
Interpretation of Some Aspects of Collapsible Corporation Legislation

DePaul College of Law

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CONCLUSION

The FTCA has waived the doctrine of sovereign immunity to a great extent. However, the courts have hesitated to interpret the act as liberally as was apparently intended by Congress. One of the basic purposes of the act was to shift the burden of loss from the injured to the public. Since the activity out of which the injury resulted was for public benefit, it is only proper that the public bear the burden. The modern notion under which losses are shifted to those who can best bear them should serve to expand governmental liability under the FTCA.

The effectiveness of the FTCA has been hampered not only by the strict interpretations of judges but also by the ambiguities within the act. For example, the first exception to the waiver of immunity has caused great frustration; interpretations of the term "discretionary" have been inconsistent; the courts have used the inconsistency to base their decision on the economic burden and the multiplicitous litigation threatened.

Undoubtedly the troublesome sections of the act will be simplified. But even without the simplification, the FTCA represents great progress and advancement from the antiquated idea of sovereign immunity.

INTERPRETATION OF SOME ASPECTS OF COLLAPSIBLE CORPORATION LEGISLATION

INTRODUCTION

Prior to the enactment of section 117 (m) of the Internal Revenue Code of 1939 (now 341 of the 1954 Code) by Congress in 1950,¹ there existed certain tax advantages whereby ordinary income could be converted into long term capital gain. This tax advantage was cultivated by the creation of a temporary or collapsible corporation. This was done most often in the motion picture and building construction industries. For example, a corporation would be organized to produce a single motion picture. The directors and actors would receive stock in lieu of salaries, and said stock would then be sold, or the corporation liquidated, as soon as the picture was completed. Under these conditions, any profits derived from the sale of the stock or liquidation of the corporation would be taxable as capital gains at a maximum rate of twenty-five per cent.

In an effort to curtail the use of collapsible corporations, Congress defined a collapsible corporation as one "formed or availed of" principally for the purpose of manufacture, construction, purchase, or production of property "with a view" to the sale or exchange of stock by its share-

¹ 64 Stat. 935 (1950), as amended, 26 U.S.C.A. 341 (1954).

holders, or a distribution to its shareholders, before the realization by the corporation of a substantial part of the taxable income to be derived from such property.² Congress further provided, inferentially, that the gain from the sale of stock or liquidation of a collapsible corporation should be taxed as ordinary income rather than a capital gain.³ This tax definition of a collapsible corporation illustrates some of the difficulties encountered by the courts in interpreting legislation which is vague and uncertain.

PRINCIPAL INTENT

The statute provides that a corporation is collapsible when it is formed or availed of principally for the manufacture, construction, production, or purchase of property with a view to the sale of stock by its shareholders or a distribution of corporate assets in liquidation to the shareholders.⁴ In explaining the statute, the courts have held that the requisite principal intent need be only to manufacture, construct, produce, or purchase the collapsible asset, rather than to maintain a view to engage in tax avoidance through the collapse of the corporation. The word *principally* should be read as modifying "manufacture, construction, or production of property" rather than as modifying "with a view to."⁵ Under this interpretation, the corporation may be collapsible if "manufacture, construction, or production" was a principal corporate activity even if the "view to" collapse was not the principal corporate aim when the corporation was "formed or availed of." This explanation seems to be in agreement with Congress' expressed purpose to reduce certain advantages in the tax structure.⁶

THE REQUISITE VIEW TO COLLAPSE

The question of when a corporation is formed or availed of with a view to the action described in section 341 has been a topic of repeated discussions among tax experts. The regulations provide that a corporation is formed or availed of with a view to the sale of the stock or liquidation of the corporation before the realization of a substantial part of the taxable income to be derived from such property, if the requisite view existed at any time during the construction, production, etc., referred to in that section.⁷ Thus, if the sale or distribution is attributable solely to circumstances which arose after the construction, etc. (other than circumstances which reasonably could be anticipated at the time of such construction,

² Int. Rev. Code of 1939, § 117(m), now Int. Rev. Code of 1954, § 341.

³ Int. Rev. Code of 1954, § 341(a).

