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COLLAPSIBLE CORPORATIONS— A QUESTION OF INTENT

DOUGLAS W. CONNER

Section 341 of the Internal Revenue Code of 1954 is designed to prevent the conversion of ordinary income into long term capital gain through the use of a "collapsible" corporation.¹ The "collapsible" corporation was used quite successfully as a tax avoidance device in the motion picture industry. To illustrate, a corporation would be organized to produce one motion picture. After completion of the picture but before the realization of any income, the corporation would be liquidated and its assets distributed to the shareholders who would then pay a tax on the difference between the basis of their stock and the fair market value of the distributed assets. Thus the corporation would pay no tax because it realized no income, and the stockholders' gain would be taxed as a long term capital gain. The fair market value of the film would be amortized against the income therefrom as it was received. There would be no further tax unless the income from the film exceeded the fair market value thereof.²

In the construction industry, the "collapsible" corporation device also met with a high degree of success. A corporation would be formed to construct a housing project. The corporation would be "collapsed" as soon as construction was completed and before any income was realized. The assets would be distributed and a valuation placed thereon based on the expected selling price of the buildings. A capital gain tax was paid on the difference between the basis of the stock and expected selling price.³

The same tax benefits illustrated previously could also be obtained without a liquidation. The shareholders could sell their stock to outside interests before any income had been

¹ This name is somewhat of a misnomer in that the provisions of section 341 are so broad as to apply to corporations which are not actually "collapsible."

² 7 CCH 1961 STAND. FED. TAX. REP. § 2484.

³ 3B MERTEN'S LAW OF FEDERAL INCOME TAXATION § 22.55 (1961).

realized by the corporation and enjoy the same preferential treatment of the gain derived therefrom. Also, the corporation might distribute the "collapsible" assets without liquidating and under the provisions of Section 301(c) of the 1954 Code⁴ the value of the property distributed would first be applied against the adjusted basis of the stock and any excess would be taxable as a long term capital gain.⁵

The Internal Revenue Service met with little success in its attempt to curb the use of this tax avoidance device.⁶ Realizing that the existing provisions of the Internal Revenue Code were inadequate, the Service sought legislation to close this tax "loophole." Section 212 of the Revenue Act of 1950⁷ was designed to do just that.

Section 117(m)⁸ converted the gain derived by the shareholders of a "collapsible" corporation into ordinary income in the following situations:

- (1) The sale or exchange of stock of a collapsible corporation.
- (2) A distribution in partial or complete liquidation of a collapsible corporation, which distribution is treated as payment in exchange for stock.
- (3) A distribution by the corporation which, to the extent it exceeds the basis of the stock, is treated in the same manner as a gain from the sale or exchange of property.

For a corporation to be characterized as a "collapsible" corporation it must be,

... formed or availed of principally for the manufacture, construction, or production of property, for the purchase of

⁴ Int. Rev. Code of 1939 § 115(d), 53 Stat. 47 (now INT. REV. CODE OF 1954, § 301).

⁵ R. I. A. FEDERAL TAX COORDINATOR, § 4401.

⁶ *Herbert v. Riddell*, 103 F.Supp. 369 (1952); *Pat O'Brien*, 25 T.C. 376 (1955); *Jack Benny*, 25 T.C. 197 (1955); *Commissioner v. Gross*, 236 F.2d 612 (2d Cir. 1956); *Frank E. Gilman*, 14 T.C. 833 (1950).

⁷ Revenue Act of 1950 § 212, 64 Stat. 934 (1950).

⁸ INT. REV. CODE OF 1939, § 117 (M), 64 Stat. 934 (now INT. REV. CODE OF 1954, § 341).

property which (in the hands of the corporation) is property described in paragraph (3) ("section 341 assets", which comprise inventoriable goods and receivables from the sale of such goods and depreciable and real property used in trade or business) 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, or a distribution to its shareholders, before the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property and

(B) the realization by such shareholders of gain attributable to such property.⁹

This definition is verbose and confusing and has proven to be a veritable breeding ground for litigation. The most litigated point in the entire section is the question of when the "view to the sale" must arise. This involves a question of subjective intent. The Treasury Department attempted to clarify this point by the publication of Regulation 1.341-2(9) (3).

