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II

Real Estate Transactions: Collapsible Corporations and Related Developments

Edward A. Eisele, Jr.

REAL ESTATE INVESTORS and developers are aware of the difficulties with which they are confronted when attempting to obtain capital gains treatment of their sales profits. A stock trader may make numerous purchases and sales of listed securities with the

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happy assurance that his gains will be capital; similar activity in the real estate field, however, runs the very real risk of profits being taxed as ordinary income. If the real estate trader

attempts to insulate himself from this risk by utilizing a corporate form of business organization and selling stock instead of real estate, he may be shocked to find a revenue agent alleging a large tax deficiency on the ground that the shares sold were those of a collapsible corporation. The thrust of the Commissioner's attack in this area is demonstrated in some recent cases which merit attention and reflection.

I. THE PURCHASE OF VACANT LAND BY A CORPORATION COLLAPSIBILITY

Most lawyers are aware that gain from the sale of stock in a collapsible corporation is taxable as ordinary income.¹ In addition,

¹ The pattern of the statute is to first rule that gain on sales of collapsible stock is ordinary income and subsequently to define the type of corporations which are collapsible. The particular provisions of the Internal Revenue Code with which this article is concerned are as follows:

A. INT. REV. CODE OF 1954, § 341 (Collapsible Corporations) [hereinafter cited as CODE §]

(a) TREATMENT OF GAIN TO SHAREHOLDERS. — GAIN FROM —

(1) the sale of stock of a collapsible corporation.

(3) a distribution shall be considered as gain from the sale or exchange of property which is not a capital asset.

(b) DEFINITIONS

(1) COLLAPSIBLE CORPORATION. — the term "collapsible cor-

most would consider a corporation which improves and subdivides land, or constructs buildings to be collapsible. However, few realize that a new corporation which purchases vacant land and does little more than hold it as an investment may also be considered collapsible. The Commissioner has lately urged application of section 341 of the 1954 Internal Revenue Code to corporations previously believed to be invulnerable to attack.

The statutory provisions relating to the purchase of "section 341 assets" were added by the 1954 Code, and it has been suggested that the inclusion of property described in section 1231(b) as "section 341 assets" was principally aimed at real estate operators.² There are a few very important aspects of section 341 that should be remembered. First, the corporation must be "formed or availed of principally" for the purchase of property "with a view to" the sale of its stock before the corporation has realized a "substantial part" of the income to be derived from such property. Second, purchased property cannot be a "section 341 asset" if it has been held *more* than three years.

It should be realized that an asset, such as real estate, may be a capital asset and hence *not* a section 1231(b) asset when in the hands of an individual, while the same asset *can* be a section 1231(b) asset in the hands of the individual's wholly-owned corporation. This raises the question as to whether Congress intended, by the enactment of section 341, to tax as ordinary income a profit on the sale of stock in a real estate corporation where, if the individual had sold the real estate, the profit would have been capital gain. This was precisely the question in *Braunstein v. Commissioner*.³ There, the government assumed, for the purposes of argument in the United States Supreme Court, that if the apartment

poration" means a corporation formed or availed of . . . for the purchase of property . . . described in paragraph (3) . . .

(3) SECTION 341 ASSETS. — . . . the term "section 341 assets" means property held for a period of less than 3 years which is —

. . .
 (B) property held by the corporation primarily for sale to customers in the ordinary course of its trade or business. . .

(D) property described in Section 1231(b) . . .

B. CODE § 1231:

(b) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS. — . . .

(1) The term "property used in the trade or business" means . . . real property used in the trade or business which is not . . .

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . .

² See 3B MERTENS, FEDERAL INCOME TAXATION § 22.64 (1958).

³ 374 U.S. 65 (1963).

building had been owned individually by the corporation's stockholders, they would have been entitled to capital gains treatment on the profit from its sale. The corporation was held to be collapsible, and the Court correctly concluded that Congress did not intend that an examination be made in each case to determine whether the corporation's assets might be capital assets in the hands of its shareholders.

The theory by which real estate loses its status as a capital asset is that a corporation owning an apartment building is engaged in only one business — real estate management; the land and building are used in that business, although not held primarily for sale to customers. This is the language used in section 1231(b), and the Commissioner apparently has taken the view that the same reasoning can apply where a corporation purchases *vacant* land.⁴ When one considers that Congress enacted the collapsible corporation provisions to counteract abuses in the motion picture industry,⁵ it is apparent that the law now has been stretched far beyond its intended limits. It has been applied to situations usually considered to be passive investment arrangements and consequently should cause counsel to carefully examine the advisability of the purchase of real estate by a corporation.