⁴ Int. Rev. Code of 1954, § 341(b)(1)(A).

⁵ *Weil v. Commissioner*, 252 F.2d 805 (2d Cir. 1958).

⁶ *Ibid.*

⁷ Treas. Reg. § 1.341-2(a)(3) (1955).

etc.), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale is attributable to circumstances present at the time of the construction, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.⁸ The Regulations also provide that the requisite view exists if the sale of stock or the distribution to shareholders is contemplated "unconditionally, conditionally, or as a recognized possibility."⁹ The statements expressed in the Regulations have been followed in a number of court decisions.¹⁰

It is of primary importance to determine when corporate activity is completed, because once the corporate activity is finished, the corporation can no longer be so formed or availed of as to be a collapsible corporation within the meaning of the aforementioned Regulations. In *Weil v. Commissioner*,¹¹ a shopping center was found not to be completed since the construction of a retaining wall and the completion of a parking lot prevented effective operation. The lower court held that final completion would not be fixed earlier than the time when the project was ready to begin earning a substantial part of the net income.

Some courts have thought that the Regulations have adopted a too narrow interpretation of the statute. Judge Parker, writing the majority opinion of the court in *Burge v. Commissioner*,¹² held that it was not necessary that the *view* exist at the time the corporation is formed, but rather it is sufficient if it exists when the corporation is *availed of*. In *Jacobson v. Commissioner*,¹³ it was held that the corporation may be availed of at any time during its corporate life. The effect of these two decisions is that a corporation may be collapsible, notwithstanding the fact that the corporate activity is completed, provided the requisite *view* exists during the corporate life. The *Burge* decision was followed in *Glickman v. Commissioner*,¹⁴ where the court held the case indistinguishable from the *Burge* case. In the *Glickman* case, the court concluded that the Regulation's interpretation of the statute was too narrow, and was in fact more favorable to the taxpayer. *Payne v. Commissioner*¹⁵ appears to favor the position of the Regulations, but *Sidney v. Commissioner*¹⁶ goes even further than the

⁸ *Ibid.*

⁹ Treas. Reg. § 1.341-2(a) (2) (1955).

¹⁰ Carl B. Rechner, 30 T. C. 186 (1958); Max Mintz, 32 T. C. 723 (1959); Elizabeth M. August, 30 T. C. 969 (1958); Robert T. Coates v. United States, 60-2 USTC ¶9673 (1960).

¹¹ 252 F.2d 805 (2d Cir. 1958).

¹² 253 F.2d 765 (4th Cir. 1958).

¹³ 32 T. C. 893 (1959).

¹⁴ 256 F.2d 108 (2d Cir. 1958), also *Spangler v. Commissioner*, 278 F.2d 665 (4th Cir. 1960).

¹⁵ 268 F.2d 617 (5th Cir. 1959).

¹⁶ 273 F.2d 928 (2d Cir. 1960).

Burge case or the *Glickman* case in using the *availed of* reference point.

The *Sidney* case also held that the predecessor section, 117 (m), enacted on September 23, 1950, and made applicable to gains realized after December 31, 1949, could constitutionally apply to a distribution on January 30, 1950. Further, the court held that Congress could retroactively attach significance to views held prior to the statute, and that the change from capital gain to ordinary income classification was essentially a change in the rate of tax, and taxpayers must expect new revenue acts every year.

POST-CONSTRUCTION MOTIVE INVOKED TO AVOID COLLAPSIBILITY

The next query to consider is the post-construction motive. It was contended by the taxpayers in *Mintz v. Commissioner*,¹⁷ that friction prompted the sale of their stock and since this arose after completion of construction, section 341 is inapplicable. The court denied this contention on the grounds that "under the correct interpretation of the statute 'construction' should be defined technically to mean all construction required to perform the contract completely."¹⁸ Attempts to render section 341 inapplicable by the use of the post-construction motive have been unsuccessfully invoked in a number of recent Tax Court decisions.¹⁹ In *Jacobson v. Commissioner*,²⁰ the discovery of a crack in the wall in one of five apartment buildings constructed by the taxpayers, which resulted in the sale of stock by the shareholders within three or four months after completion of the project, and prior to realization by the corporation of a substantial part of the net income to be derived from the project, was held insufficient to render section 341 inapplicable. This was due to the fact that the intent to make a profit before the corporation realized any substantial net income could have existed prior to, or during construction, as well as after. Furthermore, the court rejected the contention of the taxpayers which was based on the Regulations, because of prior court decisions which held that section 341 is applicable at the time the corporation is *availed*,²¹ which means at any time during the corporate life.²² In *Sterner v. Commissioner*,²³ disharmony arose between the shareholders

