Washington and Lee Law Review

Volume 8 | Issue 2 Article 3

Fall 9-1-1951

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METAPHORICAL TAX LEGISLATION: THE COLLAPSIBLE CORPORATION

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A first encounter with the phrase "collapsible corporation" is likely to summon up disagreeable remembrances of things past. Fortunate is he who has never been associated with a corporation which has collapsed. And yet a notion of the meaning of the phrase based on past unpleasant experience is quite anachronistic. In recent years, corporations now Congressionally defined as collapsible[1] have been the means for the most fundamental financial pleasure, the realization of substantial income at capital gains rates.[2]

When individual income tax rates have ranged as high as 91 percent,[3] the inducement to the taxpayer to couple imagination with logic in attacking his tax problems has been very great. The desire to convert ordinary income to long-term capital gain, taxable at a maximum effective rate of 25 percent,[4] has been overpowering. These considerations formed the rootstock for the collapsible corporation, one of the fragile blossoms in the recent crop of tax-saving devices. If the device was fragile in the past, its future has been rendered even more tenuous by the Revenue Act of 1950.

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[1]Pub. L. No. 814, 81st Cong. 2d Sess., § 212 (1950); Int. Rev. Code § 117 (m), as amended Sept. 23, 1950.

[2]The Bureau of Internal Revenue does not agree, contending, but without great assurance, that the collapsible did not accomplish its supposed tax saving even under the law as it stood prior to the recent amendment. Hearings before Committee on Ways and Means on Revenue Revision of 1950, 81st Cong. 2d Sess. (1950) 141; see statement of Secretary of the Treasury Snyder at page 152 infra.

[3]This is the combined normal and maximum surtax rate. In recent years the maximum effective combined rate has been something less than 91 per cent because of the tax reduction provided by Int. Rev. Code § 12(c), which reduction is eliminated for the year 1951. Pub. L. No. 814, 2d Sess., § 101 (1950). Furthermore, the combined normal tax and surtax has not been permitted to exceed 77 per cent, 80 per cent, or, for 1951, 87 per cent of net income. See Int. Rev. Code §§ 12(c)(2) and 12(f).

[4]The alternative long-term capital gains tax provided by Sec. 117(c) permits an individual to pay a tax of 50 per cent on 50 per cent of his gain in lieu of other income tax, if that is to his advantage; this, of course equals a tax of 25 per cent of the entire amount of the gain.

Why the Collapsible Was Used

Section 22(a) of the Internal Revenue Code[5] contains the definition of gross income for federal income tax purposes and expressly includes "gains . . . derived from . . . sales, or dealings in property." Section 111, with appropriate reference to Section 113(b), indicates the manner in which the amount of gain from the sale or other disposition of property is to be determined.[6] Section 23 authorizes certain deductions from gross income to arrive at net income upon which the tax is imposed.

If the matter rested there, no tax advantages would arise from the use of the collapsible device. That is, if all income were taxed alike, the manner in which it was acquired would be of no consequence. But provision is made for special tax treatment of some gains from the sale or exchange of property. In the case of an individual, if the gain is from the sale or exchange of a capital asset[7] as defined in Section 117(a)(1)[8] and if such asset has been held for more than six months, only 50 percent of the gain need be taken into account for tax purposes.[9] Furthermore, an alternative taxing method is provided[10] under which, instead of the gain taken into account being taxed at the regular graduated surtax rates, such gain is taxed at a rate of 50 percent when this alternative favors the taxpayer.[11] The maximum tax rate of 50 percent applied to 50 percent of the gain results in a maximum effective tax of 25 percent on long-term capital gains, which otherwise might be subject to much higher combined normal and surtax rates.

There is reason to believe that the collapsible device has been

[5]Unless otherwise stated, all section references in the text of this article are to sections of the Internal Reveue Code.

[6]Int. Rev. Code § 111 also deals with the question of recognition of gain and loss and in this connection makes reference to Sec. 112. The non-recognition provisions of the Code are not of importance at this point, but Sec. 112(b)(1), (5), (7) transactions are discussed infra at pages 159 and 166 respectively.

[7]Whether capital gains should be taxed, and, if so, how, are problems not fully settled, even apart from the question of abuse of the present capital gains provisions. See, e.g., Griswold, Cases and Materials on Feredal Taxation (3d ed. 1950) 403-405; Blum. The Decline and Fall of Capital Gains: 1921-1957, 28 Taxes (1950), digested in Monthly Digest of Tax Articles, Nov. 1950, p. 63.

[8]See also Int. Rev. Code § 117(j), which provides for similar treatment of gain from the sale or exchange of certain property not included within the definition of capital assets.

[9]Int. Rev. Code § 117(b).

[10]Int. Rev. Code § 117(c).

[11]The alternative method can favor the taxpayer only if his income without regard to capital gains, or together with his capital gains, is so large that the top increment will be subjected to rates in excess of 50 per cent.

widely used in the building and motion picture industries.[12] The nature of the device may perhaps best be explained by three oversimplified[13] examples based upon the building industry.[14]

> 1. Jones and Smith acquire Black Acres for $10,000, construct thereon twenty low-cost houses for an added cost of $90,000, and then sell the houses and lots for an aggregate of $150,000.

Conceding that Jones and Smith should not be too unhappy about the venture, much of their enjoyment will evaporate as they watch a substantial portion of their $50,000 gain melt away in the form of taxes. The houses sold by Jones and Smith, being held primarily for sale to customers in the ordinary course of business, would not be within the code definition of capital assets,[15] and the gain on the sale of the houses would not qualify for special tax treatment as long-term captial gain, but instead would be treated as ordinary income.

> 2. Jones and Smith form Construction Corporation, to which they contribute a total of $100,000 for all the stock except qualifying shares. Construction Corporation acquires Black Acres for $10,000, constructs thereon twenty low-cost houses for an added cost of $90,000, and then sells the houses and lots for an aggregate of $150,000.

In this example, the corporation's gain on the sale of the houses is ordinary income for the same reason that the gain of Jones and

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[12]See, e.g., Sen. Rep. No. 2375, 81st Cong. 2d Sess. (1950) 45. If it has not been used in several other industries, it is surprising. As the example in the text suggests, the device is most adaptable to major-project businesses, i.e., the production of a motion picture, the construction of residential or commercial buildings, etc. But consider production of a wheat or other crop by a corporate farm or the year's output of a winery or cannery.

[13]For a somewhat more realistic example see Hearings before Committee on Ways and Means on Revenue Revision of 1950, 81st Cong. 2d Sess. (1950) 140. "Mr. Jenkins . . . Suppose there is a real estate man, a plasterer and a lumberman and an electrician, a plumber and two or three more, say ten, who engaged in some construction work. Suppose they go to work and build a big addition. They buy the land cheap and they do the work economically and well. In other words, it is a money-making proposition. The ten of them build 100 houses. If it is so simple as this, after they have done the work can they dissolve and apportion those houses out ten to each one?" Doubt was expressed that the scheme would be even that obvious. Yet, as is suggested infra, page 162, this may be an example of a collapsible invulnerable under the new provison.

