)(2). If, on the other hand, the transaction is treated as a distribution in kind of the property, rather than as a "sale" followed by a distribution of the proceeds of sale, section 341(e)(4)(B) and (C) will have been violated, with the result that section 337 will not apply to the corporation's sales of other property. This, in turn, will make section 341(e)(2) inapplicable at the shareholder level to the liquidation.

AVOIDANCE OF SECTION 341 BY A SECTION 341(f) CONSENT

Not content with the three original escape hatches of section 341(d) and the labyrinthine route of section 341(e), Congress provided further relief from section 341 in 1964 by enacting the consent procedure of section 341(f).⁶³ This provision permits a shareholder to sell his stock on the normal capital gain basis, free of any threat from section 341(a), if the corporation consents to recognize gain on its "subsection (f) assets" (primarily, real estate and non-capital assets) when, as and if it disposes of them in a transaction that would otherwise qualify for nonrecognition of its gain. Such a consent insures that the gain on the collapsible property will be recognized at the corporate level regardless of the mode employed by the corporation to dispose of the property; just as the shareholder has always been protected against the application of section 341(a) if the corporation realizes a substantial part of the collapsible income *before* he disposes of his stock, so section 341(f) protects him if the corporation *promises* to recognize the collapsible income *after* he sells his stock. Accordingly, a "consenting corporation" will not be able to avail itself of such nonrecognition provisions as section 311, section 336 or section 337 when it ultimately disposes of its "subsection (f) assets." Whether the corporate gain will be taxable at that time as capital gain or as ordinary income, however, will depend on its status and the statutory rules then in force. Similarly, the amount of the gain (if any) will depend on the property's adjusted basis and the amount realized (or, if the disposition is not by sale, exchange, or involuntary conversion, on its fair market value) at the time of disposition. A consent under section 341(f) is not conditioned on a showing that the corporation is in fact collapsible; indeed, one of the advantages of section 341(f) is that it permits avoidance of such a determination. If the consent is filed, however, it cannot be repudiated at a later time on the ground that it was an empty formality because the shareholder's gain was not within the scope of section 341.

1. *Requirements and effect of section 341(f)*. Section 341(f) applies only to a "true" sale of stock, not to transactions that are assimilated to sales for some purposes (*e.g.*, distributions in redemption of stock, partial or complete liquidations, or nonliquidating distributions). To qualify for section 341(f)(1) treatment, the

⁶³ See Hall, *The Consenting Collapsible Corporation—Section 341(f) of the Internal Revenue Code of 1954*, 12 U.C.L.A. L. REV. 1365 (1965); Sinrich, *New Collapsible Relief Measure is More Useful than Most Tax Men Believe*, 22 J. TAXATION 148 (1965); S. REP. No. 1241, 88th Cong., 2d Sess. (1964).

corporation, and any subsidiary (or chain of subsidiaries) connected by stock ownership of 5 per cent in value, must file a consent to the special recognition of gain provisions of section 341(f)(2). This consent becomes irrevocable as soon as any shareholder has effected a sale of his stock. Section 341(f)(2) then provides for recognition of gain at the corporate level on the ultimate disposition of all "subsection (f) assets," even in a transaction that would otherwise qualify for nonrecognition of gain—subject to an exception for tax-free exchanges under section 332 (liquidation of subsidiary), section 351 (transfer to controlled corporation), section 361 (corporate reorganization), section 371(a) and section 374(a) (bankruptcy reorganizations), if the basis of the assets carries over to the transferee and it files a similar consent to recognize gain when it disposes of them.

For six months after the filing of a consent, any shareholder may safely sell stock of the consenting corporation in one or a number of transactions. When the consent expires, a new one may be filed, which will be similarly effective for a 6-month period, whether the shareholders have made sales under the prior consent or not; and this process may be continued indefinitely. The use of the privilege with respect to *one* corporation, however, precludes the same shareholder, or any person related to him within the meaning of section 341(e)(8)(A), from using it with respect to any other corporation for a 5-year period. There is a "first-in-first-out" quality to this one-shot rule, in that a shareholder cannot disregard a consent applicable to his first sale of stock (either because he had no gain or because he is prepared to prove that the corporation was noncollapsible) in order to get the benefit of a consent filed by another corporation whose stock he sells at a later time.