A corporation is formed or availed of with the view to the action described in section 341(b) if the requisite view existed at any time during . . . construction. Thus, if the sale, exchange, or distribution is attributed solely to circumstances which arose after the . . . construction (other than circumstances which reasonably could be anticipated at the time of such . . . construction) the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of.¹⁰

This Regulation would appear to resolve the question, but it has only compounded the confusion. In *Burge v. Commissioner*, the court states, "It is not necessary that the 'view' exist at the time the corporation is formed. It is sufficient that it exists when the corporation is 'availed of'."¹¹ The U. S. Court of

⁹ INT. REV. CODE OF 1954, § 341(b). (The provision dealing with the purchase of section 341 assets was adopted by section 326(a) of the Revenue Act of 1951).

¹⁰ Treas. Reg § 1.341-2(a) (3) (1955) (identical to Treas. Reg. 39.117(M)-1(4) of the Internal Revenue Code of 1939).

¹¹ 253 F.2d 765 (4th Cir. 1958).

Appeals for the 2nd Circuit agrees with this interpretation as indicated by the language in *Glickman v. Commissioner*:

We agree with Judge Parker's statement in *Burge*. . . . Since the corporation may at any time during its corporate life be "availed of" for the proscribed purpose (subject, of course, to the limitations imposed by section 117(m)(3)), it seems surprising that the Regulations have adopted a narrower interpretation of the statute, and require the requisite view to exist "during the construction . . ." or to be attributable to "circumstances which reasonably could be anticipated at the time of such . . . construction." We are disposed to disagree with so narrow an interpretation.¹²

The language from the preceding cases is no more than dicta, however, since in both cases the taxpayer was found to have had the requisite intent during construction.

The Tax Court indicated its agreement with this interpretation in the case of *Rose Sidney*:

Since the Court of Appeals for the Second Circuit has recently indicated in *Glickman* . . . its concurrence in the opinion of the Court of Appeals for the Fourth Circuit in *Burge* . . . to the effect that "[i]t is sufficient that [the view] exist when the corporation is 'availed of' and the corporation may at any time during its corporate life be 'availed of' for the proscribed purpose regardless of the time of completion of construction in relation to the time of the existence of the view, this argument of petitioners would not be of avail to them even if we were to accept the testimony of these witnesses as accurate."¹³

Needless to say, this view is not shared by all. A line of cases holds in accordance with the Regulation.¹⁴ In *Jacobson v. Commissioner*, the court states:

On the face of the statute Congress is here indicating a state

¹² 256 F.2d 108 (2d Cir. 1958).

¹³ 30 T.C. 1155 (1958).

¹⁴ *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959); *Jacobson v. Commissioner*, 281 F.2d 703 (3rd Cir. 1960); *C. J. Riley*, 35 T.C. 617 (1961).

of mind which must attend and gives significance to certain action. That action . . . is not merely any formation or use of a corporation but rather the formation or use of a corporation to construct or produce property. The "view" with which a corporation is used for a particular purpose must necessarily be a view entertained at the time of such use. Thus only by a distorting disregard of the phrase "for the construction of property" is it possible to reach the conclusion that the "view to sale" contemplated by the statute can arise for the first time in connection with corporate activity after the work of construction is completed.¹⁵

These two divergently opposed views serve to point out the real culprit, the ambiguity of the statute ". . . which stems from its awkward and lengthy configuration of words and phrases, which seem to tumble upon each other with increasing confusion."¹⁶ It is difficult to tell whether the word "principally" in Section 341 refers only to "manufacture . . ." or also to "with a view to." The Regulations have no trouble with this point. They state that the "view" requirement is satisfied "whether such action was contemplated unconditionally, conditionally, or as a recognized possibility."¹⁷ If all that is required is that the "view" be a "recognized possibility", then the subjective test is virtually eliminated.

