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Barring Coughlin

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show that an income projection indicated that the corporation would be able to pay the debt, and, in fact, the debt is paid at maturity, he stands a good chance of winning his case.

The careful attorney normally will suggest that the corporation issue its debt obligations to persons who are not shareholders,[39] and, when possible, refuse to permit the shareholder's debt to be subordinated to other debts.[40] In addition, he will cause the corporation to issue debt with a maturity of more than five years, and often will suggest that the maturity dates be serialized to afford the corporation the best opportunity of fulfilling its obligation to pay at maturity.

III

COLLAPSIBLE CORPORATIONS AND ONE YEAR LIQUIDATIONS

Barring Coughlin

Section 337 of the Internal Revenue Code of 1954 provides, in part, that if a corporation adopts a plan of liquidation and thereafter distributes all its assets within a period of twelve months from the date of adoption of the plan, gain or loss generally is not recognized with respect to sales of assets taking place within the twelve month period.[1] The purpose of this section is to avoid the double tax effect of first taxing the sale by the corporation in the corporate tax return and then the gain on distribution of the proceeds to the shareholders in their individual returns.

Before the enactment of section 337, those who were aware of this problem followed the practice of liquidating the corporation prior to the sale of its property, and distributing the property to the shareholders, who then made the sale. This led to disputes as to whether the contract of sale had in fact been made by the corporation rather than the shareholders, so that the income should be attributed to the corporation for tax purposes.[2] To avoid situations in which the amount of tax on the transaction depended upon the legal sophistication of the shareholders, section 337 was enacted.[3]

EXCLUSION OF COLLAPSIBLE CORPORATIONS FROM SECTION 337

A difficult and complicated problem was introduced into this statutory structure by the provision of section 337(c)(1).[4] This section provides that the advantages of section 337 are not available to a "collapsible

39. See, *e.g.,* Universal Castings Corp. v. Commissioner, 303 F.2d 620 (7th Cir. 1962).
40. See, *e.g.,* Diamond Bros. Co. v. Commissioner, 63-2 U.S. Tax Cas. 89852 (3d Cir. 1963).

corporation," as defined in section 341(b) of the Code. This provision was thought necessary no doubt in view of the fact that section 341, dealing with "collapsible corporations," was intended to close a loophole which might have been reopened if the relief provisions of section 337 had been made available.

The "collapsible corporation" is a device which, prior to the enactment of section 341, was available in appropriate circumstances to convert ordinary income into capital gain. The classic example was in the motion picture industry where the practice was developed of forming a new corporation for the purpose of producing a picture.[5] When the picture was completed, the distribution arrangements set up, and the time arrived to begin to reap the benefits from its exhibition, the corporation was dissolved. The film, worth many times what it had cost to produce, would then be distributed in liquidation to the shareholders. The shareholders would of course pay a substantial capital gains tax on the liquidation, but in exchange would acquire a commensurate cost basis which could be written off against the incoming profits from exhibition. The result, of course, was to convert a substantial part of the profit into capital gain. It can be readily seen that such a device also is available in many other situations where a valuable asset may be created within a corporation and then exploited after liquidation or sale of the stock.

The means by which Congress undertook to deprive the taxpayer of this happy outcome was section 341. This section defines a collapsible corporation as

> a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a view to —
>
> (A) the sale or exchange of stock by its shareholders

1. INT. REV. CODE OF 1954, § 337(a) [hereinafter cited as CODE §]. The general rule under this section provides that if

"(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

"(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation within the 12-month period."

2. *Compare* Commissioner v. Court Holding Co., 324 U.S. 331 (1945), where the Court held that a sale of distributed assets by the shareholders had in substance been made by the corporation, *with* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950), holding such a sale not to be attributable to the corporation. It has been observed by this author that more than seventy five other cases involving this issue have reached the courts.

3. S. REP. No. 1622, 83d Cong., 2d Sess. 48 (1954).

4. CODE § 337(c) provides that "this section shall not apply to any sale or exchange . . . made by a collapsible corporation (as defined in section 341(b)) . . . ."