[14]For an excellent pre-amendment discussion of the collapsible device as used in the motion picture industry see Bittker and Redlich, Corporate Liquidations and the Income Tax (1950) 5 Tax L. Rev. 437. As the title suggests, the authors appropriately treat the collapsible problem as just one aspect of the broader problem of the taxation of corporate liquidation. This article, however, is limited to collapsibles.

[15]Int. Rev. Code § 117(a)(1)(A).

Smith was ordinary income in the first example.[16] The corporation will be taxed on the $50,000 gain at regular corporate rates. If it continues in business and distributes earnings to Jones and Smith, they will have ordinary income in the amount of their dividends.[17] If, instead, the corporation is dissolved and the assets are distributed to Jones and Smith, they will have capital gain[18] subject to special tax treatment, but the corporate tax will have taken a big bite out of their gain.

> 3. Jones and Smith form Construction Corporation, to which they contribute a total of $100,000 for all the stock except qualifying shares. Construction Corporation acquires Black Acres for $10,000 and constructs thereon twenty low-cost houses for an added cost of $90,000. The aggregate fair market value of the houses and lots is $150,000, *but the Corporation does not sell them.* It is collapsed, that is, dissolved, and the houses and lots are distributed to Jones and Smith, who then sell them for an aggregate of $150,000.[19]

Jones and Smith lick their chops. Disregarding for the moment the recent statutory changes, the distribution to them upon dissolution is treated as payment in exchange for their stock,[20] and the stock is within the Code definition of capital assets.[21] Assuming they have held their stock for more than six months, Jones and Smith have long-

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[16]Int. Rev. Code § 117(a)(1)(A).

[17]Int. Rev. Code § 115(a) defines "dividend" to include any distribution by a corporation out of earnings and profits accumulated after Feb. 28, 1913, or out of earnings and profits of the taxable year, with certain exceptions not relevant here.

[18]Int. Rev. Code § 115(c): "Amount distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock...." White v. United States, 305 U.S. 281, 59 S. Ct. 179, 83 L. ed. 172 (1938); Helvering v. Chester L. Weaver Co., 305 U. S. 293, 59 S. Ct. 185, 83 L. ed. 180 (1938). Int. Rev. Code § 115(g), which in effect taxes certain corporate distributions "essentially equivalent to the distribution of a taxable dividend" as ordinary income, is inapplicable here. U. S. Treas. Reg. 111, § 29.115-9.

[19]There is, of course, some possibility that a sale by shareholders of property recently distributed to them by a corporation will be treated as a sale by the corporation. Commissioner v. Court Holding Co., 324 U.S. 331, 66 S. Ct. 537, 90 L. ed. 677 (1945). But if the corporation has not negotiated the sale this result will not follow. United States v. Cumberland Public Serv. Co., 338 U.S. 451, 70 S. Ct. 280, 94 L. ed. 237 (1950). Apparently the Commissioner will not attempt to use the Court Holding Company doctrine in attacking preamendment collapsibles; instead of treating the ultimate sale as made by the corporation, the plan of attack seems to be to disregard the corporate entity as a mere sham. See Hearings before Committee on Ways and Means on Revenue Revision, 81st Cong. 2d Sess. (1950) 138.

[20]See note 18 Supra.

[21]Int. Rev. Code § 117(a). It is possible, of course, to contend that the stock itself is held primarily for sale to customers and therefore removed from the definition of capital assets by Sec. 117(a)(1)(A).

term capital gain, upon dissolution, and the corporation has realized no income.[22] Jones and Smith get a stepped-up basis for the property,[23] $150,000, and therefore they have no gain upon its subsequent sale at that price.

Again disregarding for the moment the recent statutory changes, two variations of the collapsible device may have been possible. In the third example, Jones and Smith may simply sell their stock after construction of the houses, in which case their gain on the sale of the stock may be treated as capital gain. But in this variation there is a greater possibility that the stock will be considered as held primarily for sale to customers in the ordinary course of business and therefore not a capital asset within the Code definition.[24] If this were true, the gain would be ordinary income and the device would have failed.

The other possible variation is a distribution in kind without dissolution and prior to realization by the corporation of any gain. Under Section 115 a distribution by a corporation to its shareholders is a dividend only if made either (1) out of earnings or profits accumulated after February 28, 1913, or (2) out of earnings or profits of the taxable year. Thus, if the corporation has no earnings or profits, and the collapsible would have none, a distribution will not be treated as a dividend. Instead, the distribution is applied against and reduces the adjusted basis of the shareholders for their stock, and, to the extent that the distribution exceeds the shareholders' basis, the excess is taxed "in the same manner as a gain from the sale or exchange of property."[25] The corporation does not realize gain upon distribution of appreciated property to its shareholders.[26] Therefore, this variation can result in the same tax consequences that follow a distribution in liquidation, but the corporation remains in existence. That is, the shareholders acquire the property produced at a stepped-up basis, although they are taxed on their gain as capital gain only, not as ordinary income.

Thus, prior to the recent amendment to Section 117, a corporation

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[22] U. S. Treas. Reg. 111, 29.22(a)-20. But see note 19 supra.

[23] Int. Rev. Code § 113(a); Marcus Schlitt, P-H 1948 TC Mem. Dec. Serv. Para. 48,108 (1948). And see 3 Mertens, The Law of Federal Income Taxation (1942) § 21.16.

[24] Int. Rev. Code § 117(a)(1)(A). This result would probably not be reached in the absence of a series of such sales.

[25] Int. Rev. Code § 115(d).

[26] Although the Treasury has argued that it does. For a thorough discussion of this matter see Molloy, Some Tax Aspects of Corporate Distributions in Kind (1950) 6 Tax L. Rev. 57, 59. See also General Utilities Co. v. Helvering, 296 U. S. 200, 56 S. Ct. 185, 80 L. ed. 154 (1935).

may have been used to produce property, and then: (1) it may have been collapsed before realization of any gain by the corporation, or (2) the property produced may have been distributed in kind to the shareholders in the same circumstances, or (3) the stock may have been sold prior to the distribution of any dividends, with the result in each instance that the corporation may not have been taxed at all and the shareholders may have been taxed only on long-term capital gain.

