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Zolman Cavitch

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## VII

## COLLAPSIBLE CORPORATIONS

Zolman Cavitch

The collapsible corporation section<sup>1</sup> first came into the Internal Revenue Code in 1950 as a loophole-plugging law. The loophole aimed at was one which was then prevalent primarily in the movie and real estate industries and enabled the tax-sophisticated businessman to convert ordinary income into favorably taxed long-term capital gain.

The problem and the solution can be illustrated by the following example. Suppose that an individual owned a large tract of raw land which he wished to subdivide, improve, and sell as residential sites. If he proceeded without incorporating, the entire profit would constitute ordinary income. Similarly, if he formed a corporation to proceed with the project, and the corporation sold the lots, its profit would be taxed as ordinary income and, in addition, the after-tax profit would still be in the corporate till, normally requiring the payment of a second tax at the shareholder level in order to place those profits in the shareholder's pocket. Neither of these alternatives was ideal, to say the least.

Prior to 1950, there was a way out. The landowner could transfer his land to a newly-formed corporation, have the corporation subdivide and improve the land, and then, prior to the sale of the lots, cause the corporation to liquidate. The shareholder would pay a long-term capital gain tax based on the difference between the cost of his shares and the *value* of the assets received<sup>2</sup> — a maximum tax of twenty-five per cent — and the corollary would be that the shareholder would have a cost basis for the lots equal to their fair market value at the time of liquidation.<sup>3</sup> Upon a subsequent sale of the lots by the erstwhile shareholder, that excess would escape any further tax; it would have been converted from potential ordinary income to the corporation to long-term capital gain to the shareholder.

This loophole is now largely blocked by section 341. A shareholder who receives a liquidating or other distribution from a collapsible corporation, which distribution would otherwise give rise to long-term capital gain, may be taxed at ordinary income tax rates.<sup>4</sup> Indeed, he *will* be so

1. INT. REV. CODE OF 1954, § 341 [hereinafter cited as CODE §].

2. CODE § 331.

3. CODE § 334(a).

4. CODE § 341(a). The collapsible corporation provisions apply not only to corporate distributions which would otherwise give rise to long-term capital gain to the distributees, but to shareholder sales of stock as well. References throughout this article to "collapsing the corporation" should be read to mean distributions from the corporation *and* sales of shares.

taxed unless he fits into one of the several exceptions to which we shall make brief mention a little later.<sup>5</sup>

### DEFINITION OF A COLLAPSIBLE CORPORATION

The least understood aspect of collapsible corporations, which involves the most difficult statutory phraseology and is the occasion for the largest number of decided collapsible cases, is the definition of a collapsible corporation.<sup>6</sup> It is with this definition that we shall be primarily concerned.

A collapsible corporation is defined as

. . . a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of . . . [§341 assets], with a view to —

- (A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise) . . . 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.

Unfortunately, the definition is even more complex than it appears. Let us examine that definition in detail, stopping at each key phrase.

#### " . . . formed or availed of . . . "

The corporation may be formed *or* availed of for the proscribed purpose. The disjunctive is meaningful.<sup>7</sup> We tend to think of a collapsible corporation as one which is relatively new, one which has not received a significant amount of taxable income. That will *normally* be true, but it is not necessarily true. An old corporation — one which has operated profitably for fifty years or more — can be *availed of* for the proscribed purpose and land the shareholders in tax trouble. This problem will be discussed in more detail after we have examined the relevant key phrases.

#### " . . . principally . . . "

A collapsible corporation must be formed or availed of principally for the manufacture, production, etc. of property. The word "principally" modifies "manufacture, production, etc." and not "with a view to." One

5. See text beginning at page 285, *infra*. In addition to the possibility of an unfavorable tax to the shareholders, if a corporation is collapsible the elective tax treatment of the so-called "one-month liquidation" will not be available (see CODE § 333(a) and Treas. Reg. § 1.333-1(a) (1955) [hereinafter cited as Reg. §1]), and the nonrecognition provisions of section 337 of the Code will not be applicable (See CODE § 337(c) (1) (A) and Rev. Rul. 58-241, 1958-1 CUM. BULL. 179).