5. H.R. REP. No. 2319, 81st Cong., 2d Sess. 56 (1954); S. REP. No. 2375, 81st Cong., 2d Sess. 45 (1954).

> (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and
>
> (B) the realization by such shareholders of gain attributable to such property.[6]

The penalty imposed on such a corporation consists of taxing as ordinary income gains realized by shareholders on the sale of their stock, on whole or partial liquidation of the corporation, or from a capital distribution, even though it might otherwise be considered capital gain. This penalty applies, however, only where the realization of income by the shareholder takes place within three years of the completion of the manufacture, construction, or production of the property. Congress apparently considered the opportunity for tax evasion to be remote after the expiration of this three year period.[7]

It will be noted that this ordinary income treatment is applied to distributions by the corporation and to sales of its stock, but it does not apply to any gain realized by the corporation upon the sale of its assets. It will be readily seen that if section 337 were available to the shareholders of such a corporation, they could avoid the penalty of section 341 by causing the corporation to adopt a plan of liquidation, sell its assets, and distribute the proceeds. As a result, the shareholders would pay only a capital gains tax on the liquidation and would thus reap the advantages intended to be eliminated by section 341. Accordingly, if section 341 was to remain effective, it was necessary that the benefit of section 337 should be unavailable. This was accomplished by section 337(c)(1).

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6. CODE § 341(b)(1).

7. CODE § 341(d).

"*Limitations on Application of Section.* — In the case of gain realized by a shareholder with respect to his stock in a collapsible corporation, this section shall not apply —

(1) unless, at any time after the commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in subsection (b)(3) or at any time thereafter, such shareholder (A) owned (or was considered as owning) more than 5 percent in value of the outstanding stock of the corporation, or (B) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 5 percent in value of the outstanding stock of the corporation;

(2) to the gain recognized during a taxable year, unless more than 70 percent of such gain is attributable to the property so manufactured, constructed, produced, or purchased; and

(3) to gain realized after the expiration of 3 years following the completion of such manufacture, construction, production, or purchase.

For purposes of paragraph (1), the ownership of stock shall be determined in accordance with the rules prescribed in paragraphs (1), (2), (3), (5), and (6) of section 544(a) (relating to personal holding companies); 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."

Relation Between Sections 337 and 341

The problems occurring through the interrelationship of sections 337 and 341 arise out of the peculiar arrangement of section 341. Section 341 (a) is the subsection which provides, generally, that the gain on liquidation or sale of a collapsible corporation is ordinary income.[8] Section 341 (b) contains the definition of a collapsible corporation quoted above.[9] Section 341 (c) provides a presumption of collapsibility in certain cases not important to this discussion. It is only in section 341 (d) that one finds the provision that the ordinary income treatment of section 341 (a) shall not be applicable to gain realized after the expiration of the three-year period.[10] This subsection also refers to certain other conditions which make the ordinary income treatment inapplicable. Section 341 (e) contains extensive and complicated exceptions to the definition of a collapsible corporation.

The distinction between section 341 (d) and section 341 (e) is critical to the problem of relating section 341 (d) to section 337. Section 341 (d) consists of exceptions to the application of ordinary income treatment of collapsible corporations, while section 341 (e) provides exceptions to the definition of the term "collapsible corporation." If a situation falls within section 341 (e), the corporation is not considered collapsible. If it falls within section 341 (d), the corporation remains collapsible, but the sale of the stock is not subject to ordinary income tax treatment.

It is often erroneously assumed that after the critical three-year period has expired, the taxpayer no longer need be concerned as to whether his corporation is collapsible. However, this is not true. If a corporation was formed or availed of for the prohibited purposes, so as to come within the definition in section 341 (a), the expiration of the three-year period of section 341 (d) does not remove it from the definition. It merely exempts its shareholders from the penalty. "Once collapsible, always collapsible."

