1-1-1965

The Business Planner and the Collapsible Corporation

Edwin M. Larkin

Follow this and additional works at: http://digitalcommons.law.scu.edu/lawreview

Part of the Law Commons

Recommended Citation

Available at: http://digitalcommons.law.scu.edu/lawreview/vol6/iss1/3

This Article is brought to you for free and open access by the Journals at Santa Clara Law Digital Commons. It has been accepted for inclusion in Santa Clara Law Review by an authorized administrator of Santa Clara Law Digital Commons. For more information, please contact sculawlibrarian@gmail.com.
THE BUSINESS PLANNER AND THE COLLAPSIBLE CORPORATION

Edwin M. Larkin†

The creature which today is called a "collapsible corporation" was created as a device to secure capital gains treatment for funds which otherwise would have been taxed as ordinary income. In an attempt to change this result, Congress passed what is now Section 341 of the Internal Revenue Code. As it presently exists, Section 341 presents a crazy-quilt plan of fortifications designed to plug the once existing tax loophole. This bewildering set of rules has been much maligned by the commentators. It is not the purpose of this paper to add to the caustic comments which have already been rendered concerning Section 341; nor is it the purpose of this paper to defend that much abused section. Rather, an attempt will be made to view the statutory scheme as it exists today, to review the cases which have interpreted that section and to point out what, if anything, remains of the concept of the "collapsible corporation." This treatment is intended to benefit not only the business planning attorney faced with a potentially dangerous collapsible situation, but also the attorney called upon to defend a client whose capital gains have been disallowed because of a claim of collapsibility.

BACKGROUND

The motion picture industry was the first to make use of the collapsible corporation scheme. The classic situation is represented

† B.S., 1960, Fordham University; LL.B, 1963, LL.M., 1965, Georgetown University; Member, New York Bar.

1 Originally enacted as § 117(m) of the INT. REV. CODE of 1939, the collapsible corporation provisions are now found in § 341 of the INT. REV. CODE of 1954. Most of the cases which have arisen were concerned with § 117(m). Hereinafter, reference will be made only to § 341. References are to the INT. REV. CODE of 1954 and regulations promulgated thereunder except where indicated.

2 Judge Wisdom in Commissioner v. Kelley, 293 F.2d 904, 908 (5th Cir. 1961), gives a list of 30 articles and 3 text writers BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 299-320 (1959); HERZBERG, SAVING TAXES THROUGH CAPITAL GAINS 215-219 (1957); and MERTENS, FEDERAL INCOME TAXATION ¶ 22.54-22.58) which treat the problem. Since this decision, many other articles have appeared, most of which are listed in two of B.N.A.'s Tax Management portfolios, No. 29, Collapsible Corporations-General Coverage (1963) (hereinafter referred to as "Tax Mgmt. No. 29") and No. 49, Collapsible Corporations-Special Exceptions (1964) (hereinafter referred to as "Tax Mgmt. No. 49"). One article not listed is Note: Relief for Collapsible Corporations Under Subsection (e), 51 Geo. L.J. 346 (1963). An annotation appears in 74 A.L.R.2d 672 entitled "Construction, application, and effect of Internal Revenue Code provision taxing gain derived from or through 'collapsible corporation.'"
by Pat O'Brien, where four people organized a corporation to produce the movie, Secret Command. Two actors invested a total of $12,500 into the corporation in return for all the stock. The corporation then borrowed $349,000 to finance the cost of production. Fourteen months later, after the movie was completed and released for distribution but before the corporation had received any income, the stockholders voted to dissolve. The corporation redeemed their stock and assigned to the two actors the corporate assets (all right, title and interest in the picture) as well as all corporate debts. At liquidation, the stockholders valued the assigned movie rights at $150,000 after the salaries and loans had been paid, and treated the difference between this figure and their original investment ($137,500) as capital gain. The Commissioner challenged the transactions on several grounds, but the Tax Court discounted each of these and held that the gains to the shareholders were long-term capital gains not subject to taxation at ordinary rates. The court refused to apply Section 341 inasmuch as all gains were realized before it became effective.

The collapsible scheme was also used to advantage in other situations. For example, a corporation could be formed to develop an undeveloped asset (e.g., a tract of land or a new patent). Instead of liquidating the corporation after development, as was done in O'Brien, the stock would be held at least six months and then sold. The income could then be taxed at capital gains rates while the purchaser could operate and eventually liquidate the corporation, usually at no gain or loss in income because the property was taken at a stepped-up basis.

Another method utilized was to have the corporation borrow more money than was needed for the construction of the income-producing property. Once again, before any income had been realized, the corporation would be liquidated, or the stock sold, at a fair market value. The excess of the money borrowed over the cost of production was distributed to the shareholders as a capital asset. The difference between the amount of the original investment and the amount distributed was then taxed to the shareholders as long-term capital gain.


4 The reason for acting before income is produced is to prevent the corporation from realizing any corporate income which would be taxed at corporate rates and again at ordinary rates when paid out as salaries or dividends.

5 In so doing, it distinguished O'Brien from Commissioner v. Court Holding Co., 324 U.S. 331 (1945) on the basis that there had been no sale, merely an assignment of interest upon liquidation.

6 See also Emanuel E. Falk, 36 T.C. 292 (1961).
Not infrequently, the income producing asset was a tract of land upon which a housing project was to be built. Often, when the shareholders were contractors, architects, or real estate dealers, the above-mentioned devices were supplemented as in the following example. An FHA mortgage guaranty would be obtained using the highest cost estimates possible. In actual construction the shareholders would cut these costs by taking considerably less compensation for their services than provided for in the estimates. Consequently, the actual cost of construction often would be less than the ninety per cent FHA guaranty. Following construction, a disinterested appraiser would consider all the factors affecting the new development (the completed status of the buildings, the further development of surrounding land as shopping centers, increased transportation facilities, and the natural inflation during the period of construction) and generally could revalue the buildings at an amount considerably higher than that originally projected during the planning stages. Thus, an apartment house project might be estimated to cost $2,000,000 which would enable an FHA guaranty of $1,800,000 to be obtained. If costs were cut to $1,650,000, the unused funds of $150,000 would be available in cash for distribution to the shareholders at the completion of construction. After being revalued, the property might honestly be worth as much as $2,250,000. If sold at this price, the shareholders would have realized another $450,000 excess.

The Statutory Scheme of Section 341

Congress was aiming at such activities in 1950 when it passed the “collapsible corporation” provisions, Section 117(m) of the 1939 Internal Revenue Code. Section 117(m) was later amended to include inventory-type properties which would increase in value with time (e.g., whiskey, cheese). The effect of the amendment was to broaden the scope of the section to include property purchased as well as property which is manufactured, constructed or produced. Upon being incorporated into the 1954 Code, the section was again expanded; as Section 341, it included inventory assets and “unrealized receivables and fees” as the type of assets which would cause a corporation to be considered collapsible.

Section 341(b)(1) defines a collapsible corporation as one which is formed, or, if already in existence, is availed of:

1. To manufacture, construct, produce or purchase property;

2. With a view to,
   a. Distributing gains realized by it to its stockholders before
      it has realized a substantial part of the taxable income
      which could be expected to be derived from the property,
      and
   b. Having the shareholders realize such gain.

The late Chief Judge Parker in *Burge v. Commissioner* gave
this explanation of the concept:

That the 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 con-
struction of property, with the view of making the gains from the
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 avoidance
had been accomplished, the term "collapsible corporation" was em-
ployed to describe the corporations used for this form of tax
avoidance. . . .

Section 341(a) clearly applies only to gains which would nor-
mally be long-term, *i.e.*, held longer than six months. Every method
of receiving a long-term capital gain from a stock distribution is
covered by Section 341, except a redemption under Section 302(a)
which is not considered to be a partial liquidation under Section 346.
It is questionable whether this exception has any practical value to
the shareholder. However the inapplicability of Section 341 to short-
term gains does provide definite assistance, inasmuch as it permits
the shareholder with capital losses to use these against short-term
capital gains realized on the liquidation.

The gain which the shareholders receive from the assets of a
collapsible corporation will be treated as ordinary income where the
gain is from:

1. The sale or exchange of the corporation's stock;

2. A partial or complete liquidation of a collapsible corporation
   which will cause the distribution from the liquidation to be
treated as received in payment for the stock; or

---

9 253 F.2d 765, 767 (4th Cir. 1958). See also the jury instructions which defined
"collapsible corporations" given in Wheeler, Kelly & Hagny Invest. Co. v. United
States, 64-1 USTC § 9260 (1964), and Morris v. United States, 63-1 USTC § 9282
(1963).