6. CODE § 341(b) (1).

7. See Maxwell Temkin, 35 T.C. No. 101 (March 13, 1961).

hard-pressed taxpayer attempted to squirm out of a collapsible penalty by arguing that his corporation was formed or availed of *principally* to make money, not principally to obtain an income tax advantage. But the Court of Appeals for the Second Circuit reminded him that he had missed the whole point.<sup>8</sup> The view to collapse the corporation need not be the principal purpose for the formation or availing of the corporation. "Principally" defines "manufacture, etc." and is therefore of little or no help in attempting to avoid collapsible status.

*"... manufacture, construction, or production of property ..."*

The "manufacture, construction, or production of property" has been broadly defined both by the courts and the Internal Revenue Service.<sup>9</sup> An attempt to get out from under collapsible treatment on the ground that the corporation was collapsed too early in the game, before the manufacture, construction, or production began, must face the obstacle of a strict interpretation. Any integral step in the construction process will be considered construction. For example, the mere rezoning of land from residential to commercial has been ruled to be construction.<sup>10</sup> The preparation of preliminary architect's drawings is probably construction.<sup>11</sup> The obtaining of long-term leases, even before any other work is done in the construction of a shopping center or an office building, would probably be considered construction for this purpose.

Furthermore, the corporation will be deemed to have engaged in construction if someone else does construction work and then transfers the property to the corporation in a tax-free exchange.<sup>12</sup> Similarly, if the corporation constructed property and then exchanged that constructed property for other property in a tax-free exchange, the corporation will be deemed to have constructed the property so acquired, even if the corporation did not in fact lift a finger with respect to the acquired property.<sup>13</sup>

### *"Section 341 assets"*

As indicated in the immediately preceding paragraphs, a corporation may be collapsible if it manufactures, constructs, or produces any kind of property. In addition, a corporation may be collapsible if it purchases

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

9. *Abbott v. Commissioner*, 258 F.2d 537 (3d Cir. 1958); Ellsworth J. Sterner, 32 T.C. 1144 (1959); Rev. Rul. 57-346, 1957-2 CUM. BULL. 236; Rev. Rul. 56-137, 1956-1 CUM. BULL. 178.

10. Rev. Rul. 56-137, 1956-1 CUM. BULL. 178.

11. See Ellsworth J. Sterner, 32 T.C. 1144 (1959); Jack Faber, 36 T.C. 116 (1961).

12. CODE § 341(b)(2)(B); Reg. § 1.341-2(a)(5) (1955).

13. CODE § 341(b)(2)(C); Reg. § 1.341-2(a)(5) (1955).

property defined as "section 341 assets." "Section 341 assets" are defined in detail in the Code.<sup>14</sup> Very generally speaking, such assets are assets held for less than three years which are inventory or inventory-like property, property held for rental, or receivables acquired by virtue of the sale of the foregoing types of property.

". . . with a view to . . ."

Statutory language which purports to define a subjective state of mind is always troublesome. It is therefore not surprising that a great bulk of collapsible litigation to date has centered on the meaning of the phrase "with a view to."<sup>15</sup> A collapsible corporation must be formed or availed of principally for the manufacture, etc. of property *with a view to* collapsing the corporation prior to the realization of corporate profits.

The still-unsettled question is: *When* must that view to collapse first come into existence in order for the corporation to be collapsible?

Various answers are possible. The answer most favorable to taxpayers, and the one which most easily follows the statutory language, is that the view to collapse must arise at some time *during* the construction process. Suppose, for example, that a corporation were formed for the construction and leasing of a shopping center. After construction was completed, the shareholders decided for the first time that the corporation should be liquidated, or that its shares should be sold. Accordingly, the corporation is collapsed and the shareholders realize a substantial gain. Under this favorable interpretation of the statute, the corporation would not be collapsible even though all of the other elements of collapsibility might be present. It would not be collapsible because the view to collapse did not exist at any time during the construction process.