Success of the Collapsible under Prior Law

The progenitors of the collapsible device must have had many bad moments. For one thing, the whole scheme rested upon the legal fiction of the corporate entity, a notoriously perilous perch, at least since the *Gregory* case.[27] Furthermore, success of the device depended in large part upon a rather literal reading of the Code in favor of the taxpayer. In this respect we have come a long way since the *Gould* case.[28]

Nevertheless, the efficacy of the device under prior law is still a live question. On February 7, 1950, Thomas J. Lynch, General Counsel of the Treasury Department, told the Ways and Means Committee there were over one hundred cases being examined by the Bureau of Internal Revenue which involved the collapsible corporation.[29] The new statutory provision concerning collapsibles does not affect those cases. It is applicable only to taxable years ending after December 31, 1949, and applies only to gain realized after that date.[30] Moreover, it is expressly provided that the tax treatment of gains from so-called collapsible corporations realized prior to January 1, 1950, shall be made as if the new law had not been enacted, without inferences drawn from the fact that the new subsection is not made applicable to gains

[27]In Gregory v. Helvering, 293 U.S. 465, 55 S. Ct. 266, 79 L. ed. 596 (1935), the Supreme Court disregarded as a mere sham a corporation formed and utilized solely in an effort to achieve tax advantages supposedly available under the statutory provisions concerning corporate reorganizations.

[28]In Gould v. Gould, 245 U. S. 151, 153, 38 S. Ct. 53, 53, 62 L. ed. 211, 213 (1917), the Court said it was the established rule that statutes "are construed most strongly against the Government, and in favor of the citizen." More recently, however, the Supreme Court has recognized that "It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other...." White v. United States, 305 U.S. 281, 292, 59 S. Ct. 179, 184, 83 L. ed. 172, 179 (1938). But see Burns v. Commissioner, 177 F. (2d) 739, 741 (C.A. 5th, 1949): "The tax statute in question should be strictly construed in favor of the taxpayer...."

81st Cong. 2d Sess. (1950), 138.

[29]Hearings before Committee on Ways and Means on Revenue Revision of 1950,

[30]Pub. L. No. 814, 81st Cong. 2d Sess., § 212(b) (1950).

realized prior to such date and also without inferences drawn from the limitations contained in the new law.[31]

There are a number of provisions in the tax laws which, reduced to the jargon of a no-longer-popular song, say to the taxpayer: "It ain't what you do; it's the way that you do it." Sections 115 and 117 are of this type. In effect they say to the builder: "If you do it our way through the use of a corporation, you can make money at capital gains rates." Years ago the courts might not have recognized any Congressional finger-crossing in this situation. In 1873 Justice Hunt viewed a similar matter as follows:[32]

> "The Stamp Act of 1862 imposed a duty of two cents upon a bank check, when drawn for an amount not less than twenty dollars. A careful individual, having the amount of twenty dollars to pay, pays the same by handing to his creditor two checks of ten dollars each. He thus draws checks in payment of his debt to the amount of twenty dollars, and yet pays no stamp duty.... He has the legal right to split up his evidences of payment, and thus to avoid the tax."

Years later, the Supreme Court still did not doubt the legal right of the taxpayer "... to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means which the law permits."[33] But at the same time the Court refused to "exalt artifice above reality"[34] or to recognize a form which in fact lacked substance. More recently the Court has expanded the sham principle recognized in the *Gregory* case[35] and has undertaken to say, in the name of fairness, who ought to be taxed on what, and when, almost in spite of specific statutory provisions.[36] The cases are interesting and when carefully reviewed offer something of a feel for the way in which the pre-amendment collapsible may be treated.

In an article dealing in part with the Hollywood version of the collapsible,[37] Messrs. Bittker and Redlich have explored the cases and have suggested a number of ways in which the collapsible was vulner-

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[31]Pub. L. No. 814, 81st Cong. 2d Sess., § 212(b) (1950).

[32]United States v. Isham, 17 Wall. 496, 506, 21 L. ed. 728, 729 (U.S. 1873).

[33]Gregory v. Helvering, 293 U. S. 465, 469, 55 S. Ct. 266, 267, 79 L. ed. 596, 599 (1935).

[34]Gregory v. Helvering, 293 U. S. 465, 470, 55 S. Ct. 266, 268, 79 L. ed. 596, 599 (1935).

[35]Gregory v. Helvering, 293 U. S. 465, 55 S. Ct. 266, 79 L. ed. 596 (1935).

[36]See, e.g., Commissioner v. Culbertson, 337 U. S. 733, 69 S. Ct. 1210, 93 L. ed. 1659 (1949); Bazley v. Commissioner, 331 U. S. 737, 67 S. Ct. 1489, 91 L. ed. 1782 (1947); Helvering v. Clifford, 309 U. S. 331, 60 S. Ct. 554, 84 L. ed. 788 (1940).

[37]Bittker and Redlich, Corporate Liquidation and the Income Tax (1950) 5 Tax L. Rev. 437.

able even in the absence of specific legislation. For the most part, their comments apply as well to the use of the device in the building industry as in the motion picture industry. They conclude that measured, as it must be, by "such roguish concepts as equity and justice,"[38] the collapsible may be found wanting, conceding, however, that the "area is one of shifting sands, with hazy boundary lines."[39]

There may have been brave men since Agamemnon, but it is doubtful any will come forward to take a stronger position concerning the efficacy of the pre-amendment collapsible unless it be under the compulsion of advocacy or the obligation of the judicial robe. President Truman did not do so; in his January 23, 1950, message to Congress he merely said that the shoreholders of collapsibles "*might* escape as much as two-thirds of the tax they should pay."[40]

Secretary of the Treasury Snyder, testifying before the House Ways and Means Committee, made reference to the fact that shareholders of collapsible corporations "... have *attempted* to convert ordinary business and earned income into long-term capital gain."[41] Before the same committee, General Counsel of the Treasury Lynch said "... *it is by no means clear* that taxpayers using this [collapsible] device will be able to accomplish their tax saving objective, for the corporate form in many of these cases may be held to be a sham."[42]

Having suggested the nature of the collapsible device, and having recognized its uncertain pre-amendment status as deftly explained by Messrs. Bittker and Redlich,[43] it is the purpose of this article to consider in some detail the statutory answer to this recent tax-saving effort.

The 1950 Amendment

As citizens we all have a right, perhaps a duty, to complain of and combat waste and extravagance in government. We also have a right to pay our tax bills in the same fashion as we pay the bills of the butcher, the baker and the candle-stick maker, the amount properly

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[38]Bittker and Redlich, Corporate Liquidations and the Income Tax (1950) 5 Tax L. Rev. 437 at 448.

[39]Bittker and Redlich, Corporate Liquidations and the Income Tax (1950) 5 Tax L. Rev. 437, 447.

[40]Hearings before Committee on Ways and Means on Revenue Revision of 1950, 81st Cong. 2d Sess. (1950) 5. Emphasis added.

[41]Hearing before Committee on Ways and Means on Revenue Revision of 1950, 81st Cong. 2d Sess. (1950) 20. Emphasis added.

[42]Hearings before Committee on Ways and Means Revision of 1950, 81st Cong. 2d. Sess. (1950) 138. Emphasis added.