Section 337 (c) (1) — The One Year Liquidation Provision

Section 337 (c) (1) contains an exception to the one-year liquidation provision. As noted above, this section provides that section 337 shall not apply to a sale or exchange made by a collapsible corporation as de-

8. Code § 34 (a) (1). Under this section, "gain from . . . the sale or exchange of stock of a collapsible corporation, . . . to the extent that it would be considered (but for the provisions of this section) as gain from the sale or exchange of a capital asset held for more than 6 months shall, except as provided in subsection (d), be considered as gain from the sale or exchange of property which is not a capital asset."

9. See text accompanying note 6 *supra*.

10. Code § 341 (d) (3).

fined in section 341(b). Since a corporation, as has been seen, may meet the definition of a collapsible corporation even after the expiration of the three-year period of section 341(d), the one-year liquidation provisions remain inapplicable.

To illustrate, the example of the corporation organized to produce a motion picture can be used. Further, suppose that the stockholders, being aware of the ordinary income penalty imposed by section 341, put their completed film aside and refrained from selling their stock during the three-year period. The stockholders clearly had the prohibited purposes of section 341(b) in mind when they organized their corporation for the purpose of production of the property and the sale of the stock before a substantial part of the income from the property produced had been realized. The corporation, therefore, is clearly a collapsible one. Nevertheless, the gain on sale of their stock is capital gain, since they have waited three years. The gain also would be capital gain if they chose to distribute the film in liquidation.

Suppose, however, that the unwary stockholders of this corporation decide not to sell their stock. Instead they decide to cause the corporation to sell its assets and distribute the proceeds in liquidation. They will, of course, want to rely on section 337 to avoid tax at the corporate level. Section 337, however, is not applicable because the corporation is still collapsible. The result is that a capital gain is realized both at the corporate level and at the shareholder level.

SECTION 341 ASSETS

A casual reading of the statute may convey the impression that the problem is avoided by the definition of section 341 assets. It will be recalled from the discussion above that the definition in section 341(b)(1) of the term "collapsible corporation" is

> a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a view to —
>
> (A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be be derived from such property, and
>
> (B) the realization by such shareholders of gain attributable to such property.

Section 341(b)(3) defines "section 341 assets" as "property held for a period of less than three years" which is of specified kinds. Returning to the example, does this not mean that since the motion picture was completed more than three years ago, the corporation does not hold section 341 assets and, therefore, no longer is a collapsible corporation? It does not, and the corporation may nevertheless remain collapsible.

Examination of section 341(b)(1) discloses that the reference to "property described in paragraph (3)" relates only to property *purchased* by the corporation. If the corporation has been formed or availed of principally for the *manufacture, construction,* or *production* of property with the proscribed purpose, it does not matter whether the property constitutes section 341 assets or not. This construction of the statute, while grammatically correct, is certainly obscure in the statutory language.[11]

It now becomes evident that a corporation may meet the definition of a collapsible corporation even though the three-year period of section 341(d) has expired, provided that a "view" existed to the sale or exchange of the stock or the making of a distribution to the shareholders before the realization of a substantial part of the taxable income to be derived from the property. Accordingly, section 337 is not available in this situation. The rationale in support of this conclusion is sufficiently complicated that it might have been argued that an oversight in the drafting occurred, and that the statute would not in fact be so interpreted. The Regulation, however, clarifies the point by providing:

> Accordingly, section 337 does not apply to any sale or exchange of property whenever the distribution of such property in partial or complete liquidation to the shareholders in lieu of such sale or exchange would have resulted in the taxation of the gain from such distribution in the manner provided in section 341(a) as to any shareholder *or would have resulted in the taxation of the gain in such manner, but for the application of section 341(d).*[12]

Section 337 is equally inapplicable to a collapsible corporation where the three-year period has not yet expired. If the motion picture company had adopted a plan of liquidation as soon as the film was completed, the sale of the film would be taxable. If the film had been distributed in liquidation, the result would have been ordinary income under section 341(a). This result occurs by applying the test of the Regulation quoted above, under which section 337 is inapplicable.