11 See BITTKER, *op. cit. supra* note 2, at 302 n.5; Tax Mgmt. No. 49 at A-4.

12 See INT. REV. CODE of 1954, §§ 331, 346.
3. A corporate distribution which falls within the thrust of Section 301(c)(3)(A) because of lack of earnings or profits.\textsuperscript{18}

Section 341(b)(2) imputes the consequences of having manufactured, constructed, produced or purchased the property to the corporation if it engages in such activity to any extent, or if it holds property the basis of which is determined by reference to the cost to the person who originally so treated the property. A transfer under Section 351 of an asset constructed entirely by a person for all of the corporate stock would be such a “holding” by a corporation.\textsuperscript{14} In such a Section 351 exchange, the basis of the property in the hands of the corporation would be determined, according to Section 362, by the individual’s basis. Under the provisions of Section 1031, a similar rule would be applicable to an exchange of assets between two corporations.

Not all property owned by the corporation will render it collapsible. While the code clearly includes any property which has been constructed by the corporation and which is carried on its books as a capital asset, there are special rules for purchased assets. Section 341(b)(3) sets forth these special provisions for “Section 341 assets” and includes:

1. Stock in trade or inventory; or
2. Property held for sale to customers in the ordinary course of business; or
3. Unrealized fees or receivables; or
4. Section 1231(b) property, as long as that property has not been used in connection with the manufacture, construction or production of stock in trade, inventory, or property primarily for sale in the ordinary course of business.

These assets will be considered Section 341 assets only if they have been held for less than three years. The three-year limitation applies to determinations of collapsibility notwithstanding the shorter “six month” rule generally applied to Section 1231 (property used in trade or business) assets.

To determine whether the requisite three-year period has run, the tacking provisions of Section 1223 will be applied, “... but no such period shall be deemed to begin before the completion of the manufacture, construction, production, or purchase.”\textsuperscript{15} Thus, an
asset purchased by an individual on January 1, 1962, and transferred to a corporation on July 1, 1964 in return for 100 per cent of the corporation's stock, in turn held by the corporation until after the individual sells his stock on January 2, 1965, will not be considered a Section 341 asset. Care must be taken that the entire process of manufacture, construction, production or purchase has been completed before the three-year period commences inasmuch as the term "construction" has been broadly construed both by the Internal Revenue Service and the courts.\footnote{16}

Section 341(b)(3)(C) which deals with unrealized fees and receivables has been interpreted to mean any rights (contractual or otherwise) to receive payment for property otherwise considered to be a Section 341 asset,

... which has been delivered or is to be delivered and rights to payments for services rendered or to be rendered, to the extent such rights have not been included in the income of the corporation under the method of accounting used by it.\footnote{17}

While Section 341 assets purport to relate only to purchased assets, there should be no confusion on the point that the "unrealized receivables and fees" provisions of Section 341(b)(3) will also be applied to receivables due the corporation from the sale of goods or performance of services.\footnote{18}

A rebuttable presumption of collapsibility will arise under Section 341(c), if, at the time of the sale, exchange or liquidation, the fair market value of the corporation's Section 341 assets is more than half (50\%) of the total corporate assets \textit{and also} more than 120 per cent of the adjusted basis of those same assets. Both conditions must be met. The presumption is clearly rebuttable since the Regulations deem the result to follow unless shown to the contrary.\footnote{19} Conversely, however, if the corporation's Section 341 assets do not reach the 50 per cent and 120 per cent levels, no presumptions, conclusive or rebuttable, will arise in favor of the corporation, \textit{i.e.}, that it is not collapsible.\footnote{20} A crucial element in the application of the percentages to the total corporate assets is the required exclusion of cash, stock in other corporations, obligations which are corporate capital assets, and obligations of any state or of the United

\footnote{17} Treas. Reg. \S 1.341-3(b)(4) (1955).
\footnote{18} Tax Mgmt. No. 29 A-16, which would not, however, interpret the provision to include rental income or patent royalties.
\footnote{19} Treas. Reg. \S 1.341-3(a) (1955).
\footnote{20} \textit{Ibid}. 
States as defined in Section 1221(5). Because the Section 341(c) presumption works only in favor of the government, the need for it has been questioned. As Bittker notes, "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." Perhaps the only practical use of the Section 341(c) presumption is that it may provide an objective standard, "... likely to appeal to a Revenue Agent in conducting the audit of a taxpayer's return."

Section 341(d) renders the provisions of Section 341 inapplicable to the shareholder, notwithstanding qualifications under the aforementioned conditions which would render a corporation collapsible, if:

1. The shareholder did not own, outright or constructively, more than 5 per cent of the outstanding stock of the corporation at any time after construction had begun, or after a Section 341 asset had been purchased. Outstanding stock will not be considered to include treasury stock. A person will be deemed to be the owner of stock if he is: A shareholder of a corporation which also owns stock, a partner of a shareholder of a collapsible corporation, a beneficiary of a trust or estate which also owns stock, has an option to acquire stock, or if the stock is owned by any member of his family including his spouse, his ancestors, his brothers or sisters (both whole and half-blood) and their spouses, and his lineal descendants and their spouses.

2. The gain recognized on stock of a collapsible corporation from property includible under Section 341 does not exceed 70 per cent of the total gain for any taxable year. This provision is an "all or nothing" provision. If more than 70 per cent of the gain is attributable to the Section 341 property, that gain is taxable; if not, none of the gain is taxable.

---

22 BITTKER, supra note 2, at 311, n.11. Jack Saltzman, 22 CCH Tax Ct. Mem. 336, 341 (1963): "We feel that the evidence in this case which is sufficient to overcome the presumption of correctness of the respondent's [Commissioner] determination [that there was a deficiency] is also sufficient to rebut the presumption created by section 341(c)." See also DeWind and Anthoine, Collapsible Corporations, 56 COLUM. L. REV. 477, 510 (1956).
23 Tax Mgmt. No. 29 A-39.
26 INT. REV. CODE of 1954, § 341(d)(3).
3. The gain is realized more than three years after the completion of the production or purchase of the property. This provision is one of the most important limitations on Section 341.\textsuperscript{28} In effect, this carryover from the 1939 Code extends the time limitations for long-term capital gains, as applicable to collapsible corporations, from the normal six-month period to three years. The holding period of prior owners of the property may be included in the three-year period.\textsuperscript{29} This means that any corporation can be formed with the intention of collapsing it, and, as long as the shareholder does not transfer his stock or receive his gain until three years after the construction has been completed or the purchase made, the other provisions of Section 341 will not apply. A shareholder who can afford to wait three years after the completion of construction to realize his gain, will receive long-term capital gain treatment for his income.

Other provisions limiting the scope of Section 341 are found in subsection (e). A brief summary of this subsection and its "fearfully intricate provisions"\textsuperscript{30} is offered, although a complete description of this subsection is beyond the scope of this article. A principal reason for the enactment of this subsection was to avoid adverse results created by the then existing sections. The following language from the Senate Report to subsection (e) is illustrative:

The collapsible-corporation provision of present law . . . both by their terms and as interpreted, are so broad that in a number of situations they have exactly the opposite effect from that intended —instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordinary income.\textsuperscript{31}

Prior to the enactment of subsection (e), a taxpayer avoiding use of a corporate form might be taxed only at capital gain rates, while a similar taxpayer making the same transaction through a corporate entity might be taxed at ordinary income rates because of the operation of Section 341 (a) through (d). Congress sought to eliminate this anomalous result by the provisions of subsection (e). It provides, in substance, that a corporation will not be deemed to be collapsible if, "the net unrealized appreciation in subsection (e)
Subsection (e) applies to three distinct types of transaction: A sale or exchange of stock (§ 341(e)(1)), a distribution under a total liquidation (§ 341(e)(2)) or a partial liquidation under Section 333 (§ 341(e)(3)). Section 341(e)(4) gives certain collapsible corporations the right to elect the benefits of Section 337 provided that following the adoption of the plan of complete liquidation: (a) the net unrealized appreciation of subsection (e) assets does not exceed fifteen per cent of the corporation's net worth; (b) substantially all the corporate assets are sold within twelve months; and (c) no distribution of property is made for which exhaust, wear and tear, obsolescence, amortization or depletion deductions are allowable. Exemptions under the first two types of transactions are granted to individual shareholders (limited under the first type to those owning twenty per cent or less of the stock), while those under Section 341(e)(3) and (4) are granted to corporations. It is, of course, necessary to classify and evaluate both the subsection (e) assets and all assets making up the "net worth" of the corporation in order to take advantage of the subsection.