Two cases have attempted to resolve this question without going quite so far as the Regulations. In *Weill v. Commissioner* the court states:

We read the word "principally" as modifying the phrase "manufacture . . .". Under this reading, the corporation may be treated as collapsible if "manufacture . . ." was a principal corporate activity even if the "view to" collapse was not the principal corporate objective when the corporation was "formed or availed of".¹⁸

¹⁵ 281 F.2d 703 (3rd Cir., 1960).

¹⁶ 3B MERTENS, LAW OF FEDERAL INCOME TAXATION, § 22.58 (1961).

¹⁷ Treas. Reg. § 1.341-2(a)(2) (1955).

¹⁸ *Weill v. Commissioner*, 252 F.2d 805 (2d Cir., 1958).

In *Burge v. Commissioner*, the court states in a footnote as follows:

The argument that the word "principally" in the statute should be construed to modify the "view" that the statute requires instead of "for the manufacture . . ." is without support of any rule of law or of grammar with which we are familiar.¹⁹

It should be noted however that both of these courts as well as the Commissioner advocate an objective test, and such a result is necessary in order to apply this test. So there might be an element of forced rationalization involved. However, these are problems of semantics. The questions which arise cannot be resolved by scrutinizing the statute, but only by trying to ascertain the Congressional intent behind Section 341. The Committee Reports of the Revenue Act of 1950 describe a collapsible corporation as ". . . a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at a rate of twenty-five per cent."²⁰ In the Hearings before the Committee on Ways and Means of the House of Representatives there appears this exchange:

Mr. Mills. Should the legislation be specific and include definite standards, or should it be rather general and permissive of great discretion in the Internal Revenue Service?

Mr. Lynch. (Thomas J. Lynch, General Counsel, Treasury Department) 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.

Mr. Mills. It should be clearly understood, then, that there is no purpose on the part of the Treasury to jeopardize the liquidation of corporations.

¹⁹ 253 F.2d 765 (4th Cir., 1958).

²⁰ 1950 Cum. Bul. 449.

Mr. Lynch. Not those that are carried on in the traditional and regular way.²¹

The courts have almost unanimously treated "view to sale" in the statute as synonymous with "intent to sell". The "view" required by the statute is much more than an intent to sell, it is an intent to "collapse", an intent to avoid taxes by use of a "device" to convert ordinary income into capital gain, and not to interfere with legitimate business transactions which are not prompted by tax avoidance motives. If we accept this premise as correct then we are inexorably led to the conclusion that if the "view" required is one of tax avoidance, then it makes no difference when it was formed be it pre-construction or post-construction or anything in between. On the other hand, if there are no tax avoidance motives, if the liquidation is prompted by legitimate business reasons, it should make no difference when the "intent to sell" arises because it is not the design of this statute to encompass this type of transaction.

There are three types of situations which might arise:

- (1) A corporation may be formed and utilized with a subjective intent of tax avoidance.
- (2) A corporation may be formed for legitimate purposes and later after completion of "construction" be utilized with a subjective intent of tax avoidance.
- (3) A corporation may be legitimately formed and later liquidated for legitimate business reasons.

The purpose and intent of the statute would seem to be to impose ordinary income treatment on any gain derived in situations (1) and (2) and allow capital gains treatment on any gain derived in situation (3). If the *Burge* and *Glickman* cases are followed, not only would any gain derived from situations (1) and (2) be taxed as ordinary income, but any gain derived in situation (3) would be similarly taxed. If the *Jacobson* case is followed, any gain derived in situation (3) would be afforded

²¹ Revenue Revision of 1950, HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, 81st Cong., 1st Sess., at 140 (1949).

capital gains treatment, but so would any gain derived in situation (2). Neither result is satisfactory.

The result reached by the *Burge* and *Glickman* cases is probably more in accordance with the intent and purpose of the statute. Following the reasoning in these cases there could be no tax avoidance in collapsible situations, but legitimate business transactions would be impaired. However, this would be a more equitable result than allowing tax avoidance in situation (2) to take place. With the advent of the 1958 Technical Amendments Act,²² any inequity in following *Burge* and *Glickman* is greatly diminished. The shareholders under this new provision is taxed at ordinary income rates in the event that there is high unrealized appreciation in the "collapsible" assets. If there is such appreciation, it is more just to tax this gain at ordinary income rates than allow capital gains treatment regardless of the motive behind the distribution or liquidation.