Revenue Ruling 58-241

The above factors lead to a curious circular argument. If section 337 is inapplicable, the gain on sale by the corporation is taxable. If, however, the gain is taxable, the corporation has realized the income from the property. As a result, the corporation no longer is collapsible within

11. The punctuation of this section in Treas. Reg. § 1.341-2(a) (1955) is clearer in providing that the corporation must have been "formed or availed of principally (i) for the manufacture, construction or production of property, (ii) for the purchase of property which (in the hands of the corporation) is property described in section 341(b)(3). . . ."

12. Treas. Reg. § 1.337-1 (1955). (Emphasis added).

the meaning of section 341(b). Therefore, section 337 is applicable after all. The Commissioner elected to stop the rotation of this merry-go-round argument by ruling, in Revenue Ruling 58-241,[13] that in this situation neither section 337 nor the ordinary income tax treatment of section 341(a) is applicable.

While this Ruling probably produces a sensibly practical result, it is submitted that it is not consistent with the actual structure of the statute; it is an attempt to correct, by ruling, an error in the drafting of the statutory language. The inconsistency exists in the assumption that the realization of the income by the corporation (arising from the inapplicability of section 337) removes the corporation from its previous classification as collapsible under section 341(b). That subsection defines "collapsible corporation" as a corporation formed or availed of with a view to a sale or liquidation before realization by the corporation of the income to be derived from the property and the realization by the shareholders of gain attributable to the property. While there has been considerable debate as to whether it is necessary that the prohibited "view" exists at the time of production of the property, the time of the liquidation, or both, there appears to be nothing in the statute which requires that the purpose implicit in the word "view" be in fact followed through by action. Thus, it is quite conceivable that a corporation might be formed with the prohibited purpose and thereby become a collapsible corporation even though the purpose was later abandoned. This is one of the aspects of the law which makes a trap of the inter-play of the two sections, especially in cases where the property has been in existence more than three years.

The Revenue Ruling seems to assume that because the intent to evade a tax (at which section 341 was aimed) has been frustrated by the inapplicability of section 337, the prohibited "view" has not been carried out and the corporation is no longer collapsible. This interpretation ignores both the subjective character of the definition and also the fact that section 341(b) uses the word "realized" rather than "recognized." Section 337 does not provide that gain is not "realized" by the corporation where that section is applicable, but rather that it is not "recognized." The distinction is real. It is recognized throughout the Regulations in other contexts of recognition and nonrecognition of gain.[14] The corporation realizes its gain upon the sale of the property whether that gain is recognized under section 337 or not. Thus, even if the Commissioner is correct in assuming that the actual outcome (rather than the original subjective purpose) is controlling, the application of section 337 is irrelevant

13. 1958-1 CUM. BULL. 179.

14. See, *e.g.*, Treas. Reg. §§ 1.337-4(b) (1955), 1.356-1(b) (1955), 1.357-1(b) (1955), 1.1031(d)-2 (1956).

to the definition. If one assumes that the existence of the prohibited "view" on the part of the shareholders is significant, then whether the courts may hold that section 337 applies or not has nothing to do with the existence of that "view." If, on the other hand, it is not the shareholders' original view, but the action actually taken by the corporation which is significant, then the corporation obviously is not collapsible in this situation because the gain was clearly "realized" whether it was "recognized" or not.