Subsection (e) carefully defines "subsection (e) assets" (§ 341(e)(5)), "net unrealized appreciation" (§ 341(e)(6)), "net worth" (§ 341(e)(7)), "related person" (§ 341(e)(8)), and "property used in the trade or business" (§ 341(e)(9)). Unrealized appreciation of subsection (e) assets may prevent a corporation from taking advantage of the subsection's provisions and, absent other available defenses, can cause a transaction to result in ordinary income to the stockholder. These assets are defined as follows:

1. Corporate property which, if sold by the corporation or by a holder of twenty per cent of the corporation's outstanding stock, would produce ordinary income to the seller. If a twenty per cent holder would not receive capital gains treatment for the gain on the sale (e.g., as a dealer in such property), then his existence will prevent the corporation and its other stockholders from taking advantage of the subsection (e) provisions.

2. Property used in the trade or business (i.e., a Section 1231(b) asset), provided that the aggregate of unrealized depreciation exceeds the unrealized appreciation on all such property.

---

83 However, if the dealer holds these assets solely as an investment, and separately from the other assets with which he deals, this will not cause the assets to be treated as subsection (e) assets. Conference Report on Technical Amendments Act of 1958 in U.S. Code Cong. & Ad. News, 85th Cong., 2d Sess. 5053, 5059 (1958).
3. Property used in the trade or business (i.e., a Section 1231(b) asset), provided that such property, if owned by a twenty per cent holder, would produce ordinary income as the result of a sale or exchange.

4. Property consisting of a copyright, literary, musical, artistic or similar asset if it was created, wholly or partially, by the personal efforts of a holder of more than five per cent of the corporation's outstanding stock.

In each of the above-mentioned instances, the constructive ownership rules of Section 544 apply. A corporation or a twenty per cent shareholder cannot take advantage of subsection (e) if the sale is to a "related person." Other corporate assets, although not held for sale, may come within the thrust of Section 341(e)(5)(A)(i) and may be classified subsection (e) assets, e.g., stock of a corporation which is "Section 306 stock," or stock of a corporation which in turn holds stock in a collapsible corporation to which none of the Section 341(d) limitations apply. Finally, Section 341(e)(11) specifically provides that failure of a corporation to meet the requirements of subsection (e) is not to be considered in determining its collapsible status under Section 341(a) through (d). Subsection (e) is difficult to interpret, not only because its wording is complex but also because it has not yet been construed by either a court decision or revenue ruling.

In August 1964, subsection (f) of Section 341 was enacted. The Report of the Senate Finance Committee states:

... [S]ection 341(a) shall not apply to a sale of stock of a corporation if ... such corporation consents to recognize gain on any future disposition by it of its "subsection (f) assets" ... and if the sale of the stock is made within the six-month period after the consent is filed.

The new subsection is applicable only to "subsection (f) assets" which are defined as non-capital assets of the corporation; these include land, any interest in real property (exclusive of security interests) and unrealized fees and receivables.

---

34 Internal Revenue Code of 1954, § 341(e)(1). Related person is defined in Section 341(e)(5).
37 Internal Revenue Code of 1954, § 341(f)(4)(A). Special rules apply to property which is under construction, § 341(f)(4)(B), and to improvements made on land, § 341(f)(4)(C).
The general rule of collapsibility in Section 341(a)(1) will not apply to a sale of the stock of a corporation holding subsection (f) assets if that corporation consents—in accord with one of the procedures to be established in soon-to-be-released regulations—to the application of subsection (f)(2). The individual shareholder may sell some of his corporate stock without the collapsibility dangers, if the corporation consents to having its future distributions of "341(f) assets" treated as gain from the sale or exchange of such assets.\textsuperscript{88} If a transfer is made by means of sale, exchange or involuntary conversion, the gain will be the excess of the amount realized less the adjusted basis of the subsection (f) asset; gain from any other type of disposition will be the amount by which the fair market value of the asset exceeds its adjusted basis.\textsuperscript{89}

Although the full import of subsection (f) remains to be seen, some questions have been answered by the terms of the subsection itself and the accompanying Senate Report. A consent will be effective for a six-month period commencing on the date of filing, and will apply to every sale of that corporation's stock made by any shareholder during the consent period.\textsuperscript{40} Once a consent has been filed and a sale of the stock made thereunder, the consent cannot be revoked until the six-month period has expired.\textsuperscript{41} A subsequent determination that the corporation was not a collapsible corporation will not vitiate the consent; the corporation will continue to be subject to the special tax treatment of Section 341(f)(2) in regard to any future disposition of its "subsection (f) assets."\textsuperscript{42} While the consent is automatically revoked at the end of the six-month period unless the corporation files another consent, no limit has been fixed upon the number of consents which may be filed.

This new section presents no additional considerations for the determination of collapsibility. The Senate Report clearly states that a consenting corporation does not automatically become non-collapsible\textsuperscript{43} nor does it become collapsible per se. The subsection applies only to the stockholders who qualify under its provisions.

A special exception to subsection (f) is made for tax-free treatment under Sections 332, 351, 361 and 371(a) of the Code.\textsuperscript{44} Also,
Section 341(f)(6) provides that the subsection will not apply if the consenting corporation, on the date of the sale, owns more than five per cent of the outstanding stock of another corporation, which has not also filed a consent.

The nonrevocation provisions of a Section 341 consent present problems to the taxpayer who would "wheel and deal" with his corporations. Section 341(f)(5) contains another limiting provision which allows a taxpayer to take advantage of subsection (f) with only one consenting corporation during any five-year period. Thus, a taxpayer who has sold stock in a consenting corporation during a consent period may not, within five years from the date of that sale, take advantage of the provision of Section 341(f)(1) as regards the sale of the shares of stock of any other consenting corporation. He may, however, within the five-year period, take advantage of the original consent or of any subsequent consent when he makes further sales of the stock of the original consenting corporation. 45

CASE LAW

As is indicated by the statutory scheme of Section 341, the facts of a particular case will largely determine whether the corporation in question will be collapsible. 46 The cases which have thus far arisen have set forth some important principles of law. Of more importance, however, is the fact that they have applied the statutory rules and the regulations to particular fact situations, thus establishing specific guidelines which can be utilized to interpret a potential fact pattern in the future.

It is apparent from a review of the cases that two opposing philosophies have emerged in the area of collapsible corporations. One group of cases invariably looks to the Congressional purpose of preventing the use of the collapsible device to receive capital gains. Many statements of this purpose can be found throughout the various House and Senate Committee reports. This group of cases appears to concentrate on the issue of the "view"; if the taxpayer had the prohibited view, the necessary intent, the case will very nearly be decided at that point. When there are additional issues in the case, these cases will often fall back on the fact that Congress intended to penalize anyone having just such a view, quote from the relevant Congressional report, and decide the additional issue against the taxpayer concluding that Congress could not have meant to allow any taxpayer to achieve tax avoidance and thus

reach the haven of capital gains treatment. One such case is *Sidney v. Commissioner.* In that case the taxpayers organized two corporations for the purpose of constructing two housing projects with FHA secured loans. Construction was completed in 1949. The cost of construction was less than the amount of the loans; the excess was distributed to the taxpayers in 1950 and 1951 along with the current earnings.

The original collapsible provisions were passed in September of 1950 and made retroactive to January 1, 1950. The taxpayers argued that they could not have had the view referred to in Section 341 before it had been enacted and, in any event, not before the earliest date to which it was made effective. They argued further that Section 341 should not be construed to apply when the view antedated enactment and that any such application would violate the due process clause of the Fifth Amendment. The Second Circuit found that the taxpayers had the requisite view, with the following statement:

The thrust of petitioners' argument is rather that, in the absence of clear direction by the legislature, courts ought not construe a statute as attaching new consequences to views held prior to enactment, since if they do, *the statute may violate constitutional safeguards.* These generalities do not avail taxpayers here. For Congress made it clear beyond peradventure that it intended § 117(m) to apply to all gains realized after December 31, 1949, and this required that significance be given to views held prior to September 23, 1950, when the Revenue Act of 1950 became law. We therefore could not interpret the statute as inapplicable even if we had greater doubts as to its constitutionality as so interpreted than we do.