¹⁷ 32 T.C. 723 (1959).

¹⁸ *Id.* at 740.

¹⁹ Carl B. Rechner, 30 T. C. 186 (1958); Lewis S. Jacobson, 32 T. C. 893 (1959); Ellsworth Sterner, 32 T. C. 1144 (1959).

²⁰ 32 T. C. 893 (1959).

²¹ *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958); *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958).

²² Lewis S. Jacobson, 32 T. C. 893 (1959).

²³ 32 T. C. 1144 (1959).

before construction began and continued until after construction was completed. The court held that though this disharmony prompted the sale, it was not sufficient reason to avoid the corporation being labeled as collapsible.

A SUBSTANTIAL PART: REALIZED OR
UNREALIZED TAXABLE INCOME

Section 341 has confronted tax planners with the necessity of choosing one of two conflicting meanings. The clause "prior to the realization of a substantial part of the taxable income to be derived from such property" can have two meanings. It has been held to mean: (1) that a substantial part of the total taxable income must be realized before the sale or liquidation,²⁴ or (2) no substantial part of the total taxable income remains to be derived from the property at the time of the sale or liquidation.²⁵ The Congressional Committee reports do not make clear which of these interpretations is intended.²⁶ In *Commissioner v. Kelley*,²⁷ the Court of Appeals found, that as is the case of the statute itself, the numerous general statements in the Regulations using the phrase *income to be derived* can be read both ways, although it can be assumed more readily that they refer to the part of the income realized before the sale or exchange. Thus, it was decided that effect would be given to that interpretation which more naturally conveys the meaning of the words as they are written in the statute. Therefore, the Court of Appeals affirmed the Tax Court and held that the phrase refers to the income realized before the sale of stock or liquidation of the corporation.²⁸ This result was in direct disagreement with *Abbott v. Commissioner*²⁹ upon which the Commissioner in the *Kelley* case relied. In the *Abbott* case, the Court of Appeals, Third Circuit, misinterpreted the test applied by the Tax Court. The court concluded that the test applied by the Tax Court was whether that part of the total profit realized after dissolution was substantial, rather than whether a substantial part of the total profit was realized prior to dissolution. This diagnosis of the *Abbott* decision was erroneous and surprised the majority of the Tax Court in the *Kelley* case. Judge Kern writing for the majority of the Tax Court in the *Kelley* case pointed out that in the

²⁴ See McLean, *Collapsible Corporations—The Statute and Regulations*, 67 HARV. L. REV. 55 (1953), for further discussion of this matter.

²⁵ *Ibid.*

²⁶ *Hearings before Committee on Ways and Means on Revenue Revision of 1950*, 81st Congress, 2d Sess. 2, 5 (1950).

²⁷ *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961).

²⁸ *Ibid.*

²⁹ 258 F.2d 537 (3rd Cir. 1958).

Abbott case, the Tax Court inferentially held that 10.8 per cent already realized at the date of liquidation was not a substantial part. By virtue of the view expressed by the Court of Appeals in the *Abbott* case, the Commissioner in the *Kelley* case pointed out that since two-thirds of Island Shores' income had not been acquired, the sale occurred prior to the realization by the corporation of a substantial part of the total taxable income to be realized. This view was not shared by the Tax Court or the Court of Appeals and the finding on this issue was in favor of the taxpayers in the *Kelley* case. Consequently, there may be two substantial parts of a whole, and a finding that the unrealized part of such taxable income is substantial, does not preclude a finding that the realized part of such taxable income is also substantial.