The requirement that the view to collapse exist at some time *during* the construction, etc. process seems to be the proper interpretation of the statute.<sup>16</sup> Indeed, even the Treasury Department, in a diluted fashion, acknowledges this in its Regulations. The Regulations state that if the view to collapse is attributable solely to circumstances which arose after the construction, the corporation will ordinarily be considered noncollapsible.<sup>17</sup>

14. CODE § 341(b)(3).

15. *Jacobson v. Commissioner*, 281 F.2d 703 (3d Cir. 1960); *Spangler v. Commissioner*, 278 F.2d 665 (4th Cir. 1960); *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960); *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959); *August v. Commissioner*, 267 F.2d 829 (3d Cir. 1959); *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958); *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958); *Charles J. Riley*, 35 T.C. No. 95 (February 28, 1961), *appeal filed*, 1st Cir., July 19, 1961; *Benjamin Braunstein*, 36 T.C. No. 3 (April 11, 1961); *Maxwell Temkin*, 35 T.C. No. 101 (March 13, 1961); *Ellsworth J. Sterner*, 32 T.C. 1144 (1959); *Max Mintz*, 32 T.C. 723 (1959).

16. *Jacobson v. Commissioner*, 281 F.2d 703 (3rd Cir. 1960); *Charles J. Riley*, 35 T.C. No. 95 (February 28, 1961); *Maxwell Temkin*, 35 T.C. No. 101 (March 31, 1961).

17. Reg. § 1.341-2(a)(3) (1955).

It might be supposed that the Treasury's acceptance of this interpretation would put an end to the matter. No such luck. Two courts of appeal, the highly respected Second Circuit and the Fourth Circuit, plus five of the judges of the Tax Court, appear to be upset over the reasonableness of the Treasury Department's interpretation.<sup>18</sup> In dicta written by both courts and by the five minority judges of the Tax Court, the unusual position is advanced that the Treasury Department has in this respect been unwarrantedly generous to taxpayers. These authorities take the position that the "view to" language in the statute does not modify the language which precedes it. Rather, it is simply introductory to the language which follows it; that, in effect, when a corporation is collapsed there must of necessity be a *view* to collapse it and that therefore the "view to" language is always satisfied whether the intention arose during the construction process or after it. This is, of course, an unfavorable interpretation since it reads out altogether any limiting significance to the "view to" language. Under this interpretation the "view to" requirement will always be met.

The debate still rages; the last word has not yet been written by the courts. As a practical planning matter, however, the possibility that there may be a favorable answer to the "view to" debate will give little comfort. Even under the liberal interpretation, the Treasury Department imposes, and the courts enforce, a difficult burden on the taxpayers to prove a complete absence, during the construction process, of any intention to collapse.<sup>19</sup> If the intention to collapse exists at any time during the construction process, unconditionally, conditionally, or as a recognized possibility, the "view to" requirement will be met. Indeed, if merely the *circumstances* giving rise to the view were present during construction, or could reasonably be anticipated during the construction, the view would be deemed to exist.<sup>20</sup> Only in those rare instances where it can be shown that no view to collapse existed at all during construction, that wholly unanticipated circumstances arose *after* the construction was complete, and that the intent to collapse was motivated solely by these subsequent circumstances, will the corporation be noncollapsible on this account.<sup>21</sup> But this

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18. *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960); *Glickman v. Commissioner*, 256 F.2d 108 (2d Cir. 1958); *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958); *Maxwell Temkin*, 35 T.C. No. 101 (March 13, 1961) (dissenting opinion); *Charles J. Riley*, 35 T.C. No. 95 (February 28, 1961) (dissenting opinion).

19. Reg. § 1.341-2(a) (2), (3) (1955); *Spangler v. Commissioner*, 278 F.2d 665 (4th Cir. 1960); *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959); *August v. Commissioner*, 267 F.2d 829 (3d Cir. 1959); *Benjamin Braunstein*, 36 T.C. No. 3 (April 11, 1961); *Ellsworth J. Sterner*, 32 T.C. 1144 (1959); *Max Mintz*, 32 T.C. 723 (1959).