The taxpayers' due process argument was founded upon *Unterman v. Anderson* which held that the gift tax provided in the Revenue Act of June 2, 1924, could not be constitutionally applied to a gift made on May 23, 1924. The Second Circuit went to great pains to minimize the effect of *Unterman,* noting the Holmes, Brandeis, Stone dissent therein, and further noting that the Supreme Court had distinguished the case six times and followed it only once. Ultimately, the court chose to ignore the case, apparently hoping that it would disappear, and concluded that the taxpayers should have known at the time they had the view in 1949 that "1950 would probably see a new Revenue Act." Must they also have been sufficiently clairvoyant to determine that the Act would contain the complicated, confused Section 117(m) directed at their particular

---

47 273 F.2d 928 (2d Cir. 1960).
48 *Id.* at 931-32. [Emphasis added.]
49 276 U.S. 440 (1928).
50 *Sidney v. Commissioner,* *supra* note 47, at 932. [Emphasis added.]
type corporation? No indeed, says the Second Circuit, for on January 25, 1950, President Truman stated that such a bill might include provisions for the taxation of gains from collapsible corporations. Does the Second Circuit mean to imply that all hortatory messages of Presidents are now sufficient to put the public on notice of what might happen, thus giving it force of law? Conceivably President Truman's message and the "general" knowledge that there would probably be a new revenue act in 1954, might have lent some support to the Court's decision. However, from the decision of the Tax Court, the fact appears that the transaction for which the taxpayers were taxed occurred prior to January 25, 1950, the date of the Presidential message to Congress.

Another entirely different approach to the collapsible corporation problem has been expressed. The philosophy of these cases is that the purpose expressed in the Congressional records is not all-controlling, but is to be used as an aid to interpretation of the statute. These cases take into consideration what Congress actually did, i.e., what the final wording of the statutory scheme has finally achieved, as well as what the drafters hoped to do, i.e., the Congressional report statements. The fact that Congress intended to catch these persons in its collapsible corporation net would not necessarily mean that they were, in fact, entrapped by its provisions. Just as, conversely, the provisions succeeded in catching some taxpayers which Congress had no intention of taxing at all. The following cases have tended toward this view: Jacobson v. Commissioner, Commissioner v. Kelley, Heft v. Commissioner and

---

51 Rose Sidney, 30 T.C. 1155 (1958).
52 For an example of a Congressional drafting error, see DeWind and Antholne, Collapsible Corporations, 56 COLUM. L. Rev. 475, 497-8 (1956); Axelrad, Collapsible Corporations and Collapsible Partnerships, So. Cal. 12th Tax Inst. 269, 293-7 (1960).
53 See the discussion concerning subsection (e) and Braunstein litigation, note supra, and note 79 infra, and accompanying texts.
54 281 F.2d 703, 707 (3d Cir. 1960). This case presents the only reversal by an appellate court in the area of collapsible corporations. In so doing, Judge Hastie stated: "If the self-serving testimony of the taxpayers stood alone its rejection might be permissible. But when several other established facts so strongly corroborate their testimony and nothing significant appears to the contrary, we think it must be recognized that the taxpayers have established their contention."
55 293 F.2d 904, 911-912, (5th Cir. 1961). "... Section 117(m) does not use the definite article 'the' in referring to 'substantial part.' The statute does not require that the substantial part be realized . . . or that the part unrealized be insubstantial in relation to the part realized, in order for a corporation to escape collapsibility. . . . Section 117(m) requires only that 'a substantial part' be realized. The indefinite article 'a' says in plain language that there may be two or more substantial parts. . . . There is nothing in the legislative history or in the factual setting that produced Section 117(m) to indicate that Congress designed the law to penalize the reasonable use of the corporate form of enterprise."
56 294 F.2d 795, 798 (5th Cir. 1961). "It may well be that shareholders who liquidate their corporation by a series of distributions may be caught under section
Levenson v. United States. This dichotomy of judicial approach does not facilitate a uniform and certain approach to the already monstrously complex Section 341.

**View**

One of the principal factual considerations when dealing with collapsibility is whether the taxpayer-stockholder has taken certain actions "with a view to" acquiring capital gains rates on the income from the transaction. Of course, only the individual taxpayer really knows the answer to this question. His testimony is one indication of whether the view, the requisite intent to receive capital gains, existed, but other factors weigh heavily. One early argument advanced on the issue of view was that the word "principally" in the definition modified the words "with a view to" rather than the words "manufacture, construction, or production." The effect of such an interpretation would have eased the taxpayer's burden considerably since the term "principally" forces a quantitative distinction upon whatever it refers to. If a corporation were required to be formed or availed of "principally" with a view to its collapsing, then a determination would have to have been made in every case...
as to what portion of its activities were conducted with this view as compared to its other activities. Moreover, the courts would have had to determine what constitutes “principally,” i.e., 51 per cent of the corporation’s activities, 75 per cent, or even 10 per cent, if the other 90 per cent of the corporate activity was spread out over a multitude of activities, none of which included more than 2 or 3 per cent of the total corporate activity. Unfortunately for subsequent taxpayers, one of the early cases decided the issue noting that the argued for interpretation, “... is without support of any rule of law or of grammar with which we are familiar.”

Perhaps the greatest conflict with respect to view arises over the question of when the view must have been entertained. Under the statute a corporation will be regarded as collapsible if the view existed either at the time of formation or when the corporation is later “availed of.” The requisite view need not exist when the corporation is formed; it is sufficient if it exists when the corporation is availed of at some later time. Of the two possibilities set forth in the statute, i.e., “formed” or “availed of,” the “availed of” alternative is of much greater importance. Even if the corporation is “formed” for the purpose of collapsing, but is never actually used for this purpose, no gain would be attributable to the shareholders, and thus the purpose of formation would be of little importance. On the other hand, if any corporation, whether or not formed for the explicit purpose, is so “availed of,” then, and only then, would gains be attributable to such corporation, thus bringing it within the thrust of Section 341.

The regulation states that the view must exist “... at any time during the manufacture, production, construction, or purchase...” of the collapsible property. Both the Second and Fourth Circuits think that the regulations are too favorable to the taxpayer and do not hesitate to say so. The Second Circuit has held that the view need only exist when the corporation is availed of, despite the fact that the regulations prescribe a narrower test which requires that the view be availed of during construction. With respect to the test in the regulations the court has stated: “We are disposed to disagree with so narrow an interpretation...” The Fourth Circuit takes a similar position. It is worthwhile noting, however, that these find-

---

62 Burge v. Commissioner, 253 F.2d 765, 768, n.2 (4th Cir. 1958); See also Mintz v. Commissioner, 284 F.2d 554, 558 (2d Cir. 1960); Weil v. Commissioner, 252 F.2d 805, 806 (2d Cir. 1958).
63 J. D. Abbott, 28 T.C. 795, aff’d, 258 F.2d 537 (3d Cir. 1958).
66 Burge v. Commissioner, 253 F.2d 765 (4th Cir. 1958).
ings in Burge and Glickman were not necessary to the final outcome of the cases since there was an additional finding that the view existed during the process of construction. Furthermore, in a later decision by the Second Circuit, when again faced with the problem of when the necessary view had to exist, the statement was made that, "Whether when the view to distribute arises after completion of construction the gain on distribution would be treated as ordinary income need not be decided . . . ." Again, the view existed during construction, and although it again appears to be merely dictum, this may be a slight withdrawal from the earlier strict interpretation in Glickman.

The Third and Fifth Circuits interpret the problem much more reasonably in favor of the taxpayer. The Third Circuit in Jacobson v. Commissioner met the problem head on and stated: "The 'view' with which a corporation is used for a particular purpose must necessarily be a view entertained at the time of such use."

The Court continued:

To us this seems so clear on the face of the statute that we would content ourselves with the foregoing brief analysis of the statutory text were it not for the fact that other highly respected courts have been persuaded to a contrary interpretation. [Citing Glickman and Burge] . . . However, there is an additional consideration which to us seems decisive in support of our reading of the statute and against the cited cases. The interpretation which to us seems most natural and reasonable has been adopted administratively and published in a formal Treasury regulation. [Treas. Reg. 1.341-2(a)(3).] . . . Thus, the regulation, adopting what is certainly not an arbitrary interpretation of the statute, treats a corporation as collapsible only if "the view to sale" shall have existed at the time of the construction in which the corporate entity was used, or if circumstances which subsequently induce sale were themselves within contemplation during the period of construction. We are guided by and shall apply the statute as thus reasonably interpreted in the regulations.