Finally, the Revenue Ruling is inconsistent in that it treats the corporation as collapsible for the purposes of section 337(c), but not for purposes of section 341(a). Even if "realized" could be equated properly with "recognized," a holding that the corporation is collapsible for one purpose would necessarily imply its collapsibility for the other. It is submitted that the correct answer is to deny the significance of "recognition" in determining whether the corporation is collapsible. It is collapsible if the prohibited "view" existed; if it is collapsible, section 337 is not applicable, so that there is a capital gain at the corporate level and ordinary income at the shareholder level. On the other hand, the action taken by the corporation at least should be evidentiary of the fact that the requisite "view" to liquidation before "realization" of the income did not exist. If it did not exist, the corporation is not collapsible for any purpose. The result is a single capital gains tax at the shareholder level. Admittedly, this interpretation would re-introduce into the Code the opportunity to use section 337 to escape the collapsible corporation penalty, but this is the fault of the statutory language. Nevertheless, it may well be that if the situation arises in litigation, the courts will prefer to depend on what the Code should have said, rather than recognize the ineffectiveness of section 337(c).

Exceptions in Section 341(e)

The Technical Amendments Act of 1958 introduced a new element into the situation with the enactment of section 341(e). This new subsection provides a number of exceptions to the collapsible corporation rules. Since it contains a provision specifically exempting shareholders from collapsible treatment in a section 337 liquidation under certain circumstances, and also a provision exempting the corporation from collapsible treatment in a section 337 liquidation under other conditions, it is quite possible that it may be held to have superseded Revenue Ruling 58-241.[15] Since Regulations under section 341(e) have never been promulgated, it is not possible at this time to determine the answer to this question. The Ruling, therefore, must be assumed to continue in ef-

15. See text at note 13 *supra*.

fect to the extent that it is not inconsistent with subsection (e) of section 341.

Section 341(e)(4) provides, if certain conditions are met, that

> for purposes of section 337, a corporation shall not be considered to be a collapsible corporation with respect to any sale or exchange by it of property within the 12-month period beginning on the date of the adoption of a plan of complete liquidation.

One condition requires the sale by the corporation of substantially all its properties.[16] Another requires that no property subject to depreciation, depletion, etc., be distributed in liquidation.[17] A third provides that no sale of such property be made to a major shareholder.[18] These conditions are easily met. The remaining condition, however, requires that unrealized appreciation at the time of the adoption of the plan of "subsection (e) assets" shall not exceed 15% of net worth.[19] Such assets as defined by section 341(e)(5) are for the most part similar to section 341 assets. The effect of this condition, of course, is to limit the exception. Hence, if the motion picture in the above example is sold in the twelve month period for a profit of more than 15% of its net worth, the exception is not applicable, and the corporation remains collapsible for purposes of section 337.

Suppose, however, that the film was sold for less than 15% profit and that the other conditions of section 341(e)(4) are met. In this situation, the collapsible corporation definition is avoided for purposes of section 337. Section 337 applies and the gain on the sale is tax free. If the three-year period has expired, the transaction is the same as it would have been if the corporation had never been collapsible. But suppose that the transaction took place *within* the three-year period. Under Revenue Ruling 58-241, if the corporation is collapsible, section 337 does not apply and there is a tax on the corporate sale, but only a capital gains tax on the liquidation. If, however, the exception of section 337(e)(4) applies, the situation is removed from the limitation on section 337 so that the benefits of 337 are obtained. It does not, however, relieve the corporation of its status as a collapsible corporation.

16. CODE § 341(e)(4)(B) provides that a corporation shall not be considered collapsible if "within the 12-month period beginning on the date of the adoption of such plan, the corporation sells substantially all of the properties held by it on such date. . . ."

17. CODE § 341(e)(4)(C) requires that if "following the adoption of such plan, no distribution is made of any property which in the hands of the corporation or in the hands of the distributee is property in respect of which a deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion is allowable."

18. CODE § 341(e)(4).

19. CODE § 341(e)(4)(A) requires that "at all times after the adoption of such plan, the net unrealized appreciation in subsection (e) assets of the corporation (as defined in paragraphs (5)(A)) does not exceed an amount equal to 15 percent of the net worth of the corporation. . . ."