20. See *Ellsworth J. Sterner*, 32 T.C. 1144 (1959); *Max Mintz*, 32 T.C. 723 (1959).

21. Reg. § 1.341-5(c) Example (3) (1955). If the view to collapse arises during construction, or is deemed to have arisen during construction, it is immaterial that it was motivated by a compelling business reason rather than by a tax avoidance purpose. *Ellsworth J. Sterner*, 32 T.C. 1144 (1959).

burden of proof can sometimes be met, as witness a few taxpayer victories in court on this issue.<sup>22</sup> There is therefore reason to hope that the proper interpretation of the "view to" language will be the one which ultimately prevails.

*"... substantial part of the taxable income  
to be derived from such property ..."*

A fundamental requirement of collapsibility is that the corporation must be collapsed *prior* to the realization by the corporation of a *substantial part* of the taxable income to be derived from the property manufactured, constructed, etc. Here again the courts are not in agreement; how is "substantial part" measured and how much is "substantial"? Let us start with an example. Suppose that a corporation is formed — or availed of — to construct a twenty-house residential development. The twenty houses are built and the corporation actually begins to sell them. Eight houses are sold by the corporation for a net profit of \$3,000 per house, or \$24,000 of corporate profit. Then, before the twelve remaining houses are sold, the corporation liquidates and the shareholders take over these twelve houses at their estimated fair market value. Did the corporation, prior to the liquidation, realize a substantial part of the taxable income when it realized 8/20ths, or forty per cent of the total anticipated profit? The majority of the Tax Court and the Court of Appeals for the Fifth Circuit would say "yes."<sup>23</sup> One-third of the total anticipated profit is substantial.<sup>24</sup>

But the Treasury Regulations and, apparently, the Court of Appeals for the Third Circuit would say that a substantial part has not been realized until the unrealized profit is insubstantial.<sup>25</sup> In other words, these authorities would look to the quantity of the *unsold* houses in our example. Since sixty per cent of the houses had not been sold by the corporation, and presumably sixty per cent of the profits had not been realized, the substantial part requirement had not been met.

This latter, unfavorable interpretation seems clearly to be an unjustified reading of the statute. Its justification, to the judges who advance it, and presumably to the Treasury Department, is that unless the statute is so interpreted, the loophole at which the statute is aimed still remains two-thirds open. This is undeniably true, but the complete answer ought to be that Congress left the loophole open to that extent and it is up to Congress, if it sees fit, to close it.

22. *Jacobson v. Commissioner*, 281 F.2d 703 (3d Cir. 1960); *Charles J. Riley*, 35 T.C. No. 95 (February 28, 1961); *Maxwell Temkin*, 35 T.C. No. 101 (March 13, 1961).

23. *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961), *affirming* 32 T.C. 135 (1959). See also *Levenson v. United States*, 157 F. Supp. 244 (N.D. Ala. 1957).

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

25. Reg. § 1.341-5(c)(2) (1955); *Abbott v. Commissioner*, 258 F.2d 537 (3d Cir. 1958).

At any rate, the chances are that the proper interpretation will prevail and if the corporation has realized a substantial part of the taxable income to be derived from the particular project or building, the corporation will not be collapsible. It appears, furthermore, that one-third will be the dividing line; anything less than that will *not* be substantial.<sup>26</sup>

Some nice questions are presented as to the proper method for computing the amount of the total income to be derived from the property — problems which, by virtue of space limitations, must be glossed over.<sup>27</sup> It might be well to emphasize, however, that an argument by the taxpayer that a substantial part has already been realized because business is not likely to be good in the future will not be persuasive unless the taxpayer can document his case, a fairly unlikely possibility. In brief, several courts have announced that they will not speculate pessimistically over the likelihood or unlikelihood of future profits.<sup>28</sup>