The Tax Court opinions have oscillated between the two divergent positions. Numerically, more cases have followed the regulations than have declined to follow them. More significant is the fact that all the Tax Court cases since Jacobson was decided in 1960, have followed that decision on this point. The trend appears

---

67 Mintz v. Commissioner, 284 F.2d 554, 558 (2d Cir. 1960).
68 281 F.2d 373, 375 (3d Cir. 1960).
69 Id. at 705-06.
70 Estate of Louis Alper, 20 TCM 1626 (1961); Elizabeth M. August, 30 T.C. 969 (1958); Arthur Glickman, 16 TCM 532 (1957); Jesse Hartman, 34 T.C. 1085 (1960); Ralph J. Solow, 22 TCM 398 (1953), aff'd, 333 F.2d 76 (2d Cir. 1964); Southwest Properties, Inc., 38 T.C. 97 (1962).
to be definitely toward the position that the requisite view must exist during construction. Should a subsequent case reach the opposite conclusion, it would seem to be a ripe question for determination by the Supreme Court.

Another question with respect to view that has produced considerable conflict is who must have the requisite view. The regulations state that "...those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise," are required to have the view. It appears that a dissenting minority shareholder, who did not have the requisite view, or even a person who became a shareholder after the view had been entertained by others, could be brought within the ambit of the statutory rules through the intentions of other shareholders who did have the view. In only one instance is the individual minority shareholder relieved of the effect of the statute. This is the exception, previously noted, and found in Section 341(d)(1), which exempts the owner of five per cent or less of the stock from the effects of the section. Note, however, the further limitation of Section 341(d) whereby an owner of stock is deemed to own the stock of other persons closely related to him in business or personally, which narrows the rule considerably. This is important in the collapsible corporation situation which usually involves closely held corporations. In a recent Court of Claims case, and in two recent Tax Court opinions, the courts considered the question of who must have the requisite view. In each case, minority shareholders holding more than five per cent of the stock became disenchanted with the policies of the majority or controlling stockholder, and sold out to the latter. Each time, the majority stockholders continued to hold their stock, and the sale of the stock by the minority shareholders was held not to be a collapsible transaction. In so holding the Court of Claims made the following statement:

The essence of the Tax Court's rulings [in Solow and Lowery] is that the collapsible corporation provisions are not applicable in a case in which a minority stockholder has his stock redeemed and the majority stockholder continues to own the corporation.

The following criticism of this holding has been advanced: "But this surely must be regarded as an overstatement. Obviously, it cannot

---

73 See Butler v. Patterson, 148 F. Supp. 197 (N.D. Ala. 1957), for an example of how one person will be deemed to be the owner of another's stock.
74 Goodwin v. United States, 320 F.2d 356 (Ct. Cl. 1963).
75 Ralph J. Solow, supra note 70; Sylvester J. Lowery, 39 T.C. 959, aff'd, 335 F.2d 680 (3d Cir. 1964).
76 Goodwin v. United States, supra note 74, at 359.
be assumed automatically that a less than 50 per cent shareholder is not in control of the policies of the corporation. However, this much seems clear; a transaction will not be considered to be within Section 341 when a minority shareholder, or even a 50 per cent shareholder, who does not control the policies of the corporation (as was the case in Solow), sells his stock to the majority or controlling shareholder, or has his stock redeemed by the corporation while the other shareholder keeps his stock, if the transaction is free from obvious self-dealing between the two parties. This result would appear to be true whether or not the transaction took place before, during, or after the collapsible activity has been completed.

One specific area of conflict that developed involved the question of whether Section 341 applies even if the sale of the corporate assets would have produced capital gain had no corporation existed. The Fifth Circuit in *United States v. Ivey* held that a shareholder's gain from sale of his stock in a collapsible corporation was not taxable as ordinary income if such gain would have been entitled to capital gains treatment had the taxpayer not incorporated. The case was remanded to determine whether in fact the gain would have qualified for capital gains treatment. In *Braunstein v. Commissioner* the taxpayer argued for the position that had been accepted by the court in the *Ivey* case. The Second Circuit rejected the view taken by the Fifth Circuit despite their recognition that "this occasionaly produces unwarranted taxation of capital gains as ordinary income." Because of the conflict between the circuits the Supreme Court granted certiorari on the limited question of whether Section 341 is inapplicable "where the stockholders would have been entitled to capital gains treatment had they conducted the enterprise in their individual capacities without utilizing a corporation."

The Supreme Court first determined that since neither the taxpayer nor the corporation was engaged in the trade or business of selling apartment houses, "... the corporations were not used to convert ordinary income into capital gain and the provisions of ... [Section 341] are inapplicable." The Court gave a brief history of the section and concluded:

77 29 Tax Mgmt. A-25.
78 294 F.2d 799 (5th Cir. 1961), opinion on rehearing, 303 F.2d 109 (1962), where the court stated: "As we see it, the statute cuts both ways. To use the statute as a means of converting into ordinary income gain that would have been capital gain to the individual would be at odds with the statutory purpose and incompatible with the principles underlying the distinction between ordinary income and capital gain."
79 305 F.2d 949 (2d Cir. 1962).
80 Id. at 957.
There is nothing in the language or structure of the section to demand or even justify reading into these provisions the additional requirement that the taxpayer must in fact have been using the corporate form as a device to convert ordinary income into capital gain. . . .

For example, if we were to inquire whether or not the profit would have been ordinary income had an enterprise been individually owned, would we treat each taxpaying shareholder differently and look only to his trade or business or would we consider the matter in terms of the trade or business of any or at least a substantial number of the shareholders? There is simply no basis in the statute for a judicial resolution of this question, and indeed when Congress addressed itself to the problem in 1958, it approved an intricate formulation falling between these two extremes. [Citing subsection (e).]

The Supreme Court thus answered the problem posed by the differences between Ivey and the Second Circuit in Braunstein. The impact of the Braunstein decision is, of course, diminished as a result of the enactment of subsection (e).

The existence of the requisite “view” is a factual question to be determined by examination of all the relevant facts and circumstances. The regulations point out with compelling clarity that if the sale, exchange or distribution takes place solely because of the occurrence after construction or purchase of an event which could not be contemplated beforehand, the corporation will not be deemed to have been unlawfully availed of with the requisite view.4

This section of the regulations complements the previous statement in the regulations that: “The requirement [that the corporation is availed of with the requisite view] is satisfied whether such action was contemplated unconditionally, conditionally, or as a recognized possibility.”5 When read together, the two sections require the taxpayer to produce evidence of an unanticipated occurrence which precipitated the disposition of his stock at the exact time it was disposed of in order to negate the conclusion that the view existed. The “recognized possibility” provision in the regulations has been particularly troublesome in the normal FHA case. Often a loan is acquired in an amount which is excessive, or after completion of the building, a reappraisal shows that it should be revalued. The excessive funds which result from either of these two potentialities are treated, especially where the taxpayer is a man experienced in the building industry,6 as either within the contem-

83 Id. at 70-72.
86 See the statement in Short v. Commissioner, 302 F.2d 120, 122 n.3 (4th Cir. 1962), where the court notes “with more than passing interest” the fact that the architectural firm in the instant case is the same one involved in Spangler v. Commissioner, 278 F.2d 665 (4th Cir. 1960), cert. denied, 364 U.S. 825 (1961).
What have the courts been willing to accept as an "uncontemplated occurrence" so as not to taint the transaction with the undesirable view? Jacobson v. Commissioner presents virtually the only instance where an appellate court has accepted the taxpayer's argument that the view was formed after the uncontemplated occurrence. There, construction of the apartment was completed in July of 1950. During the same month, a real estate broker tried to induce the shareholders to sell their apartment houses, but they rejected the offer. Later, the majority shareholder discovered some cracks in the walls of the building and advised the minority stockholders to sell their shares (presumably to him). The minority group countered with an offer to purchase his shares. Finally, both sides agreed to sell their stock. The Commissioner determined that the corporation was collapsible and the Tax Court agreed. The Third Circuit reversed the Tax Court stating:

The refusal of the stockholders to permit a broker to list or offer the property for sale in July, the fact that the parties had made other long term investments in rental property and the manifest unwillingness of the majority to sell even after Winograd [the majority shareholder] discovered the cracks and recommended sale, are all facts found by the Tax Court. In aggregate they make a very strong and persuasive case in support of the appellant's claim that they had no thought of selling until after the cracks were discovered.