In three recent cases,⁶ the Commissioner has asserted that corporations which purchased vacant land were collapsible. In *Max N. Tobias*⁷ the corporation had been newly formed to buy the land, had leased it, and had collected one year's rent. These facts alone were sufficient for the Tax Court to conclude that the land was used in the corporation's business of renting real estate. There were no physical improvements made on the land, nor did the corporation do anything else with respect to the property during the year of ownership.

A group of Denver attorneys made a vacant land investment in *Morris Cohen*⁸ and were able to convince the court that in fact the land was held as an investment. Although rezoning had occurred after the acquisition, and the owners had a topographic map and preliminary subdivision plot prepared, the court apparently did not

⁴ See note 6 *infra*.

⁵ See 3B MERTENS, *op. cit. supra* note 2, § 22.55.

⁶ Guy A. Van Heusden, 44 T.C. 351 (1965) (held collapsible); Max N. Tobias, 40 T.C. 84 (1963) (held collapsible); Morris Cohen, 39 T.C. 886 (1963) (held not collapsible).

⁷ 40 T.C. 84 (1963).

⁸ 39 T.C. 886 (1963).

consider such activities sufficient to classify the property as used in the corporation's business. The Commissioner acquiesced in the decision.⁹

The Tax Court's holding in *Guy A. Van Heusden*¹⁰ seems open to question, although from the facts it appears that the case involved a taxpayer who, as an individual, would very likely have been classed as a "dealer," and who thus sought to disguise a real estate transaction as a sale of stock. The court went beyond the language of the statute in concluding that "since the corporation's only trade or business was to *deal with* this property the tract was a Section 341 asset."¹¹ However, *using* real estate in a business is somewhat different than *dealing with* it. Although the court did find that the corporation was not holding the property primarily as an investment, it did not suggest for what purpose the real estate was being held.

While it is difficult to draw general conclusions from these cases, it seems reasonable to state that corporations purchasing vacant land which is subsequently held less than three years are open to collapsible treatment if (1) the land is held for a short period of time; (2) the land is affected by some type of "economic activity"; (3) the land is used to derive rental income; (4) the value of the land is substantially increased by rezoning or the introduction of utility services; or (5) the stockholders of the corporation owning the land are persons actively engaged in real estate activities.

II. THE "CONSTRUCTION" TRAP AFFECTING THE PURCHASE OF VACANT LAND

In attempting to treat real estate gains as ordinary income, the Commissioner has an alternative route to that described above. Section 341 uses the words "construction . . . to any extent"¹² in describing actions which may designate a corporation as collapsible; almost any economic activity affecting vacant land can be considered "construction." In *Farber v. Commissioner*,¹³ the court noted that "the legislative history [of section 341] shows an intent to equate construction with anything that adds value to the property." Thus, in *Farber*, payments made for utility connections and water line ma-

⁹ 1965 INT. REV. BULL. NO. 22, at 6.

¹⁰ 44 T.C. 351 (1965).

¹¹ *Id.* at 357. (Emphasis added.)

¹² CODE § 341(b)(2)(A).

¹³ 312 F.2d 729, 734 (2d Cir.), *cert. denied*, 374 U.S. 828 (1963).

terials were held sufficient to show "construction" even though none of the materials had been actually affixed to the land at the time of the sale of the corporation's stock. In *Sproul Realty Co.*¹⁴ the corporation was held to be collapsible where its only activities were having vacant land rezoned for a shopping center, finding the first tenants, engaging an architect, and attempting to arrange financing. These actions were held to constitute "construction."

It has already been noted that vacant land cannot be a "section 341 asset" if it has been held for *more* than three years.¹⁵ However, if three years have passed since the acquisition, but there has been activity in the interim which has enhanced the value of the land, the Commissioner may allege that such activity constitutes construction. He may do so if the sale of the corporation's stock took place within a period of three years after the completion of construction; this, obviously, might be much longer than three years after the land acquisition. It would appear, in view of the holding in *Sproul*,¹⁶ that the Commissioner could also have taken the position that the activities of the owners in *Morris Cohen*¹⁷ constituted "construction." This would not be inconsistent with his position in *Cohen* that the purchased land constituted a "section 341 asset."

III. THE PURCHASE AND MODIFICATION OF AN OLD BUILDING

The broad meaning given the word "construction" by the Commissioner and the courts is further illustrated by Revenue Ruling 63-114¹⁸ which holds that minor alterations to a building do not constitute "construction" if the alterations do not (1) increase rentable area, (2) change the character of the building, (3) increase the net income from the building, or (4) increase the market value of the structure. It is obvious that almost any modification or alteration of an older building which has been purchased as an investment will have one or more of these proscribed objects. Every investor in an older building hopes to upgrade it in some manner, with a view to its ultimate sale at a profit. But because of this Revenue Ruling he will be committed to hold the property until at least

¹⁴ 38 T.C. 844 (1962).