*“ . . . gain attributable to such property.”*

To fall within the collapsible proscription, a shareholder must realize gain which is attributable to the property manufactured, constructed, etc. by the corporation. The early litigation in the collapsible area centered largely around the taxpayer's contention that his gain was *not* attributable to property constructed by the corporation.<sup>29</sup> Many of these cases were so-called “excess mortgage” cases. For example, a corporation would be formed to build an apartment project to be financed by an FHA-insured mortgage. The shareholders would put in little or nothing. Apparently, it was not unusual in the immediate post-war years for builders to obtain FHA commitments substantially in excess of construction cost. In these instances, when the project was completed or substantially completed, and before the corporation had any earnings, the excess mortgage proceeds would be distributed out to the shareholders. That corporate distribution, to the extent it exceeded the shareholders' basis for their shares, would normally be taxed as long-term gain.<sup>30</sup> The Commissioner argued, however, that the collapsible provision applied to make the gain taxable as ordinary income. The issue in most of these cases was whether the gain was attributable to property constructed by the corporation.

26. Compare *Heft v. Commissioner*, 294 F.2d 794 (5th Cir. 1961), where the same court which decided the *Kelley* case held that one eighth of the total profits was *not* substantial.

27. Note the different approach taken in *Abbott v. Commissioner*, 258 F.2d 537 (3d cir. 1958) from that taken in *James B. Kelley*, 32 T.C. 135 (1959), *aff'd*, 293 F.2d 904 (5th Cir. 1961); *Levenson v. United States*, 157 F. Supp. 244 (N.D. Ala. 1957); *Frank B. Short*, 35 T.C. No. 103 (March 14, 1961).

28. *Spangler v. Commissioner*, 278 F.2d 665 (4th Cir. 1960); *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959); *Max Mintz*, 32 T.C. 723 (1959).

29. *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959); *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958); *Frank B. Short*, 35 T.C. No. 103 (March 14, 1961).

30. CODE § 301(c) (3) (A).



The Government invariably won these "excess mortgage" cases and in the process it has been pretty well established that the phrase "gain attributable to such property" is to be broadly construed. If the gain would not have been realized by the shareholders *but for* the manufacture, construction, etc. by the corporation, then the gain is virtually certain to be attributable to the property so constructed.<sup>31</sup>

### *Statutory Presumption of Collapsibility*

Since 1954 the collapsible section of the Code has contained a provision creating, in certain defined instances, a rebuttable presumption that the corporation meets the definition of a collapsible corporation.<sup>32</sup> This presumption applies if, at the time the corporation is collapsed, the fair market value of its section 341 assets<sup>33</sup> is (1) fifty per cent or more of the fair market value of its total assets,<sup>34</sup> and (2) 120 per cent or more of the adjusted basis of such section 341 assets. To date there have been no reported cases relying on or interpreting this statutory presumption. In view of the difficult burden of proof imposed by the courts upon taxpayers who are trying to prove the noncollapsibility of their corporations, it is not likely that this statutory presumption will add greatly to taxpayers' woes.

### LIMITATIONS ON ADVERSE COLLAPSIBLE TREATMENT

The second matter of fundamental importance in working with the collapsible rules is that there are certain statutory exceptions to collapsible *treatment* even though the corporation may admittedly be collapsible. That is, even though the definition of a collapsible corporation is clearly satisfied, the gain realized by a shareholder will *not* be converted from long-term capital gain to ordinary income if one of the statutory exceptions applies.<sup>35</sup> In many cases involving the closely-held corporation, there will be reasonable assurance, for planning purposes, that the collapsible penalty will not apply *only if one of these statutory exceptions is applicable*.

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31. See in addition to the cases cited in footnote 29 *supra*, Paul Braude, 35 T.C. No. 121 (March 31, 1961); Erwin Gerber, 32 T.C. 1199 (1959).

32. CODE § 341(c).

33. See text beginning at p. 280 *supra*.

34. For this purpose "total assets" does not include the corporation's cash, obligations which are capital assets to the corporation, most government obligations even though not capital assets, and stock in other corporations. CODE § 341(c)(2).