Revenue Ruling 51-575 provides another instance of an uncontemplated occurrence. A corporation completed construction of a housing project under the Wherry Act. Later, the Housing Act of 1956 was passed which required the project to be sold to the proper military authority. The sale of the property, solely because of the enactment of the latter Act, was an uncontemplated occurrence and thus not a collapsible transaction.

In Braunstein v. Commissioner, petitioner claimed that sale of the property was due to unanticipated circumstances which caused a decrease in rents and an increase in operating expenses. The Second Circuit found that: (a) real estate taxes on the property had increased; (b) discontinuance of free rubbish removal by the city cost taxpayers $8,500; (c) to meet competition, the corpora-

---

87 281 F.2d 703 (3d Cir. 1960).
88 Id. at 707.
89 1957-2 CUM. BULL. 236.
92 305 F.2d 949 (2d Cir. 1962).
tions were required to furnish free gas and electricity; and (d) there was an increase in vacancy rates. Although some of these expenses were admittedly unexpected, the Second Circuit found, on balance, that the annual surplus of one apartment project was only $1,010 dollars less than projected, the other only $5,100 less. The court stated that, "It is difficult to believe that this small decrease, which is all the taxpayers had cause to expect, would have caused experienced real estate operators like the three taxpayers to sell their stock unless they had a previous view to its sale."98

Despite the court's conclusion, a strong argument can still be made that, under proper circumstances, such factors as increased real estate tax, added expenses for rubbish removal, gas, or electricity, price competition, higher vacancy rates than had been expected and other similar expenses, are facts which may negate the conclusion that the view existed before the completion of construction.

The health of one of the parties to the sale has often been a controlling factor. In Elliott v. United States,94 one of the minority shareholders suffered two strokes and was advised to retire from active participation in the project. He convinced another minority shareholder to sell also, and finally, they both convinced the majority shareholder to give in. Nine months after construction was completed, the sale was consummated. The court held that the requisite view did not exist.95

Other examples of unanticipated occurrences have been upheld. In Wheeler Kelly & Hagny Invest. Co. v. United States,98 the gain was attributable to a general appreciation in market value. Similarly, in Morris Cohen97 a factual situation was presented where:

There is evidence here that the early sale at a profit of the DOM stock was made possible by the selection of nearby land for the location of two large manufacturing plants, a fortunate circumstance not anticipated by the petitioners.98

Southwest Properties, Inc.,99 involved the increase in value of land in question because of the decision of a bank to open near the cite

98 Id. at 955.
95 For additional cases where health has been a significant factor see, e.g., Charles J. Riley, 35 T.C. 848 (1961); Maxwell Temkin, 35 T.C. 906 (1961); Shilowitz v. United States, 221 F. Supp. 179 (D.N.J. 1963).
96 64-1 USTC ¶ 9260 (1964).
98 Id. at 892.
99 38 T.C. 97 (1962).
owned by the taxpayers. In *Jack Saltzman*, the petitioner used the cash which he received from the sale of his property to further invest in his electrical business which he had purchased over a year after the purchase of his office building. In each of the above-mentioned cases, the events were found not to have been anticipated by the taxpayers, thus not tainting their actions with the view necessary to make Section 341 applicable.

It will be recalled that the statute requires that the property be constructed, "... with a view to—

(A) the sale or exchange of stock ... and,

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

Both views are necessary in order that the statutory requirement be met. *Payne v. Commissioner* is the only reported instance where the taxpayer attempted to separate the two views which are required under Section 341. The taxpayer in *Payne* was not successful in his attempt to separate the two views. The failure emphasizes once again that if a view to the sale or exchange of the stock is found, and if in fact a gain does accrue to the stockholder, then aside from very unusual extenuating circumstances, the view to the realization of the gain attributable to the property will be imputed. There seems to be little hope that the separate view distinction may be argued with success in the future.

**Construction**

The collapsible corporation is one which is "availed of principally for the manufacture, construction, or production of property . . . ." Most of the cases arising under Section 341 are concerned with real estate corporations which have been engaged, directly or indirectly, in the construction of buildings. The question of whether construction is in process at certain stages of the transaction is important in three contexts:

1. If construction has not begun, Section 341 does not apply.
2. If construction has not been completed at the time of the sale, distribution or exchange, the corporation may be regarded as

---

100 22 TCM 336 (1963).
102 268 F.2d 617 (5th Cir. 1959).
103 Tax Mgmt. 29, A-26.
collapsible. The regulations, and several of the cases applying
them, concede that if the requisite view arises after construction is
completed, the collapsible provisions of Section 341 will not attach.

3. If Section 341(d) is to apply, three years must have passed
after construction is completed.

It is thus necessary to know when construction has begun as
well as when it has been completed. In all three situations the term
“construction” has been broadly construed both by the Internal
Revenue Service and the courts.

Activities prior to sale or exchange which have been held to
constitute construction include:

1. Successfully petitioning to a zoning board to have land
owned by a corporation re-zoned from a residential to a commercial
class.

2. Engaging an architect to revise boundary lines on a plat,
paying for a building permit, making a deposit for the purchase of
water materials, advancing money to the utility company to make
connections, and making payments to acquire FHA loans. The
Second Circuit felt that it did not have to rely wholly on the filing
of applications for permits, loans and the payment of filing fees in
order to hold that “construction to any extent” had started since
the corporation had also paid for water materials and utility con-
nections. In dictum the court declared that it was not saying that
the filing alone would not have been enough since real estate develop-
ment is so heavily dependent upon government licenses and loans.
The court then concluded that the word “construction” had to be
interpreted broadly since the legislative history showed an equation
of “construction” with “adding value to the property.”

3. Subdividing the corporate property, making provisions for
sewers, streets and utilities and arranging for FHA financing of the
project. The taxpayers, who had acted on behalf of the corporation,
argued in Abbott v. Commissioner, that the statute required the
construction to be done by the corporation, whereas in this case
much of the construction enhancing the value of the land had been
done after the liquidation of the corporation. In finding that con-

a view to the action described in Section 341(b) if the requisite view existed at any
time during the manufacture, production, construction, or purchase referred to in
that section.” [Emphasis added.]


108 Farber v. Commissioner, 312 F.2d 729 (2d Cir. 1963).

109 Id. at 734.

110 258 F.2d 537 (3d Cir. 1958).
struction had begun, the court stated that the entire operation was arranged for and covered by binding agreements that only the corporation was in a position to carry forward at the time these agreements were entered into. The court then stated: 

"... [I]f individuals could thus project the acts which would take place after distribution and dissolution as though the corporation was in no sense a participant, all of the provisions in question would be meaningless."\(^{111}\)

4. Subdividing land, having the land annexed to a city, and obtaining an FHA commitment, all of which was done by individuals, was held, in *Payne*\(^{112}\) to be as much an integral part of construction as is the erection of a building.

5. Contracting to buy land, seeking an FHA mortgage commitment through a mortgage broker, and employing an architect who had completed about 40 per cent of the total plans. These activities of a corporation formed to erect and own apartment houses were sufficient to sustain a finding that it had engaged in construction.\(^{118}\)

6. Applying for and receiving a zoning change, hiring an architect to draw preliminary plans, negotiating with a city for building permits and acquiring two tenants were held to be construction in *Sproul Realty Co.*\(^{114}\)

On the other hand, several recent opinions have held that a certain amount of preliminary activity on the part of a corporation would not constitute "construction." In *Morris Cohen*\(^{115}\) the corporation had attempted to have water service supplied to the land, employed a surveyor to make a contour map showing how the property could be developed as commercial land, and filed a petition to have the property rezoned as residential instead of agricultural. During this period two large manufacturing plants were built near the corporation's land, and an unsolicited offer was made to buy either the corporation's stock or its land. The offer was accepted. In finding that there was no construction under Section 341(b), Judge Murdock, speaking for the Tax Court, held:

The very limited activities of representatives of Sarkisian or of DOM while the petitioners owned its stock did not put either in the real

---

\(^{111}\) Id. at 541.