"Subsection (f) assets" are defined in section 341(f)(4) as those noncapital assets which the corporation owns, or has an option to acquire, at the date of any qualified sale of stock by a shareholder. Whether they would otherwise constitute noncapital assets or not, however, land, any interest in real property (except a mortgage or other security interest), and unrealized receivables or fees as defined by section 341(b)(4) constitute "subsection (f) assets"; and so do two other categories of property: (a) if any assets of the above categories are being manufactured at the time the stock is sold, the property resulting thereafter from the manufacturing process; and (b) in the case of land or real property, any improvements resulting from construction commencing within two years after the date stock is sold. As already noted, the character and

amount of the corporation's gain on disposing of its "subsection (f) assets" depend on their status at the time of disposition, not on their status when the consent is filed or the stock is sold.

2. *Uses of section 341(f)*. Section 341(f) was designed to allow the shareholders of a rapidly growing corporation, whose produced or purchased properties have substantially increased in value but have not given rise to a realization of income at the corporate level, to reap the benefit of the company's prospects by selling their stock to a buyer who intends to continue operation of the corporation as a going concern. A sale in such circumstances invites a dispute under section 341, and any tincture of "dealership" on the part of the corporation or its shareholders makes it perilous to rely on section 341(e). Section 341(f) intervenes at this point to provide a safe harbor for the sellers if the new shareholders are willing to have the potential profit recognized in future years at the corporate level. If the buyers are not willing to continue the corporation as a going concern, however, but intend to liquidate it to acquire the assets, section 341(f) gives no practical assistance to the selling shareholders, since the buyers (at least if they are competently advised) will discount the price to reflect the corporate tax liability which will be generated by section 341(f)(2) at the time of the liquidation. Moreover, even if they intend to keep the corporation alive, the buyers must take account of its low basis for the assets, since this will be reflected in an increase in corporate gain (or in reduced depreciation deductions) and will adversely affect the value of their shares. Although incoming shareholders can ordinarily remedy an abnormally low basis for corporate assets by liquidating the corporation and getting a stepped-up basis under section 334(a) or section 334(b)(2), such a liquidation of a consenting corporation is a taxable event.

PEACEFUL COEXISTENCE WITH SECTION 341

While the reach of the collapsible corporation provision is indeed broad, even excessively so, several techniques are available to mitigate or avoid its application. A check list of these possibilities, some of which are discussed above, would include:

1. *Selling the assets under section 337*. If the corporation is found to be noncollapsible, the corporate gain will go unrecognized; and there will be a tax at the shareholder level only. If, to the contrary, the corporation is collapsible, the realization of income at the corporate level (resulting, usually, in capital gain) will serve to oust section 341 of jurisdiction. The tax at the shareholder level will, in such a case, qualify for capital gain treatment.

2. *Realization at the corporate level.* In jurisdictions following *Commissioner v. Kelly*,⁶⁴ realization of one-third (or more) of the potential income at the corporate level will avoid collapsible status for the corporation.

3. *Election under subchapter S.* If there is to be a sale of the corporate assets, the shareholders may be able to qualify for a single tax at the capital gain rate by an election under subchapter S prior to the sale. This possibility, however, was drastically curtailed by a statutory change in 1966 under which there may be a tax at the corporate level as well as at the shareholder level.⁶⁵

4. *Multiple corporations.* By segregating each potentially collapsible project in a separate corporation, the shareholders may fight the "substantial realization" and "tainted view" issues separately for each corporation—provided they stand up as independent entities. Segregation also has its drawbacks, *e.g.*, gain on noncollapsible projects cannot be balanced against the gain on collapsible projects in applying section 341(d)(2).

5. *Statutory escape routes.* At the shareholder level, reliance may be placed on the exemptions created by section 341(d) for 5-per cent shareholders, the 70-30 per cent rule, and the 3-year waiting period; or on the special rule applied by section 341(e) to "subsection (e) assets." At the corporate level, a consent under section 341(f) may be feasible.

6. *Spread-out or splitting of ordinary income.* If ordinary income cannot be avoided, or if the shareholder is forced to rely on an escape route that may prove unavailing, his pain and suffering may be reduced by spreading the gain over a period of years (*e.g.*, by use of the installment method under section 453) or among a number of taxpayers (*e.g.*, children, trusts, etc.).

7. *Charitable contributions.* If all else fails, the taxpayer can donate collapsible stock to a charitable institution,⁶⁶ thereby avoiding the recognition of gain while deducting the value of the stock under section 170.

⁶⁴ 293 F.2d 904 (5th Cir. 1961).

⁶⁵ See I.R.C. § 1378.

⁶⁶ The authors would be happy to introduce persons wishing to employ this suggestion to the treasurers of their respective universities.