35. But, the corporation being collapsible under the statutory definition, the nonrecognition provisions of section 337 will not be applicable, and the elective tax treatment of the so-called "one-month liquidation" may not be available. See note 5 *supra*.

### *Three-year Limitation*

Even though the corporation may be admittedly collapsible, the penalty will not apply on a shareholder sale or corporate liquidation if the sale or liquidation occurs more than three years after completion of the manufacture, construction, etc. of the property.<sup>36</sup> For this purpose, the Treasury Department takes the position that the three-year period does not begin to run until the particular property or project is *completely* finished; substantial completion is not enough in the view of the Treasury Department.<sup>37</sup> The courts are somewhat equivocal on this point, but *apparently* will support the Treasury.<sup>38</sup>

In many instances, this exception will be an important planning tool. The liquidation or sale of shares of a corporation owning a shopping center or office building, or apartment project, may in some instances conveniently be postponed for a time until the three-year period has run. This alternative is not likely to be feasible in the case of a corporation which owns a residential subdivision ready for sale.

### *The "Subsection (e)" Limitation*

A second exception to collapsible treatment is couched in statutory terms which clearly take top prize for obscurity of meaning.<sup>39</sup> No attempt will be made in this paper to unravel the garbled language of this relatively new limitation.<sup>40</sup> It will suffice for present purposes to state simply that the section applies if the unrealized appreciation in corporate assets which could be sold by the corporation or by certain shareholders only as ordinary income items does not exceed fifteen per cent of the corporation's total net worth, as adjusted in various ways. In working with this limitation it is essential to have the precise facts and figures of a given situation and to analyze them in terms of each phrase of this difficult provision.

### *The "5% shareholder" Limitation*

A third exception to collapsible treatment applies if a shareholder realizing the gain did not, at any time during the construction process or

36. CODE § 341(d)(3). The period of a predecessor's ownership is tacked on if the corporation acquired the property in a wholly or partly tax-free transaction. Rev. Rul. 57-491, 1957-2 CUM. BULL. 232.

37. Reg. § 1.341-4(d) (1955); Rev. Rul. 56-137, 1956-1 CUM. BULL. 178.

38. Glickman v. Commissioner, 256 F.2d 108 (2d Cir. 1958); Ellsworth J. Sterner, 32 T.C. 1144 (1959). *But cf.* Maxwell Temkin, 35 T.C. No. 101 (March 13, 1961), where, in holding that the view to collapse did not arise during construction, the Tax Court ignored the fact (or deemed it insignificant) that the lawn and landscaping were not completed until after the view arose.

39. CODE § 341(e).

40. For a more detailed treatment of this limitation, see Modrall, *Collapsible Corporations and Subsection (e)*, 37 TAXES 895 (1959).

thereafter, own more than five per cent in value of the corporation's stock, provided further that during such time none of his stock was attributable to a more-than-five per cent shareholder.<sup>41</sup> Both in testing the five per cent ownership and in determining whether any of a shareholder's stock is attributable to another, very broad attribution of ownership rules apply.<sup>42</sup>

This stock ownership limitation will rarely be helpful with respect to the closely-held corporation. It suggests, however, a possible escape from collapsible treatment if the collapsible corporation can be disposed of by way of a tax-free reorganization. That is, if the stock or assets of a collapsible corporation are exchanged for stock of a publicly-held corporation in a transaction which is completely tax-free,<sup>43</sup> there can be no collapsible tax treatment by virtue of that exchange. Thereafter, if the shareholder does not own, after the application of attribution rules, more than five per cent of the publicly-held corporation's stock, he will be able to dispose of such stock free of collapsible worries.<sup>44</sup>