The 1958 Technical Amendments Act seems to be a step in the right direction. Although the Committee Reports do not expressly say so, they certainly imply that this provision was passed to alleviate the inequities under the *Burge* and *Glickman* cases.

The collapsible-corporation provisions of present law . . . both by their terms and as interpreted, are so broad that in a number of situations that may have exactly the opposite effect from that intended—instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordinary income.²³

It is my contention that the confusion and the divergence in the court decisions stems from a fundamental misinterpretation (or complete disregard) of what the collapsible corporation provisions are designed to do. This misinterpretation is fostered by the ambiguous wording of Section 341. The Congressional intent and the purpose of the provisions seem unequivocally to prevent tax avoidance by the use of "collapsible corporations"

²² Technical Amendments Act of 1958, 72 Stats. 1606.

²³ S. Rep. No. 1983, 1958-3 Cum. Bul. 953.

and at the same time not interfere with legitimate business transactions.

Mr. James T. Wilkes, Jr., formerly a trial attorney with the Office of the Regional Counsel of the I. R. S., states as follows:

The "collapsible corporation" provisions are intended to thwart the taxpayer who by design seeks to convert ordinary income into capital gain. Under the *Burge* interpretation the statute would do more than this. It would penalize the unsuspecting taxpayer who, for a valid business purpose and after construction is completed, finds it necessary to dispose of his stock interest. It is not the proper function of the statute to hamper normal business decisions and transactions not motivated by a desire to avoid taxes.²⁴

An excellent example of the disagreement that exists among learned jurists as to the interpretation of the collapsible corporation provisions is contained in a recent Tax Court case. In *Maxwell Temkin*, the majority opinion, one of the most erudite ever written on "collapsible" corporations, states as follows:

There is no doubt that in the case before us Audubon [a corporation] was "availed of" or used . . . to construct an apartment house . . . and there is no doubt that petitioner's stock in Audubon was sold prior to its realization of a substantial part of the rental income to be derived. In the light of *Burge v. Commissioner* and *Sidney v. Commissioner*, it makes no difference whether it was so "availed of" before or after construction of the apartment project was complete. *What prevents the application of Section 117(m) is the absence of the proscribed "view", intent or purpose.* We think it is clear and virtually uncontradicted by direct evidence that from its creation petitioners had no intention to collapse Audubon or sell their stock therein until Shapiro was so frightened by an attack of angina and the advice of his physician that he feared to retain any business interest which required of him more than a minimum output of energy. (Emphasis supplied).²⁵

²⁴ *Post Construction Decision to Sell Avoids Collapsibility, CA-3 Says*, 13 J. TAXATION 244 (1960).

²⁵ 35 T.C. 906, 911 (1961).

Judge Oppen dissented and was joined in his dissent by four other judges of the Tax Court. Judge Oppen states:

The majority opinion asserts that "there is no doubt that petitioner's stock in Audubon was sold prior to its realization of a substantial part of the rental income to be derived" and that "it makes no difference whether it was so 'availed of' before or after construction . . . was completed." What is apparently supposed to make the section inapplicable is the absence of the "proscribed view," intent or purpose. But there is only one "intent or purpose" referred to in the statute and the opinion evidently recognizes that such an "intent or purpose" namely to dispose of the stock before the realization of a substantial part of the income, existed here.²⁶

The majority holding in the *Temkin* case is the only holding in any case dealing with collapsible corporations that takes full cognizance of the Congressional intent behind the statute. The dissenting view, which is shared by many, completely ignores this Congressional intent; it looks solely at the statute and, as I have stated before, the statute is so ambiguously worded that it is next to impossible to ascertain what is intended.

The Congressional Hearings and the Committee Reports speak of a "device" used for tax avoidance, of not seeking to "jeopardize the normal liquidation of corporations". The dissenting opinion completely ignores this.