[43]Bittker and Redlich, Corporate Liquidations and the Income Tax (1950) 5 Tax L. Rev. 437.

due and no more. Beyond this, however, we do well to remember that in present times legitimate costs of government are high and that when we help to defray these costs by way of tax payments we are paying for an organized society without which many of our pleasures and privileges could not exist.[44]

However, the existence of loopholes in the tax law through which persons in special circumstances can escape their fair share of the tax burden is destructive of the equanimity with which most Americans otherwise are willing and able to view the federal exactions. Congress is sensitive to this and quick to close the loopholes as they are brought to light.[45] Particularly in times such as these, when tax rates are high, a popular feeling of substantial fairness and uniformity in the imposition of taxes is essential to the relatively smooth operation of the federal taxing program. Without any thought of moral indignation[46] concerning those who may[47] have benefited from the collapsible device, and, indeed, perhaps with a kind of wish-I'd-thought-of-that feeling, we may well applaud the Congressional effort to eliminate this recently discovered possible pathway to tax inequality.

In the Code amendments made by the Revenue Act of 1950, [48] Congress has attempted to put an end to the tax advantages which may have flowed from the use of the collapsible corporation. Under Section 117, as amended,[49] gain realized upon the sale or exchange, whether in liquidation or otherwise, of stock in a collapsible corpora-

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[44]See Griswold, The Blessings of Taxation: Recent Trends in the Law of Federal Taxation (1950) 36 A. B. A. J. 999.

[45]See, e.g., Commissioner v. Korell, 339 U. S. 619, 70 S. Ct. 905, 94 L. ed. 862 (1950), and Pub. L. No. 814, 81st Cong. 2d Sess., § 217 (1950), noted (1951) 4 Fla. L. Rev. 118. A loophole involving the deduction for amortizable bond premium, Int. Rev. Code § 125, was recognized by the Supreme Court and closed by Congress in the same year.

[46]But see Sen. Rep. No. 2375, 81st Cong. 2d Sess. (1950) 45: "A *legitimate* corporation . . . would ordinarily pay the corporate income tax on its net income and its shareholders would pay ordinary income tax on their dividends from the corporation." Emphasis added.

[47]And it still is "may," as suggested supra page 150.

[48]Pub. L. No. 814, 81st Cong. 2d Sess., § 212 (1950).

[49]For convenient reference, new Int. Rev. Code § 117(m) is set forth here in full:

"(m) Collapsible Corporation.—

"(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

"(2) *Definitions.*—

(A) For the purposes of this subsection, the term 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction,

tion will, subject to certain limitations, be treated as ordinary income.

At the outset it should be observed that under Section 117(m) gain will be treated as ordinary income only if it would, except for that section, be long-term capital gain. If the stock in a collapsible is not held more than six months, gain on its disposition retains its character as short-term capital gain. Although such capital gain is taken into account in full[50] in determining net income and does not qualify for the 25 percent tax limitation applicable to long-term capital gain, nevertheless it is capital gain against which capital losses may be deducted.[51] Therefore, one with a substantial capital loss carry-over,[52] or already

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or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

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

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

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced property, if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

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

(A) This subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 percentum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 percentum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 percentum of such gain is attributable to the property so manufactured, constructed, or produced; and

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

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503 (a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants."

[50]Int. Rev. Code § 117(b).

[51]Int. Rev. Code § 117(d) limits the deduction for losses from sales or exchanges of capital assets, in the case of individuals, to the amount of gains from such sales and exchanges, plus the taxpayer's net income or $1,000 whichever is less.

[52]See Int. Rev. Code § 117(e).

aware of substantial capital losses during a taxable year, may still profitably resort to the collapsible device if he can realize the hoped-for capital gain within the six months period.

It is equally important to observe that Section 117(m) does not alter the character of losses from the sale or exchange of stock in a collapsible corporation. Such losses remain capital losses subject to the statutory limitations on allowance.[53]

As suggested previously in this article, the objective in resorting to the collapsible device was the realization as long-term capital gain of what would, except for the device, constitute ordinary income. Before undertaking a discussion of the detailed provisions of Section 117(m), it is appropriate to suggest that the new subsection thwarts this objective regardless of which of the three variations of the device described above is used. For this purpose it is assumed the corporation involved is a collapsible and that none of the statutory limitations on the application of the new section is applicable. First of all, if the corporation is dissolved prior to realization of gain by the corporation, amounts distributed in complete liquidation are to be treated under Section 115(c) as in full payment in exchange for stock. If the stock has been held for more than six months and there is a gain, this would normally be long-term capital gain, and it is converted to ordinary income by Section 117(m).[54]

Secondly, if the stock in the corporation is sold and there is a gain, this again would normally be long-term capital gain,[55] and again the new subsection converts it to ordinary income.

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[53]See Int. Rev. Code § 117(d).

[54]Sometimes the value of property distributed in liquidation of a corporation is not ascertainable at the time of distribution. This was the case in Commissioner v. Carter, 170 F. (2d) 911 (C.A. 2d, 1948), in which upon liquidation 32 oil brokerage contracts, and certain other assets, were distributed to the corporation's sole shareholder who had owned the stock for more than ten years. No additional services were to be performed by the corporation under the contracts, but payments under the contracts were dependent upon future contingencies which made valuation of the contracts impossible at the time of distribution. When payments under the contracts were subsequently received by the shareholder, all of which payments together with prior distributions exceeded the shareholder's basis for the stock given up upon liquidation, the Second Circuit held such payments constituted capital gain, just as if the contracts had been valued upon distribution at a figure equal to the payments finally received. Inasmuch as this result rests on the requirement of Section 115(c) that amounts distributed in liquidation be treated as in full payment in exchange for stock, it appears that under Section 117(m), if the corporation involved in the Carter case were deemed to be a collapsible, gain there properly treated as capital gain would now be converted to ordinary income.

[55]Again assuming the stock is not held for sale to customers in the ordinary course of business. Int Rev. Code § 117(a)(1)(A). Of course, if the stock is treated as so held, the gain on the exchange is ordinary income regardless of Sec. 117(m).

Finally, if corporate assets are distributed to shareholders at a time when the corporation has no earnings or profits, so that the distribution cannot be treated as a dividend and taxable for that reason as ordinary income, and if there is a gain on such distribution, the new subsection again converts the gain to ordinary income. The conclusion as regards this variation is not quite so clear from a reading of the statute alone. Section 117(m) is concerned only with "gain from the *sale or exchange* of stock." As observed previously in this article, Section 115(c) provides that distribution in liquidation "shall be treated as in full payment *in exchange* for the stock," so that in the case of liquidation distributions the resulting gain is gain from an *exchange* for tax purposes and therefore within Section 117(m). However, Section 115(d), which applies to non-dividend distributions other than upon liquidation, requires instead that the excess of the distribution over the cost bases of the stock "... shall be *taxable* in the same manner as a gain from the sale or exchange of property." This may seem to leave room for making a technical argument that the third variation on the collapsible device is not covered by the new subsection.[56] The parenthetical clause in the new provision[57] and its legislative history,[58] suggests that the courts will give such an argument short shrift, if anyone is bold enough to advance it.