¹⁵ See text following note 2 *supra*.

¹⁶ *Sproul Realty Co.*, 38 T.C. 844 (1962).

¹⁷ 39 T.C. 886 (1963).

¹⁸ 1963-1 CUM. BULL. 74.

three years after the completion of modifications, if the purchase was made through the corporate form of business organization.

A similar case affecting the real estate investor is *Louis Lesser*.¹⁹ There, the taxpayer bought a building and made extensive alterations which were required by the prospective tenant. The owner desired to take as much depreciation as possible and urged that the building's composite life was no more than twenty years at the time of purchase. By analogizing to the treasury regulations²⁰ and cases,²¹ which deny a deduction for loss where a building is demolished after its purchase, the court held that the correct useful life of the building *when acquired* was forty-five years. The crux of the court's decision was: "Accordingly, to the extent that it was contemplated at the time of acquisition of the building . . . that some components would be torn out, such components would not have any basis allocable to them nor would it be proper to take into account any theoretical remaining useful lives in respect of them."²² The decision seems justified and will result in much smaller depreciation projections when similar transactions are negotiated in the future.

IV. REAL ESTATE PURCHASED INDIVIDUALLY OR BY A PARTNERSHIP

Obviously, the developments discussed above will tend to persuade investors to utilize something other than the corporate form for engaging in real estate transactions. Other considerations, such as limited liability and ease of transferability of interests, will still be quite significant. Another factor, however, that must be kept in mind, is the "investor-dealer" distinction. If real estate is to be treated as a capital asset, it must consist of property which is *not* held primarily for sale to customers or which is used in a trade or business. Property will fall into one of these categories if the investor,

¹⁹ 42 T.C. 688 (1964).

²⁰ Treas. Reg. § 1.165-3 (1960) [hereinafter cited as Reg. §]: "when, in the course of a trade or business or in a transaction entered into for profit, real property is purchased with the intention of demolishing either immediately or subsequently the buildings situated thereon: No deduction [for loss] shall be allowed under § 165(a). . . ."

²¹ The rationale of Reg. § 1.165-3 (1960) is best illustrated by *N. W. Ayer & Son, Inc.*, 17 T.C. 631, 635 (1951), where the court stated that: "the buildings have no value to the purchaser." See also *Providence Journal Co. v. Broderick*, 104 F.2d 614 (1st Cir. 1939); *Super Mkts., Inc. v. United States*, 194 F. Supp. 291 (N.D.N.Y. 1961).

²² *Louis Lesser*, 42 T.C. 688, 705-06 (1964).

or members of the owning group, are classified as "dealers."²³ This area has been the subject of a fantastic number of reported cases.²⁴ It is beyond the scope of this article to treat this problem in detail, but the following are the major factors that bear on the determination of whether the property sold was or was not a capital asset: (1) Was the land acquired as an investment, or for some other purpose? (2) What were the number, frequency and continuity of sales? (3) What was the occupation of the seller?²⁵ (4) What was the extent and substantiality of the sales? (5) Did the owner engage in any extensive sales, advertising, or promotional activities with respect to the land? (6) Was the land subdivided or sold in separate parcels by metes and bounds description? (7) Were there any activities or expenditures to improve the property?

V. CONCLUSION

A corporation which purchases vacant land may be a collapsible corporation if there are factors tending to show that the land was used in the corporation's business, or if there have been any activities affecting the land which constitute "construction." A corporation which purchases a building that is modified or remodeled is probably collapsible, and its useful life for depreciation purposes will be unexpectedly long. Furthermore, one seeking to avoid the collapsible corporation trap by purchase of real estate as an individual or partnership should be wary of the "investor-dealer" distinction.

²³ Reg. § 1.1221-1(b) (1957).

²⁴ See, e.g., Jerome S. Murray, 24 CCH Tax Ct. Mem. 762 (1965) which contains a good discussion of the law in this area. Compare F. B. Tippins, Jr., 24 CCH Tax Ct. Mem. 521 (1965), with Samuel Segal, 24 CCH Tax Ct. Mem. 1131 (1965).

²⁵ Compare *Rossiter v. Commissioner*, 282 F.2d 892 (7th Cir. 1960) with *Goldberg v. United States*, 63-2 U.S. Tax Cas. 9505 (N.D. Ill. 1963), where one group of attorneys received capital gains treatment while another did not.