\(^{112}\) 30 T.C. 1044, aff'd, 268 F.2d 617 (5th Cir. 1959).

\(^{113}\) Sterner, 32 T.C. 1144 (1959). See also the Tax Court decision in Abbott, 28 T.C. 795, 805, aff'd, 258 F.2d 537 (3d Cir. 1958), where the statement was made: "Indeed, it may be said that construction of a road is no less 'construction' than building an apartment house."

\(^{114}\) 38 T.C. 844 (1962).

\(^{115}\) 39 T.C. 866 (1963).
estate business, did not result in any physical danger or improvement to the property of either and, in the case of DOM, did not constitute "construction" even within the broad meaning of that term as used in Section 341(b).

Cohen and Vernon M. McPherson, the most recent cases to deal with the problem of preliminary activities and construction, can be reconciled with the earlier cases solely on the basis that they, unlike the earlier cases, did not involve FHA loans.

An even more liberal interpretation of "construction" has been applied to determine the point of completion. If anything remains to be done the courts will find that "construction" has not been completed. The extreme, thus far, is Glickman v. Commissioner, where the buildings in question were entirely finished when the sale was made, but some minor landscaping and a final FHA inspection remained. The FHA had, however, made preliminary inspections and had permitted occupancy as the individual buildings were completed. In addition, the municipal authorities had issued their final certificate of occupancy. The cash distribution was made on January 13 and four days later the final FHA inspection was made. The Second Circuit, in holding that "construction" had not been completed, stretched the term almost to the breaking point by saying, "... [T]hat under the correct interpretation of the statute 'construction' should be defined technically to mean all construction required to perform the contract completely."

In Edward Weil, a retaining wall and a parking lot remained to be constructed. In setting the outer limit of the word "construction," the court said, "the final completion could not be fixed earlier than the time when the project was ready to begin earning a 'substantial part' of the 'net income'..." The Weil test is easier for the taxpayer to meet than the Glickman test since, in Glickman, the

---

116 Id. at 892.
117 21 TCM 583 (1962), involving employment of a land planning consultant and engineering firm.
118 Tax. Mgmt. No. 29, A-11 notes that: "FHA corporations ... present a classic example of what the collapsible corporation provisions were intended to forestall. ... It is not so clear from the facts [of Cohen and McPherson] that the purpose of the collapsible corporation provisions would be frustrated if the taxpayer in those cases were permitted to realize capital gains. Thus, in the earlier cases the court was probably more disposed to extend the ordinary meaning of construction than it was in the later two decisions." Cf., the similar argument made and rejected in Braunstein v. Commissioner, 305 F.2d 949, 957 (2d Cir. 1962).
119 256 F.2d 108 (2d Cir. 1958). Cf., Epstein v. United States, 221 F. Supp. 479 (N.D. Ohio 1963), where the point was assumed for discussion but the decision was grounded on another issue.
120 256 F.2d at 111.
121 28 T.C. 809 (1957).
122 Id. at 816.
The corporation could have begun, and as a matter of fact had begun, to earn a substantial part of its net income, but technically, had not completely performed the contract. A good example of how the Weil test can work to the taxpayer's advantage is Maxwell Temkin,\textsuperscript{123} where repairs to walks, driveways, steps and a considerable amount of landscaping remained to be completed to fulfill the contract. These facts did not prevent the Tax Court from finding the construction had been completed, since the building had been occupied and producing rents for some time. Temkin and Weil, unlike Glickman, did not involve corporations using FHA financing and are, therefore, analogous to Cohen and McPherson, which were concerned with the beginning of construction. A recent revenue ruling\textsuperscript{124} dealt with facts similar to those in Glickman. Following completion of construction as set forth in the plans and specifications, minor alterations and corrections (including a change of decor, removal of an obstruction and installation of rest rooms) were made. The alterations did not increase rental area, change the character of the structure or increase the fair market value or realizable net income of the building. This was not considered to be "construction." There is no indication whether an FHA commitment was involved. The ruling may be an indication that the Internal Revenue Service is retreating from its absolute position.

The final chapter on the judicial definition of "construction" has not yet been written. As to commencement and conclusion, there remains a sharp split of authority. Perhaps this dichotomy will be rationalized on the basis of the presence or absence of FHA guarantees. This rationale is, of course, a pure fiction. No good reason can be advanced to support the proposition that different rules should apply to two corporations with identical work remaining, merely because one has obtained an FHA loan and the other has used conventional bank financing. Such a result is, obviously, a throwback to the philosophy of strict interpretation and congressional intent and an undue reliance on the fact of "view." The better rule of Weil and Temkin should be followed whether or not there was an FHA commitment.

**SUBSTANTIAL PART**

The Courts are clearly split as to the interpretation of the words "a substantial part of the taxable income to be derived from such property."\textsuperscript{125} Section 341(b)(1), from which these words are drawn, declares that the collapsible provisions will apply when the

\textsuperscript{123} 35 T.C. 886 (1963).
\textsuperscript{124} Rev. Rul. 63-114, 1963-1 CUM. BULL. 74.
\textsuperscript{125} INT. REV. CODE of 1954, § 341(b)(1)(A).
sale or exchange is made before a substantial part of the corporation’s net income has been earned. A major problem has arisen because of the courts’ inability to agree on the time when these words should apply. The Fifth Circuit\textsuperscript{126} has declared that “substantial part” refers to the income which the corporation has realized up to the time of the sale or exchange. Under this theory, if at the time of the sale or exchange the corporation \textit{has realized} a “substantial part” of the net income to be realized, the corporation will not be collapsible within the meaning of Section 341. The Third Circuit,\textsuperscript{127} on the other hand, has stated that “substantial part” means that the corporation cannot have a “substantial part” of its income \textit{yet to be realized} at the time of the sale or exchange. A related problem is: What constitutes a “substantial part” since this term is not defined by the Code or Regulations?\textsuperscript{128}

A starting point is provided by the relatively early case of \textit{Levenson v. United States}\textsuperscript{129} wherein the court noted that Congress had given no indication of what per cent of income would be “substantial,” and expressed its belief that the phrase would cause interpretive difficulty. The court said that, absent any amendment to the statute, determination would be made on an \textit{ad hoc} basis “by the courts and local tax officials.”\textsuperscript{130}

Whether pre-sale or post-sale income was to be used to determine if the substantial-part test has been met, was first considered in \textit{Abbott}.	extsuperscript{131} The Third Circuit affirmed the Tax Court, believing that the lower court had followed the post-sale rule, and stated:

The real question posed by the statute, however, is not whether a substantial part of the total profit was realized prior to dissolution, but rather whether that part of the total profit \textit{realized after dissolution} was substantial. This was the test correctly applied by the Tax Court in making its finding that the dissolution took place before a substantial part (nearly 90\%) of the total profit was realized.\textsuperscript{132}

However, \textit{James B. Kelley}\textsuperscript{133} (the next Tax Court case) indicated that the Third Circuit had misinterpreted the Tax Court’s application of the substantial part test. In a sharply divided opinion (five judges dissented, including the judge who wrote \textit{Abbott}), the Tax Court stated that it had not meant to follow the post-sale test, and did not believe that it had done so. On appeal, the Fifth Circuit

\textsuperscript{126} Commissioner v. Kelley, 293 F.2d 904 (5th Cir. 1961).
\textsuperscript{127} Abbott v. Commissioner, 258 F.2d 537 (3d Cir. 1958).
\textsuperscript{128} 157 F. Supp. 244 (N.D. Ala. 1957).
\textsuperscript{129} Id. at 250.
\textsuperscript{130} 28 T.C. 795, \textit{aff’d}, 258 F.2d 537 (3d Cir. 1958).
\textsuperscript{131} Abbott v. Commissioner, 258 F.2d 537, 542 (3d Cir. 1958).
\textsuperscript{132} 32 T.C. 135 (1960).
affirmed in a very comprehensive opinion. The court noted that
the opinion of the Third Circuit in Abbott was a surprise to the Tax
Court; it cited the lower court's opinion in Kelley, and took note of
the position of the Commissioner and the taxpayer. The court
stated, "The grit in the oil is that a substantial part has already been
realized, but a substantial part remains to be realized, leaving plenty
of life in the collapsible corporation device." Then, deciding in
favor of the taxpayer, the opinion continued, "Section 117(m)
requires only that 'a substantial part' be realized. The indefinite
article 'a' says in plain language that there may be two or more
substantial parts."