This point is covered by section 341(e)(2), which provides that the distribution in liquidation also escapes collapsible corporation treatment under certain conditions. One of these conditions is that pursuant to section 341(e)(4) section 337 is applicable. The other condition is that the *unrealized* gain on "subsection (e) assets," *plus the gain on certain other assets,* be less than 15% of the net worth.[20] It thus appears that, under circumstances which meet the 15% test of section 341(e)(4) but fail to pass the somewhat more difficult 15% test of section 341(e)(2), the corporate sale may be tax free, but the shareholders' gain may be ordinary income. This result, in respect to high-bracket shareholders, may well be worse than the result obtained under Revenue Ruling 56-241 if *neither* test is satisfied.

As indicated above, it is not yet possible to determine whether Revenue Ruling 56-241 has been entirely superseded by subsections (e)(2) and (e)(4) of section 341. If it has not, it still can be applicable to convert the gain on liquidation into a capital gain in a situation where the test of neither subsection (e)(2) nor subsection (e)(4) has been met.

The apparent results under the existing Code, Regulations, and the Revenue Ruling are as follows:

A. Liquidation during the three-year period:
   1. 15% test of section 341(e)(4) satisfied — no tax on corporation
      (a) 15% test of section 341(e)(2) satisfied — capital gain for shareholders
      (b) 15% test of section 341(e)(2) not satisfied — ordinary income tax on shareholders;
   2. 15% test of section 341(e)(4) not satisfied — corporation taxable — shareholders will experience capital gain if Revenue Ruling 58-241 is still effective, otherwise ordinary income;

B. Liquidation after the three-year period — shareholders have capital gain
   1. 15% test of section 341(e)(4) satisfied — no tax on corporate sale
   2. 15% test of section 341(e)(4) not satisfied — corporation taxable.

The exceptions of section 341(e) undoubtedly will have the intended[21] effect of eliminating risk under section 341 in cases to which that section was not intended to apply. On the other hand, although

20. CODE § 341(e)(2).
21. S. REP. NO. 1983, 85th Cong., 2d Sess. 31 (1958).

section 341(e)(11) provides that failure to meet the exemptions of section 341(e) creates no presumption of collapsibility,[22] it seems quite possible that time will make these sections the limit of safety from collapsible treatment. Furthermore, it must be recognized that the 15% limitations of these subsections erects a rather low ceiling.

For example, suppose Company *A* manufactures a highly profitable product. Because of rapid expansion, it has found it necessary to obtain adequate capital by borrowing its working capital and leasing its plant and equipment. On these facts, the company's net worth is apt to be low in relation to the size of its business, and the value of its completed goods inventory may be high in relation to cost. It is quite possible for such a company to have an unrealized gain on inventory which is much more than 15% of its net worth. Inventory is a subsection (e) asset which is seldom more than three years old. Such a corporation might well encounter unexpected trouble with section 337.

CONCLUSION

Avoidance of all these problems depends first, of course, upon being aware of them. If dangers are discovered, in most cases they can be avoided or minimized. The following suggestions may be pertinent:

1. In any case where section 337 is to be used, the values of the assets should be compared with their tax cost to determine whether there is any danger of failing to meet both 15% tests. If there is such a danger, the net worth may be increased or the unrealized appreciation in subsection (e) assets may be decreased, or both. This result can be achieved by the judicious disposition of selected assets to produce some gain (which will of course be taxed) before the plan of liquidation is adopted. Additional capital may be contributed where this is practical.

2. Where the transaction is to take place within the three-year period and where the corporation clearly meets the test of collapsibility, consideration should be given to whether Revenue Ruling 58-241 may be relied upon to produce a double capital gains tax. In many cases, this course will be less expensixe than ordinary income tax on sale of the stock or liquidation in kind.

3. Where the transaction is to take place after the three-year period and if there is danger of collapsible treatment, sale of stock is always preferable to the use of section 337.

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22. CODE § 341(e)(11) provides that "in determining whether or not any corporation is a collapsible corporation within the meaning of subsection (b), the fact that such corporation . . . does not meet the requirements of paragraph (1), (2), (3), or (4) of this subsection shall not be taken into account, and such determination which does not meet such requirements, shall be made as if this subsection had not been enacted."