Congress had several possible approaches to the collapsible problem. It might have attacked the device by a brief and very general provision similar in nature to Section 45. That section, aimed at a more ancient income-distorting device, gives the Commissioner broad authority to allocate gross income, deductions, credits or allowances among commonly owned businesses if he determines such allocation is necessary to prevent tax evasion or clearly to reflect the income of such

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[56]The technical argument is: Section 117(m) applies only to "gain from the sale or exchange... of stock." Section 115(d) does not say that gain from a 115(d) distribution shall be *treated as* gain from a sale or exchange, but only that it shall be taxed as if it were such gain. If the gain is not in fact from a sale or exchange and is not required to be treated as if it were, Section 117(m) is inapplicable.

[57]"(whether in liquidation or otherwise)."

[58]See, e.g., Sen. Rep. No. 2375, 81st Cong. 2d Sess. (1950) 89: "In like manner, the corporation might distribute the property in question without liquidating and, under Section 115(d), the value of the property distributed, to the extent that it was not a dividend, would first be applied against the adjusted basis of the stock to the shareholders and the excess, if any, would be taxable in the same manner as a gain from the sale or exchange or property." While this statement skirts the technical argument, supra note 36, the context in which it appears makes it evident that the Finance Committee felt the new provision covered this possibility.

businesses. Apparently the Commissioner desired a more specific guide for his attack on collapsibles.[59]

On the other hand, Congress could have undertaken permanently to collapse the collapsible by a destructive statutory provision spelled out in fine detail. This means has been used, for example, to prevent the allowance of deductions for artificial losses by enumerating precise circumstances in which losses from sales or exchanges will not be allowed.[60] But it would require tremendous imagination and ingenuity to deal effectively with the collapsible in any such precise fashion.

In any event, the final legislative product is between the two extremes suggested. It combines a full measure of discretion in the Commissioner with difficult fact determinations and some amazingly precise rules of thumb in a manner more reminiscent of Section 129,[61] another loophole plugging provision. An analysis of the specific provisions of the new subsection follows.

Use of the phrase "collapsible corporation" requires a definition. Under Section 117(m)(2) a corporation is a collapsible only if, among other things, it is "... formed or availed of [62] principally for the manufacture, construction, or production of property. . . ."[63] Obviously, as far as this part of the definition is concerned, it makes no difference whether the corporation was created for or merely utilized for the condemned purpose.

The use of the word "property" in a subsection of Section 117, which deals with gains and losses from the sale or exchange of property, does not seem surprising. And yet any casual explanation for the use of the word based on this coincidence is apt to be fallacious. The

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[59]Thomas J. Lynch, General Counsel of the Treasury department, testifying before the Ways and Means Committee, replied to a question on the nature of remedial legislation sought as follows: "We would not like to ask for great discretion. On the other hand, we would like to be assured that the legislation does not place in jeopardy the normal liquidation of corporations, corporations which are organized and carried on regularly to conduct a business." Hearings before Committee on Ways and Means on Revenue Revision of 1950, 81st Cong. 2d Sess. (1950) 140.

[60]See Int. Rev. Code § 24(b).

[61]Int. Rev. Code § 129 deals with acquisitions which have as their principal purpose the evasion or avoidance of federal taxes, but the Commissioner's authority to deal with such cases is sharply limited by specific rules laid down in the section. See, generally, Rudick, Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code (1944) 58 Harv. L. Rev. 196.

[62]For similar language in a long-standing Internal Revenue Code provision see Sec. 102.

[63]Or principally for the holding of stock in a collapsible. Int. Rev. Code § 117(m)(2)(A).

property produced by a collapsible is not a capital asset in the hands of the corporation originally or, later, in the hands of the shareholders. The stock in the corporation is a capital asset, and it was this fact, not the character of the property produced, which made possible utilization of the device. However, the existence of property, which increased in value without the realization of income either by the corporation or its shareholders, was an essential element in the tax-saving scheme. Increase in the value of the stock resulting from such increase in the value of the corporation property was what made available the beneficial provisions of Section 117.[64]

It is true, of course, that an increase in the value of stock might result from appreciation in the value of property owned but in no sense produced by the corporation. However, if such property is investment property, it qualifies as a capital asset and it would be unnecessary to resort to the collapsible device in an effort to have gain from its sale or exchange come within the capital gains provisions. Similarly, property used in a trade or business qualifies for capital gains treatment under Section 117(j). Thus the new subsection is pointed at property produced for sale in the usual course of business.

Bearing in mind that there is no direct relationship between the word "property" as used in Sections 117(a) and 117(m), it still seems reasonable to suppose that anything which would be considered property under the former may also be regarded as property under the latter. For example, if a corporation entered into a valuable contract and then distributed it to shareholders upon dissolution, the contract would probably be regarded as property produced by the corporation.[65]

Definitions concerning the production[66] of property are included within the principal definition in Section 117(m). First of all, a corporation is deemed to have produced property if it engaged in such

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[64]See 3 Mertens, Law of Federal Income Taxation (1942) § 21.16.

[65]This example does not have reference to what appears to have been the usual Hollywood procedure of producing a picture, contracting for its distribution, and then distributing the contract to the shareholders. See, e.g., Hearings before Committee on Ways and Means on Revenue Revision of 1950, 81st Cong. 2d Sess. (1950) 70. In those cases the picture produced would constitute the property for the purpose of Sec. 117(m), and the contract would simply provide for realization of the gain from such picture. But compare Commissioner v. Carter, 170 F. (2d) 911 (C.A. 2d, 1948), involving the distribution of a brokerage contract to the corporation's sole shareholder.

[66]The statutory language is, of course, "manufactured, constructed, or produced." However, for the sake of simplicity the word produced alone, or one of its variations, is used in the text unless the content requires the use of one of the other two words.

production to any extent. Therefore, if Jones and Smith partially construct houses and then transfer them to a corporation for completion, by means of a taxable sale or exchange, upon completion the corporation has constructed the houses for the purposes of Section 117(m).

Secondly, a corporation which has in fact had nothing to do with construction will be deemed to have constructed property if it holds such property with a substitute basis determined by reference to the basis of the person who constructed the property. For example, if Jones and Smith completed the construction of houses and then transferred them to Construction Corporation in a Section 112(b)(5) tax-free exchange, the corporation would be deemed to have constructed the houses.[67]

Finally, if the corporation holds property which has a basis determined by reference to other property which it has produced, the property held is deemed to have been produced by the corporation. Thus, in the case of a tax-free exchange under Section 112(b)(1) of property for property of like kind, the property acquired in the exchange will be deemed to have been produced by the corporation if the corporation produced the property given up in the exchange.[68]

But, obviously, not every corporation which is formed or availed of principally for the production of property is a collapsible corporation. If the new subsection is to apply, such action must have been taken with a view to the sale or exchange of stock by the shareholders or a distribution to them prior to the corporation's realization of a substantial part of the net income to be derived from the property and with a view to realization by the shareholders of the gain attributable to the property.