Kelley provides the better reasoned rule, since it interprets the
statutory language clearly and precisely. Nevertheless, the split
between the Circuits remains and is emphasized by the fact that the
Internal Revenue Service has served notice that it will not follow
Kelley as well as by the fact that even the Kelley decisions were
not unanimous. However, the present judicial trend clearly follows
the Kelley doctrine.

On the issue of what actually is a substantial part of the taxable
income to be derived from the property, there has been a wide diver-
gence of opinion among the courts. Some have held 50 per cent,
40 per cent, 33 per cent, and 34 per cent constituted a sub-
stancial part. On the other hand, 17 per cent, 10 per cent,
and 9½ per cent have been held not to be a substantial part. It should
be kept in mind that the "substantial part" in issue is a substantial
part of the taxable rather than net income. And it also should be
emphasized that the particular facts of the case are important. Thus,
the Fifth Circuit has found one-third to be a substantial part and


138 Commissioner v. Kelley, 293 F.2d 904 (5th Cir. 1961).
139 Id. at 909.
140 Id. at 912.
142 Commissioner v. Zongker, 334 F.2d 44, 45-46 (10th Cir. 1964), refers to the Kelley decision as, "an exhaustive and penetrating treatment . . . " of the statutory
meaning which is, "more plausible and certainly less penal." The court in Winn v.
United States, 243 F. Supp. 282, 290 (W.D. Mo. 1965) stated, "The opinion of Judge
Wisdom appears to be unassailable unless one ignores the plain language of the
statute . . . ."
145 Commissioner v. Kelley, 293 F.2d 904 (5th Cir. 1961).
147 Heft v. Commissioner, 294 F.2d 795 (5th Cir. 1961).
seventeen per cent to be insubstantial. In holding that thirty-four per cent was substantial, the Tax Court found no cases indicating that more than twenty per cent was insubstantial. Below twenty per cent will probably be held insubstantial; above thirty per cent will probably be held substantial. A case involving something between these two figures will be decided on the facts presented. Since no hard and fast rule can be established without legislative direction, in the exceptional case even the 20-30 per cent rule may not stand up. Prior to Kelley, the Internal Revenue Service followed a rule of thumb that over fifty per cent would be considered substantial. In view of the fact that the Service declines to follow Kelley, it can be expected to require at least fifty per cent in the future.

Present Availability of Section 341

Although several courts and the Internal Revenue Service have taken an overly stringent view of Section 341, there is, as Judge Wisdom has sagely noted, “plenty of life in the collapsible corporation device.” Regarding the present availability of Section 341, the following factors must be carefully considered:

1. Negation of the Requisite View. This can best be achieved by showing that prior to the time the corporation was “availed of,” there was an absence of factors which would indicate that the taxpayer intended to utilize this corporation for tax avoidance purposes. For example, one might show; (1) other investments for long-term capital gains in this type of property, (2) absence of two classes of stock “so that one class could be redeemed as soon as the building was completed,” (3) no FHA mortgage guaranty during construction. On the other hand, an unanticipated occurrence after construction has been completed (decrease of rental income, increase of expenses, health reasons, increased valuation of the land because of activities of other landholders nearby) can also show a lack of the necessary view.

2. Construction. If the sale or exchange is early in the series of transactions, an argument should be made that construction has not begun, especially if the corporation has not relied upon an FHA guaranty. It also can be argued, on the basis of Maxwell...
Temkin,162 that Section 341 does not apply because the "view" did not exist until after the completion of construction.

3. Substantial Part. The better-reasoned rule of Commissioner v. Kelley158 should be followed in regard to when the corporation must earn a substantial part of its taxable income. If the Kelley rule is followed by the courts, a minimum of thirty per cent of the income will have to be earned by the corporation before the sale or exchange. Whereas, if the Abbott rule is followed,154 fifty per cent would seem to be necessary.

4. Section 341(d) Limitations. These exceptions become important only if the corporation is found to be collapsible.

a. Seventy per cent rule. If less than seventy per cent of the gain is attributable to the collapsible property of the corporation, Section 341 is inapplicable. If a corporation which owns a building is later availed of to construct a second building, and the gain can be equally divided between the two buildings, the seventy per cent exception will absolve the taxpayer from any liability. This may be one of the most important means of escaping the burden of Section 341.156

b. Three year rule. If the corporation holds the property for three years following construction, before the shareholder sells or exchanges his stock, Section 341 does not apply. Care must be taken to see that construction is completed.156

c. Five per cent rule. A taxpayer who owns less than five per cent of the outstanding shares in a corporation is relieved from liability although the corporation is collapsible.157

5. Section 341(e). In general, subsection (e) provides for an exemption from the collapsible provisions of Section 341 if the net unrealized appreciation of the corporation's subsection (e) assets does not exceed fifteen per cent of the corporation's net worth at the time of: (a) a sale or exchange of stock under Section 341(a)(1), (b) a complete liquidation under Section 341(a)(2), (c) a Section

153 293 F.2d 904 (5th Cir. 1961).
154 Abbott v. Commissioner, 258 F.2d 537 (3d Cir. 1958).
155 Moses, The 70 Per Cent Rule-A Possible Haven for Taxpayers Faced With Collapsible Corporation Problems, 51 A.B.A.J. 188 (1965); Chodrow & Castro, How to Use the "70-30" Exception to Avoid Collapsible Corporation Treatment, 21 J. TAXATION 258 (1964).
157 Levenson v. United States, 157 F. Supp. 244, 251 (N.D. Ala. 1957). In Levenson the 10% rule of § 117(m)(3)(A) was applied. The per cent requirement was changed by the 1954 amendment to 5% and is now found in § 341(d)(1).
333 partial liquidation, (d) a Section 337 dissolution. If it is suspected that the provisions of subsection (e) may be applicable to a particular fact situation, care should be taken to investigate this extremely complex subsection. The authorities listed above will undoubtedly prove extremely useful.

6. **Section 333.** If a corporation is found to be collapsible, but is able to take advantage of one of the exceptions in Section 341(d) or 341(e), then it is not a corporation to which Section 341(a) applies, and may qualify under Section 333. This section specifically states that it applies to complete liquidations other than a collapsible corporation to which Section 341(a) applies.158

7. **Six-Month Rule.** If the sale or exchange is within six months from the time it was acquired, none of the collapsible corporation provisions will attach, inasmuch as Section 341 applies only to gains which would otherwise be long term capital gains.159

8. **Election.** A timely election of Subchapter S160 is a possible solution to the collapsible problem, if the collapsible property of the corporation is not inventory.161

9. **Section 337.** Under certain conditions, a taxpayer might be able to take advantage of Section 337.162

10. **Section 341(f) Exception.** These provisions remove from the operation of Section 341, sales of stock during a six-month period after the corporation has consented to a recognition by it of future gain on its subsection (f) assets. The subsection (f) provisions are expected to provide assistance in cases of stock sales in a corporation which is "rapidly growing and expects to continue in business but which holds constructed or produced properties which are worth substantially more than their cost and upon which there has not been substantial realization of the profits to be derived from the properties."163

**CONCLUSION**

The foregoing shows that the collapsible corporation, while considerably limited in scope by statute, judicial decision, and the Internal Revenue Service, from what it once was, has by no means

---

158 INT. REV. CODE of 1954, § 333(a).
160 INT. REV. CODE of 1954, §§ 1371-77.
162 20 Tax Mgmt. A-51.
become a useless concept. In an attempt to plug the collapsible corporation loophole, Congress has succeeded only in constructing a confusing statutory framework which fails to do the job. This has resulted in a series of confusing and conflicting decisions by the courts. As Judge Wisdom has noted, "The effect of our holding is to leave the loophole two-thirds open . . . . If Congress wants a better job done, Congress should provide a tax that will not just plug the loophole 'a substantial part of the way.'"164 If this is to be the case, the business-planning attorney has a duty to his client to utilize the loophole left open by the statute, for, as Judge Lynne noted, "It is too late in the day for the . . . [United States] to insist that its citizens are obliged to conduct their affairs and mold their businesses so as to produce for its treasury the maximum amount in taxes."165 The device of the collapsible corporation, when employed wisely and with the necessary safeguards, can be an effective tool in the hands of the skilled business-planning attorney.

164 Commissioner v. Kelley, 293 F.2d 904, 913 (5th Cir. 1961).