The writers on the subject of "collapsible corporations" are almost unanimous in their agreement that Section 341

²⁶ 35 T.C. 906, 912 (1961). See also, Ellsworth J. Sterner, 32 T.C. 1144 (1959). In this case disharmony arose between the two principal stockholders during construction and as a result thereof a decision was made to sell their stock. After finding that this was not the real cause of the dissolution, the court added as dictum, "Moreover, section 117(M) is applicable even if it be assumed that petitioners sold their stock because of shareholders disharmony. In terms, section 117(M) requires only that the corporation be availed of for construction with a view to the sale of its stock prior to the realization by the corporation of a substantial part of the net income to be derived from the property. These conditions apply precisely to the instant case. Petitioners not only sold their stock prior to the realization of any income from the property, but they concede that the decision to sell was reached prior to completion of construction. In light of these circumstances, the fact that shareholder dissent prompted the sale is immaterial."

requires a subjective intent. Charles C. MacLean, Jr., in his article in the *Harvard Law Review*, states, "In common with the phrases using the word 'purpose', however, 'with a view to' is subjective in nature, depending for its application on what is in someone's mind."²⁷ This view is supported by J. Bruce Donaldson in his article in *Taxes*, where he states:

One of the most difficult areas of construction under the collapsible corporation definition is what interpretation to give the phrase "with a view to". The view requirement is, of course, a subjective standard, so that—at the very least—there is present the problem inherent in ascertaining corporate intentions.²⁸

In their article in the *Columbia Law Review*, Adrian W. DeWind and Robert Anthoine had this to say:

Another substantial question is whether a showing of subjective intent or purpose is compelled by the requirement that the corporation be principally used "with a view to" subsequent "collapse". For the most part, it has been concluded that the existence of such a purpose or intent is required, although its existence to a large extent will have to be shown by objective evidence.²⁹

And further:

[H]owever watered down or "presumed" into existence the subjective intent may be, its presence is an integral requirement under the regulations.

These two gentlemen were somewhat prophetic when they observed "whether the courts will direct much attention to the subjective purpose requirement remains to be seen." Irving I. Axelrod in his article in the *Southern California Tax Institute* states:

The phrase "with a view to" connotes a subjective standard. The Commissioner, however, has taken the opposite

²⁷ *Collapsible Corporations—The Statute and Regulations*, 67 HARV. L. REV. 55 (1953).

²⁸ *Collapsible Corporations*, 36 TAXES 777 (1958).

²⁹ *Collapsible Corporations*, 56 COLUM. L. REV. 475 (1954).

approach and attempted to convert the subjective requirement into an almost wholly objective one.³⁰

The courts apparently have been doing a little "judicial legislating." Possibly the reason for this is the fact that Section 341 is unusual in that it requires a subjective intent to avoid taxes before its provisions come into operation. It is true that usually when Congress seeks to close a tax "loophole" the legislation which is passed closes the "loophole" without regard to the intent of the parties. Probably Section 341 should not turn on the intent of the parties—but it does. It is only by total disregard of Congressional intent and the words "with a view to" that any other opinion can be reached. The courts seem bent on rectifying this situation through their decisions.

Section 341, in requiring a subjective intent of tax avoidance, is not alone. The accumulated earnings tax applies only if the corporation is "formed or availed of for the purpose of avoiding the income tax. . . by permitting earnings and profits to accumulate instead of being divided or distributed."³¹

The real question is not when the intent that is the "view to sale" must arise, but what intent is actually required. Is it merely the intent to sell or liquidate, or is it a subjective intent to avoid taxes through the use of a tax avoidance "device"? It is undoubtedly the latter. If so, it makes no difference when the intent arises. If the intent to avoid taxes is present, Section 341 should apply regardless of when the intent happens to come into existence. If such intent is not present, Section 341 should not apply.

To base the ultimate result of a case on when the intent to sell arises without regard to whether this intent was prompted by tax avoidance purposes or legitimate purposes is to put

³⁰ *The Tax Advantage and Pitfalls in Collapsible Corporations and Partnerships*, 34 TAXES 841 (1956). See also, Irving Salem, *Collapsible Corporations: An Analysis of the Past, Present, and Proposed Collapsible Concepts*, 28 GEO. WASH. L. REV. 855. Also, see note in 1961-2 DUKE L. J. at page 323.