In Section 117 (m) (2) (A) (i) and (ii) the phrases "the property" and "such property" are used, referring back to the first part of the

[67]Int. Rev. Code § 112(b)(5) provides against the recognition of gain or loss, in certain circumstances, upon the transfer of property to a corporation in exchange for stock in the corporation. In such a case, under Sec. 113(a)(8), the basis for the stock received is the same as the shareholder's basis for the property which he transferred to the corporation. So it would appear that if the collapsible device did not occur to the hypothetical builders, Jones and Smith, until after they had completed construction of the houses, they could run the property through a Sec. 112(b)(5) incorporation and then collapse it with the same consequences as if they had undertaken the venture originally by means of a collapsible corporation. The recent amendment squarely prevents this avoidance possibility as regards future transactions. It is just as clear that Gregory v. Helvering, 293 U. S. 465, 55 S. Ct. 266, 79 L. ed. 596 (1935), prevented successful utilization of this device in the past.

[68]This is so because, under Int. Rev. Code § 113(a)(6), a Sec. 112(b)(1) exchange results in a basis for the acquired property determined by reference to the cost of the property given up in the exchange.

definition of a collapsible, concerning property for the production of which the corporation was principally formed or utilized. In other words, a corporation is a collapsible only if formed or availed of principally for the production of property with a view to sale or exchange of stock by the shareholders or distribution to them prior to the realization by the corporation of a substantial part of the gain attributable to *the property* for the production of which the corporation was principally formed or utilized and with a view to realization by the shareholders of the gain attributable to *such property*. The Senate Finance Committee Report on H.R. 8920[69] appropriately explains that under this language the shareholders of an ordinary corporation, which has produced and disposed of property in the usual manner, will not be caught by Section 117(m) upon dissolution, or in other circumstances, merely because the corporation has produced property from which it has not derived a substantial portion of the available net income. It would not be held to have been formed or utilized principally for the production of *such* property. In general, the effect of Section 117 (m)-(2) (i) and (ii) is to narrow the scope of the new subsection down to the more or less artificial, one-shot collapsible such as is suggested earlier in this article[70] in the example explaining the nature of the device. It could hardly be applied to a long-established concern, although there is the possibility that such a concern might be used principally for a particular project and, so availed of, might fall within the new subsection.

If some ordinary corporations which have a long, continued existence escape difficulties under Section 117(m), as they clearly do, it is not so clear that all will fare as well. Speaking before the Senate Finance Committee on behalf of the United States Chamber of Commerce, Ellsworth C. Alvord called attention to this problem in the following words:[71]

> "Much worse is the extreme breadth of application of the section, extending to many areas of legitimate enterprise.... The Bureau might... seek to apply the provision to legitimate business promoters who initiate a business venture and, after its successful establishment, dispose of their stock in a bona fide sale

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[69]Sen. Rep. No. 2375, 81st Cong. 2d Sess. (1950) 89.

[70]Supra page 148.

[71]Statement by Ellsworth C. Alvord, Chairman, Committee on Federal Finance, Chamber of Commerce of the United States, contained in Hearings before Committee on Finance on H. R. 8920, 81st Cong. 2d Sess. (1950) 839; see also Statement of the American Mining Congress, Hearings before Committee on Ways and Means on Revenue Revision of 1950, 81st Cong. 2d Sess. (1950) 730.

> to buyers who expect to continue the business indefinitely. True, Section 211 [enacted as Section 212] according to Treasury statements and the Ways and Means Committee report, is not intended to apply to these situations. Perhaps the bureau would not seek to apply it in an improper fashion. Nevertheless, it is bad law-making to declare everybody a criminal on the assumption that the police will arrest only wrong doers."

In this regard, the new subsection depends very heavily on fair and enlightened administration. The severe uncertainty facing the taxpayer in this circumstance suggests that the Commissioner should be required to issue rulings concerning the tax consequences of such sales of stock.[72]

The use of words such as "principally for" and "with a view to," which are suggestive of subjective intent, is not new in the tax law.[73] There is some possibility these words may be interpreted as merely raising questions concerning objective results.[74] The Commissioner may take the position that the liquidation of a corporation under such circumstances as would result in the conversion of substantial ordinary income to capital gain is in itself sufficient indication of the proscribed purpose and views, if the more objective features of the Section 117(m) tests are met.

Perhaps it would have been better to inject no subjective element into the new provision.[75] Tax provisions involving difficult factual determinations, particularly those resting on motive or purpose, do not promote the kind of certainty that business men reasonably like to find in the law.

Limitations on Application of Section 117(m)

Even if a corporation is within the statutory definition of the phrase "collapsible corporation," a sale or exchange of its stock or a distribution by it may not subject a shareholder to the rigors of the new pro-

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[72]Cf. Mim. 4963, 1939-2 C. B. 459.

[73]See, e.g., Int. Rev. Code § 129, "the principal purpose for which;" § 811(c)(1)(a) "in *contemplation* of his death;" § 811(c)(1)(C), "*intended* to take effect in possession or enjoyment." Emphasis added.

[74]In Estate of Spiegel v. Commissioner, 335 U. S. 701, 706, 69 S. Ct. 301, 303, 93 L. ed. 330, 337 (1949), Justice Black successfully extracted the subjective element from the estate tax provision concerning transfers "intended to take effect ... at or after ... death," Int. Rev. Code § 811(c), saying: "... a post-death attempt to probe the settlor's thoughts in regard to the transfer, would partially impair the effectiveness of the 'possession or enjoyment' provision as an instrument to frustrate estate tax evasion."

[75]But it is difficult to see how non-avoiding entrepreneurs could be protected, even to the extent they are under the new section, by means of an objective, let-the-chips-fall-where-they-may provision.

vision. Section 117(m) is made inapplicable if any of the following three conditions is met:[76]

1. If the shareholder owns, or is considered as owning, no more than 10% in value of the stock at any time after commencement of production of the property, or
2. If not more than 70% of the gain recognized during the taxable year upon the sale, exchange or distribution is attributable to the property, or
3. If the gain is realized more than three years after completion of the property.

The report of the Ways and Means Committee explains the objective of the first limitation as follows:[77]

> "It is the purpose of the first limitation to insure that the provision will only be applicable to a shareholder who by virtue of his stock ownership can be presumed to be an interested party to the project whether at the time of its organization or at some intermediate date."

It is difficult to see how this purpose is effectively carried out by the limiting provision. It is not improbable that a minority shareholder may be a very interested person in the transaction, and may be influential in promoting the scheme. This is particularly likely since the passage of the new law because a minority shareholder owning no more than 10 percent of the stock will escape the pinch of section117(m). On the other hand, the new provision will, for example, hit a minority shareholder who owns 12 percent in value of the outstanding shares and who is forced by a decision of the majority to participate in a proscribed distribution.