#### *The "70%-30%" Limitation*

A fourth, and important, exception requires a little explanation. No matter how collapsible the corporation may be, a *particular* shareholder will not be penalized at all unless more than seventy per cent of *his* gain is attributable to the assets which have made the corporation collapsible.<sup>45</sup> An example will be helpful. Suppose that X Corporation has been in existence for thirty years. For the first twenty-nine years it was engaged in a retail grocery business and did quite well, having accumulated a substantial amount of earned surplus. One year ago it invested a portion of its resources in the construction of a shopping center and before the construction was complete, it became obvious that the shopping center was worth a great deal more than it cost X Corporation to construct. The shareholders decide to sell their stock. There are two equal shareholders, A and B. A was one of the founders of the corporation; the cost basis for his shares is only \$10,000. B purchased his shares one year ago, just before the shopping center construction commenced, and he paid \$200,000 for his shares. A and B each realize \$300,000 for his shares and each would have realized \$200,000 if the shopping center had never been constructed. On these facts shareholder A would realize a total profit of

41. CODE § 341(d) (1).

42. Thus, for example, attribution of ownership applies for this purpose between brothers-in-law and sisters-in-law, as well as between various other relatives by blood and marriage.

43. See CODE §§ 354(a), 368(a) (1) (A)-(C).

44. Also, it may be possible to conclude with reasonable assurance that the publicly-held corporation is not collapsible in the first instance, in which event it would be unnecessary to meet one of the limitations in order to escape collapsible tax treatment.

45. CODE § 341(d) (2).

\$290,000, but only \$100,000 of that profit is attributable to the collapsible property. Since the portion of his gain which is attributable to collapsible assets is less than seventy per cent, no part of his profit will be ordinary income. By contrast, shareholder B realizes a profit of \$100,000 and all of it is attributable to the collapsible property. All of his profit will be ordinary income.

The point is that this seventy per cent test is applied to each shareholder separately and it requires a computation of the percentage of *his* profit which is attributable to the collapsible assets — that is, a computation based upon the difference between the profit he actually realized and what would have been realized by him if the corporation had not manufactured, constructed, etc. the relevant collapsible property.

The applicability of this seventy per cent test should be contrasted in one important respect with the "substantial part" portion of the collapsible definition. If, as is fairly likely, the "substantial part" requirement of collapsibility is met when at least one-third of the anticipated profit is realized by the corporation, the corporation will be noncollapsible if at least one-third of the profit anticipated *from the particular project as to which the requisite view exists* has been realized by the corporation.<sup>46</sup> Corporate profits previously realized from completed projects as to which no view to collapse was present are of no consequence for this purpose. Suppose, for example, that a corporation has \$1,000,000 of earned surplus. It embarks upon an entirely new project, the construction and sale of houses, upon which the entire profit will be \$100,000. Prior to the completion of the project, the shareholders decide to collapse the corporation. At the time when the corporation is collapsed, it has already realized \$20,000 of the anticipated \$100,000 profits. The corporation will probably be collapsible notwithstanding that the corporation's total earned surplus at the time it is collapsed is \$1,020,000 and its unrealized profit is only \$80,000. The relevant fact for this purpose is that *with respect to the collapsible property* (the property as to which the requisite view exists), only twenty per cent of the profit has been realized by the corporation.<sup>47</sup>

By contrast, some or all of the shareholders may be free of the collapsible penalty by virtue of the seventy per cent limitation even though the corporation is collapsible. In applying the seventy per cent limitation, only the shareholder gain which is attributable to noncollapsible property is helpful. Not only does the unrealized profit count against the shareholder; so also does the realized profit which is attributable to the collapsible property. In our prior example, the entire \$100,000 profit

46. See text p. 283 *supra*.

47. See Reg. § 1.341-2(a)(4) (1955).

— realized and unrealized — will count against the shareholder. Only the shareholder gain attributable to the \$1,000,000 of corporate earnings derived from prior completed projects will be considered as noncollapsible gain.<sup>48</sup>

### CONCLUSION

The collapsible provision was undoubtedly enacted in order to stop deliberate tax-avoidance plans. Its impact, however, is far wider than that. Indeed, careful attention must be given to the possible application of this provision whenever a corporation is to be liquidated or a significant portion of its shares is to be sold. Particularly is this true where the corporation has been recently engaged in operating or constructing a relatively few large projects, as distinguished from the sale of a multitude of relatively small inventory-type goods.

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48. Reg. § 1.341-4(c) (4) (1955).