A SUBSTANTIAL PART—JUDICIAL INTERPRETATIONS

Section 341 also presents the problem as to what is substantial. The statute uses the phrase *a substantial part*, but there is nothing in the legislative history or in the factual setting that produced section 341 to indicate that Congress designed the law with a fixed percentage in mind.³⁰ The Regulations go so far as to suggest that until the unrealized income from the property is insubstantial in relation to the income that has been realized, the realization may not be regarded as having been of a substantial part of the taxable income.³¹

The courts have attempted to determine what "*a substantial part*" is in four recent decisions. The first of these, *Levenson v. United States*,³² involved the sale of trailers. When the corporation was organized, there remained available to it, under contract, 3,495 trailers. When the corporation was liquidated on February 15, 1954, it had sold 1,795 trailers, and had realized 51.37 per cent of the total anticipated taxable income. The court held that this percentage realized prior to the sale of the stock constituted a substantial part of the taxable income to be derived from all of the corporate property. Following closely on the heels of this first interpretation was *Abbott v. Commissioner*,³³ decided in 1958. In that case, a profit of \$23,472.75 was realized by the corporation from the sale of land prior to liquidation. Since the total profit was \$215,349.20, the profit prior to liquidation amounted to 10.84 per cent of the total profit. The court decided that this did not constitute a substantial part of the taxable income to be derived from such property, and thus held the corporation collapsible.

³⁰ S. REPT. No. 2375, 81st Cong. 2d Sess. 88, 1950-2 Cum. Bull. 546-47. H. R. REP. No. 2319, 81st Cong., 2d Sess. 97, 1950-2 Cum. Bull. 449.

³¹ Treas. Reg. § 1.341-5 (c) (2) (1955).

³² 157 F. Supp. 244 (N.D. A1a. 1957).

³³ 258 F.2d 537 (3rd Cir. 1958).

In August, 1961, the United States Court of Appeals, Fifth Circuit, affirmed the decision of the Tax Court in the *Kelley* case.³⁴ The court held that one-third of the anticipated taxable income realized prior to the sale of the stock of the corporation constitutes a substantial part of the total taxable income to be derived from the property by the corporation. In retrospect, the court held, there is "no litmus-paper test."³⁵

Forty-four days after the *Kelley* case was affirmed, the same court announced its decision in *Heft v. Commissioner*.³⁶ With the facts essentially the same as those in the *Kelley* case, and a profit of 17.07 percent realized prior to liquidation proceedings, the court determined the corporation to be collapsible inasmuch as 17.07 per cent was not a substantial part of the taxable income. The court in rendering its decision held that the meaning of the word *substantial* rests upon an implied comparison between the described subject and the larger unit. They said that to ascertain its meaning in any particular concept, one must examine the frame of reference and the purpose intended by the use of the term.

From an analysis of the foregoing cases, it can be seen that a *substantial part* means somewhere between 17.07 per cent and 33 per cent of the taxable income to be derived from the property. It can readily be seen that the door is beginning to close on this phrase. However, there is enough room open to permit a still narrower breaking down of the phrase. Perhaps in the near future, a specific percentage will be applied to determine what is substantial. However, such an exact percentage must, by its very nature, be statutory.

Even though a corporation is collapsible, under certain circumstances, gain recognized by its shareholders with respect to its stock is still given capital gains treatment.³⁷

CONCLUSION

One can readily see the inadequacies of section 341 of the Internal Revenue Code of 1954. It is saturated with vague phrases and offers many opportunities of escape to those who are intentionally trying to accomplish the avoidance at which the section is aimed. This section could be established as a symbol of legislation which is passed without foresight or meaning. Perhaps in the future, legislation will be so worded as to avoid having to burden the courts with the necessity of interpreting vague Congressional language and intent.

³⁴ *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961).

³⁵ *Id.* at 914.

³⁶ *Heft v. Commissioner*, (C.A. 5th 1961).

³⁷ See Int. Rev. Code of 1954, § 341(d) and DeWind and Anthoine, *Collapsible Corporations*, 56 COLUM. L. REV. 475 (1956), for a further discussion of limitations on collapsible treatment.