Interesting in the light of statements before the Ways and Means Committee[78] is the possibility that under the new provision ten persons may form an invulnerable collapsible corporation. If they divide the shares so that no one person's equals in value more than 10 percent of the outstanding stock, each shareholder may escape the effects of the new provision and realize capital gain in lieu of ordinary income. This arrangement, which the Bureau might have attacked successfully prior to the recent amendment,[79] now appears impregnable in the

[76]The summary expression in the text of the three principal limitations is in general terms and is therefore inaccurate in detail. See Int. Rev. Code § 117(m)(3), supra note 49.

[77]House Rep. No. 2319, 81st Cong. 2d Sess. (1950) 98.

[78]See note 13 supra.

[79]See discussion in text supra page 150.

light of the very specific terms of Section 117 (m) (3) (A).[80] But if the collapsible device was vulnerable absent Section 117(m), an arrangement such as this may continue to be vulnerable, because the limitation simply places it outside the scope of the new provision.

For the purposes of the stock ownership limitation, ownership rules applicable to personal holding companies under Section 503 (a) (1), (2), (3), (5) and (6) control. In addition, however, the family of an individual is defined to include the spouses of the individual's lineal decendants. These rules of stock ownership "... prevent any one shareholder's disguising his interest by the placement of stock of the corporation among the different members of his family."[81]

The second limitation is intended to insure that the new provision will apply only in instances in which there is a substantial relationship between the gain realized by the shareholder and the property produced by the corporation.[82] If the gain is substantially attributable to other transactions on which the corporation has been taxed, the section is appropriately made inapplicable. Accordingly, the new provision does not apply unless more than 70 percent of the gain recognized by a shareholder during the taxable year is attributable to the property produced by the corporation with a view to distribution or some other transaction under which the shareholders, but not the corporation, would realize the gain attributable to such property.

The 70 percent limitation should be read in connection with the question of whether the corporation was formed or utilized "principally for" the production of property and with the proscribed view. Even so, the actual effect of the second limitation is difficult to ascertain and will depend greatly on the way in which the new provision is administered. Two possibilities, based on the example of a collapsible previously set out in this article,[83] will suggest the uncertainty. Suppose that for the proscribed purpose and with the proscribed view Jones and Smith establish Construction Corporation, which then carries out the building project. Upon completion of the houses, Jones and Smith become aware of Section 117(m). At this point they cause the corporation to sell 30 percent of the houses, and then dissolve the corporation and distribute the proceeds of the sale and the unsold houses. The corpora-

[80]See, e.g., Statement by Ellsworth C. Alvord, contained in Hearings before Committee on Finance on H. R. 8920, 81st Cong. 2d Sess. (1950). "The inevitable consequence is that schemers can tailor their plans so as to avoid the application of this provision."

[81]House Rep. No. 2319, 81st Cong. 2d Sess. (1950) 98.

[82]House Rep. No. 2319, 81st Cong. 2d Sess. (1950) 98.

[83]Supra page 148.

tion is a collapsible and the gain of the shareholders will be taxed as ordinary income, because the corporation constructed the property; and it was formed for that purpose; and the property was produced with a view to distribution and to realization of the gain attributable to it by the shareholders. Futhermore, the second limitation is not applicable, because the shareholders' gain is all *attributable* to the property produced, even though part of the gain has been taxed to the corporation. This result seems desireable; otherwise the effect of the section would merely be to make collapsibles 30 percent less efficient taxwise.

However, take a more extreme case. Suppose, upon the same facts as those in the example just stated, that when Jones and Smith become aware of Section 117(m) they cause the corporation itself to sell all the houses.[84] If the corporation were then dissolved, again all the gain of Jones and Smith would be attributable to the property, and the second limitation still would not apply.[85] It hardly seems likely Congress intended the new provision to cover such a case, and perhaps the new provision should not be so interpreted. And yet, it is difficult to see how regulations under the new section can solve this dilemma; how can the first possibility suggested be explained to remain within the section, as it should, while the second possibility is removed, as it clearly should be? Such a matter should not be left to *ad hoc* determinations by the commissioner.

This seems to be the difficulty. Congress may have intended the part of the definition dealing with realization by the corporation of a substantial part of the income to be derived from the property to make the actual operation of the corporation in part determinative of whether a corporation is a collapsible. But the statute does not say so. The entire definition makes the collapsible status dependent upon the purpose and views of those forming or using the corporation. If the corporation were formed or used for the condemned purpose and with the proscribed view, it would seem not to escape the collapsible definition by subsequent action, although upon dissolution one of the limitations written into the new provision might relieve its shareholders of the rigors of Section 117(m).

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[84]This might be preferable to a straight 117(m) liquidation under which Jones and Smith were taxed at ordinary income rates, if the effect was for them to be taxed at capital gains rates on subsequent liquidation. That is, the corporate tax plus their capital gains tax might equal less than their tax on the entire gain treated as ordinary income.

[85]Note that the corporation is within the definition of a collapsible, because it was formed and, for a time, utilized with the proscribed purpose and view. The second limitation does not take into account a change of purpose or view.

The third limitation establishes an arbitrary time limit of three years beyond which gain realized will not be affected by the new provision. That is, if the shareholders do not realize their gain until after three years following the completion of the production of the property, then the corporation will not be treated as a collapsible corporation.[86] The reasoning behind this limitation appears to be that it would generally be undesirable for the corporation to hold the completed property in disuse for a period of three years, and, therefore, if it is held that long a substantial part of the gain attributable to the property will probably have been realized by and taxed to the corporation. In so far as the new provision is aimed at the motion picture and building industries, this reasoning seems sound, but the limitation may need clarification by way of the regulations as regards other types of businesses.

There is at last one industry which must store its product for a long period of time, often exceeding three years. Whiskey, of course, must be aged. For this reason it may appear that the new provision has in effect confirmed the efficacy of the collapsible device in the distilling industry. The use of the collapsible prior to the passage of the new law may have been vulnerable on corporate sham principles. Seemingly now there is need for administrative interpretation of the word "completion" as used in the third limitation, so as to indicate there is not now a certain loophole where there was only a dubious one before.

One interesting consequence of the three-year limitation should be mentioned. To go back again to the example at the beginning of this article,[87] if Jones and Smith set up Construction Corporation to construct houses but have the corporation rent such houses for three years, any gain to Jones and Smith upon liquidation or distribution or upon the sale of their stock will get the benefits of the capital gains provisions. Probably the way to look at this is that, under the new provision, property initially held primarily for sale to customers loses its characteristics as such if held for more than three years. Thus, gain attributable to such property should be treated as analogous to gain from a Section 117(j) sale or exchange.[88] In any event, it may be greatly to the advantage of the speculative corporate builder to be in part a landlord. Whether market risks and working capital difficulties render this impracticable for business reasons will depend upon the facts in a

[86]See House Rep. No. 2319, 81st Cong. 2d Sess. (1950) 99.