³¹ Int. Rev. Code of 1954, § 532; See also, Int. Rev. Code of 1954 §§ 703-704 dealing with distribution of partnership income.

the cart before the horse. *Whether* the requisite intent is present and not *when* such intent arose is the ultimate question to be resolved. In both the *Burge* and *Glickman* cases the requisite intent was found to exist, and the court was correct in saying that it makes no difference when the intent arose. In the *Jacobson* case the requisite intent was not found, and therefore the Court was correct in holding that Section 341 did not apply. All of these cases reached the correct result, but this reasoning is misleading. The cases should have turned on the question of whether or not the requisite intent was present. The result in the *Temkin* case offers a slight ray of hope that the courts will at last reach the results that the statute contemplates. But in view of the fact that five judges dissented, I would say that the road to a correct result will be a rocky one.

The most feasible solution would be to completely revise Section 341. This was the proposal of the Advisory Group on Subchapters C, J, and K of the Internal Revenue Code. In 1959 this body recommended that Section 341 be completely revised. Pursuant to recommendations, the new collapsible corporation provisions would differ from the old in three principal respects: (1) It would operate entirely under objective tests and would not depend upon the intention of the shareholders. (2) There would be a "fragmentation" of the gain. The shareholder would be taxed at ordinary rates only on the gain attributable to property which, if sold by the corporation, would have produced ordinary income. (3) Shareholders would not be taxed at ordinary income rates on items which would have produced capital gains treatment if no corporation had been used.

The Advisory Group in its report states:

[T]he law is based upon a determination [of the intention of the parties, a matter that is difficult to determine. It is not clear to what extent this is a subjective intent test or an objective intent test, but in any event, it speaks in terms of a corporation formed or availed of with a view to sale prior to the realization of a substantial part of the income.

The Advisory Group feels this is an unfortunate test in an area of this kind which has such drastic effect on the

question of whether a substantial gain is capital gain or ordinary income. We are inclined to feel it is difficult to administer and that any tax that is based in this area upon determining whether a person had a particular view when he started out or not is likely to produce unfair and inconsistent results.

We would prefer, and our draft provides for, objective standards that would depend upon the type of assets and the amount of appreciation that exists in particular assets, without regard to whether someone was intending to convert ordinary income into capital gain or happened to do so without deliberate intention.³²

The recommendation of the Advisory Group was not adopted. The Chairman of the Ways and Means Committee, Mr. Mills, states:

I had thought in this whole area that possibly some type of consolidation of the thought advanced by the Advisory Group and the provision of existing law might be more nearly equitable in many cases than a mere test without consideration of intent as we do under existing law.

I do not want an individual to get by with minimizing tax through this device, if that is his intent, when he does not fall within the rules, and I do not want the individual who happens to fall within the rules be so heavily burdened when it is clearly demonstrated that there is no intent of tax evasion.³³

That the recommendations of the Advisory Group were not adopted is indeed unfortunate. Their recommendations, if followed, would have provided a more feasible approach to the collapsible corporation problem. Naturally, administrative problems would be created by adoption but this is to be expected in such an intricate area of taxation. However the incurrence of administrative problems is a small price to pay if the uncertainties respecting Section 341 can be reduced.

³² *Hearings Before The Committee on Ways and Means, House of Representatives, on Advisory Group Recommendations on Subchapters C, J, and K of The Internal Revenue Code*, 86th Cong., 1st Sess., at 399 (1959).

³³ *Id.* at p. 406.

Under the Advisory Committee's recommendations, the definition of a collapsible corporation would be clear and concise. A collapsible corporation would be defined as "a corporation the unrealized appreciation on whose Section 343 assets is more than 15 per cent of the excess of the fair market value of all the assets of the corporation over all its liabilities."³⁴ This definition would leave little room for misinterpretation; there would be no need to delve into the intent of the parties. This is by far the best solution that has as yet been advanced and its adoption was, and still is, sorely needed.

³⁴ *Id.* at p. 520.