[87]Supra page 148.

[88]In certain circumstances, under Int. Rev. Code § 117(j), gain from the sale or exchange of property used in a trade or business qualifies for capital gains treatment, even though the property is outside the definition of capital assets.

particular case. But, apart from such other considerations, there seem to be substantial tax advantages.

Collapse under Section 112(b)(7)

There remains to be considered the relationship between newly revived Section 112(b)(7)[89] and new Section 117 (m). It has been suggested[90] that for the year 1951 Section 112(b)(7) makes possible successful use of the collapsible device by way of a partially tax-free liquidation under that section. Such a suggestion seems to evidence a misunderstanding either of Section 112(b)(7), of Section 117 (m) or of the collapsible problem generally.

Under Section 112(b)(7) an individual shareholder of a corporation which is liquidated within one calendar month in 1951, in conformance with other specific requirements of the section, may elect to be taxed specially on his gain on the liquidating distributions. His gain, of course, is the difference between the adjusted basis of his stock and the value of what he receives. Upon election, he is taxed as follows:

> 1. To the extent that his gain does not exceed his ratable share of the corporate earnings and profits, it is taxed as a dividend;
>
> 2. To the extent that his gain exceeds his share of corporate earnings and profits but does not exceed the value of money or or of stock or securities acquired by the corporation after August 15, 1950, and received by the shareholder, it is taxed as long-term or short-term capital gain, depending upon how long he has held his stock; and
>
> 3. To the extent that his gain is not taxed under (1) or (2) above, it is not recognized.

The important point here, as far as the collapsible device is concerned, is the effect of a 112(b)(7) liquidation on the shareholder's basis for the property acquired. This is governed by Section 113(a)(18), which provides that the basis for the property acquired shall be "... the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by ... [the shareholder], and increased in the amount of gain recognized to him." Thus a Section 112(b)(7) liquidation would fail to result in the stepped-up basis for the property acquired upon liquidation which is an essential cog in the collapsible device,[91] except where the sale-of-stock variation

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[89]Pub. L. No. 814, 81st Cong. 2d Sess., § 206 (1950).

[90]See, e.g., Landman, Tax Highlights of 1950 (1951) 29 Taxes 39, 42.

[91]Admittedly, the suggestion made here presupposes that the property distributed would not qualify as a capital asset in the hands of the shareholder. If it did so qualify, the shareholder would secure the benefits of the capital gains provisions,

is used. Section 112(b)(7) has no bearing, of course, on the latter variation.

Except for flaws and uncertainties in the definition of capital assets,[92] the non-recognition provisions of the Code could hardly promote the collapsible device,[93] because the success of the plan depends upon recognition of gain, capital gain of course, so as to produce the necessary stepped-up basis for the property acquired. To go back once more to the example of a collapsible set out previously in this article,[94] Jones and Smith could resort to a Section 112(b)(7) liquidation after Construction Corporation had completed construction of the houses, but if they did they would simply wind up owning the houses with a tax basis equal to the cost of their stock, which is exactly what they would seek to avoid by way of the collapsible.[95]

On the other hand, a consideration of the non-recognition provisions in connection with collapsibles is not wholly unprofitable. These provisions suggest a manner in which two variations of the collapsible device could perhaps have been better attacked. The new provision saps the life of the collapsible by providing ordinary income treatment for what would otherwise be long-term capital gain. Much the same thing could have been accomplished by providing for partial non-recognition[96] of gain realized upon liquidating or other non-dividend distributions of collapsibles. The foregoing comments on the relationship between Sections 117 (m) and 112(b)(7) suggest how this would thwart the device. That is, upon distribution the shareholders would fail to get the stepped-up basis necessary to the success of the plan.

One advantage in non-recognition treatment of the collapsible device would be avoidance of imposition of the tax at an inappro-

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and the only effect of Sec. 112(b)(7) would be to postpone his realization of capital gain until he disposed of the property. In the simple example, supra note 19, used throughout this article, the houses should be treated as held primarily for sale to customers even in the hands of Jones and Smith after dissolution, and therefore they would not be capital assets. But that result would not always follow. See, e.g., Commissioner v. Carter, 170 (2d) 911 (C. A. 2d., 1948).

[92]See note 91 supra.

[93]Except for Int. Rev. Code § 117(m), the non-recognition provisions might be of incidental use. See, e.g., note 67 supra.

[94]Supra page 148.

[95]This assumes, of course, that Int. Rev. Code § 112 (b)(7) in a sense overrides Sec. 117(m), which seems to be a proper assumption in that Sec. 117 deals with the manner in which gain shall be taxed but Sec. 112 determines whether it shall be recognized at all for tax purposes.

[96]In this respect the suggested provision could closely parallel Int. Rev. Code § 112(b)(7). As suggested supra note 91, this might necessitate further amendment of the Code definition of capital assets. Int. Rev. Code § 117(a).

priate time. A shareholder may be hard pressed for cash with which to pay a tax imposed upon a distribution in kind. More important, however, would be the avoidance of having to determine the value of the property distributed. The tax would, of course, be imposed when the property was disposed of, and if it were disposed of by sale there would be no valuation problem at all.

Thus, in so far as the use of the collapsible device hinges on corporate distributions, a mandatory Section 112(b)(7) might be a very satisfactory solution to the problem. However, the sale-of-stock variation would remain to be dealt with.

If the sale of stock in a collapsible were allowed at capital gains rates, even if the corporation retained its character as a collapsible after the sale, the new shareholder would have a new costs basis for his shares and the property produced by the corporation could be distributed in such a manner that neither the corporation nor the shareholders ever would be taxed at ordinary income rates on the gain from the property. Section 117(m) appropriately prevents this. If the nonrecognition approach to the other variations of the collapsible device were adopted, the sale-of-stock variation could probably be taken care of by excluding stock in a collapsible corporation from the definition of capital assest.[97]

It will be observed that this treatment of the sale of stock is not subject to the objections aimed at similar treatment of gain from distributions. That is, the gain is taxed at an appropriate time from the standpoint of ability to pay, and no valuation problem is presented. The exchange of stock other than in cancellation or redemption would, of course, raise the usual valuation problems, but the shareholder who elected to make the exchange would not be heard to object to the time of imposition of the tax.

Conclusion

With only minor reservations, new Section 117(m) effectively sounds the death knell of the collapsible. Properly administered, it will not give rise to harsh or inequitable results. That there may be more satisfactory methods of dealing with the problem, either along the lines suggested in this article or otherwise, is hardly to be doubted. It is even more clear that the collapsible corporation has simply served to spotlight one of the many small flaws in the capital gains provisions of the Code. It will probably be a cold day down under before everyone agrees that these provisions contain no imperfections.

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[97]Although it might be considered desirable to treat loss as capital loss and short-term gain as capital gain, as has, in effect, been done under Int. Rev. Code § 117(m).