Rental Real Estate Corporations and Section 341 (e) (3) of the Internal Revenue Code

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I. Incorporation as a Forced Choice

Advantages of Noncorporate Ownership

Tax attributes inherent in the financing, construction and operation of rental real estate frequently make partnership and individual ownership clearly preferable to corporate ownership. The bulk, if not the entirety, of the cost of such enterprises is lent by outsiders rather than contributed by the owners. Because of the nature of mortgage loan amortization—equal installments consisting initially of large interest payments and relatively small repayments of principal, followed by small interest payments and substantially larger principal repayments—there is a heavy shifting of deductible interest expense from the later to the earlier years of the life span of the operation. This shifting of expense is augmented by the use of accelerated depreciation methods.

The paradoxical result is a flow of available cash from rental operations, coupled with recurrent net operating losses during the first years of tenancy. Additional cash may be available from “excess mortgage proceeds.” It is possible at times in arranging the permanent financing of a rental property for the borrower to obtain a loan equal to or in excess of the property’s cost if it has a higher fair market value on completion. In such a case, he is said to have “mortgaged out,” and if the borrowing exceeds cost, he has excess mortgage proceeds.

When an enterprise of this nature has been undertaken by an individual or partnership, this cash flow, whether from operations or excess mortgage proceeds, can be absorbed by the entrepreneurs at no imme-
The operating losses generated will be available as offsets to the owner's ordinary income from other sources.

The income statement of a typical partnership owning a garden-type apartment project might show the following:

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<table>
<thead>
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<tbody>
<tr>
<td><strong>Gross rents</strong></td>
<td>$275,000.00</td>
</tr>
<tr>
<td><strong>Interest</strong></td>
<td>$ 75,000.00</td>
</tr>
<tr>
<td><strong>Depreciation (accelerated)</strong></td>
<td>100,000.00</td>
</tr>
<tr>
<td><strong>Other expenses</strong></td>
<td>150,000.00</td>
</tr>
<tr>
<td><strong>Net Loss</strong></td>
<td>($ 50,000.00)</td>
</tr>
</tbody>
</table>

Observe, however, that notwithstanding a net loss which the partners could take on their individual income tax returns against their other income, they could pocket cash in the amount of $50,000 (rental receipts of $275,000 minus actual disbursements of $225,000). While the distribution to a partner of his share of the $50,000 cash would effect a reduction in the basis of his partnership interest, if the distribution did not exceed such basis (which would include his proportionate share of the partnership debt incurred to finance the project) the distribution would have no immediate tax consequence to him.

The interposition of a corporate entity destroys these advantages. The corporation will be able to make use of early years' operating losses only if, when, and to the extent it can carry them forward against future earnings. While there will be no corporate taxes to pay in the early years, any amount distributed to a shareholder out of the corporation's cash flow will be taxable to the extent such amount exceeds the recipient's basis for his shares. At best, such excess will be taxed as capital gain. However, it is not only possible but highly probable that

1. Ultimately the recipient of excess mortgage proceeds will incur a tax cost as he repays the loan with after-tax dollars. If he disposes of the property other than by gift while it is still subject to an indebtedness in excess of basis, he will be required to recognize gain to the extent of the excess. The gain may be ordinary or capital depending on the capacity in which the owner has held the property, i.e., as dealer or investor. See Schlesinger, *Disposition of Property Having a Negative Basis*, N.Y.U. 15th Inst. on Fed. Tax 339 (1957); Greenbaum, *Effects of Mortgage Borrowing on Real Estate: Depreciation, Basis, Etc.*, N.Y.U. 12th Inst. on Fed. Tax. 127 (1954); Spears, *Disposing of Property Mortgaged Above Basis: Opportunities and Hazards*, 12 J. of Tax. 110 (1960).


3. *Int. Rev. Code of 1954*, § 301. A Subchapter S election would solve the problem were it not for the fact that "gross receipts derived from . . . rents" constitute "passive investment income" for the purposes of Section 1372(e)(5).
it will be taxed as ordinary income, given the circumstances of rental property construction in corporate form. Such corporations are among the special prey of section 341 of the Internal Revenue Code, dealing with "collapsible corporations," discussed below.

In recent years, differences in non-tax in legal incidents attaching to the various entities by which business may be conducted have been eclipsed by distinctions in tax treatment. In selecting the proper entity form, however, non-tax considerations have not yet become so unimportant as to be disregarded. Two of them are of especial pertinence at present: the question of limited versus unlimited liability, and the inhibitions of the various state usury laws relative to the current money market.

An individual proprietor or partner may limit his personal liability by the use of appropriate exculpatory clauses in debt instruments by which he binds himself. Liability insurance would hopefully seal the other major corridor to unlimited liability. However, these methods of curtailing liability may not be available under some circumstances, particularly during the construction period of a substantial real estate venture. The construction lender may be unwilling to exculpate the borrower even though the permanent lender may be willing to do so, the latter having much more in the way of security upon which to rely. Extrahazardous conditions existing during the construction period may adversely affect the availability and cost of adequate liability insurance coverage. As a result, it may be desirable to carry on business in corporate form, at least for the duration of construction, if the venturer can thereby effectively limit his risk.

Another compulsion (and one over which the venturer may have little control) towards incorporation is provided by today's tight money market. Rising interest rates have made the maximums allowed by state usury statutes unreasonably low. Consequently, the lending institution, if it is to obtain a reasonable return on its money, must lend to corporate borrowers who are exempted under many local usury laws. Thus incorporation becomes a prerequisite to financing.4

There is a body of federal tax law to the effect that certain corporations—so-called "nominee corporations"—are too insubstantial to be treated as taxable entities.5 The protection afforded by these cases is,

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5. Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945); Seattle Hardware v. Squire,
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however, a narrow one. The corporation which has done no more than hold title to property may be disregarded for tax purposes. One which has engaged in any significant business activity will not be so disregarded. What the courts regard as being significant business activity may be as little as the making of a note, the giving of a mortgage, the receipt of rent payments, or the making of leases.

It is extremely unlikely that persons engaged in the construction and operation of rental property, who have selected the corporate form as the result of one of the dictates discussed above, will succeed in having their choice disregarded for tax purposes. A lending institution, advancing money at a rate in excess of that allowed by the local usury statute on the strength of the corporate borrower's being deprived of the usury defense, must be sure that the loan is in fact and in substance a loan to a corporation. Otherwise, the lender may be held to have been a party to a sham for avoidance of the usury laws. To give the transaction proper substance, the lender should negotiate the loan directly with the corporation, make the loan to the corporation, take property owned by the corporation as security, and receive its mortgage or deed of trust from the corporation. A stockholder who wishes to

83 F. Supp. 106 (W.D. Wash. 1948); John A. Mulligan, 16 T.C. 1489 (1951); Moro Realty Holding, 25 B.T.A. 1135 (1932).

6. Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945); John A. Mulligan, 16 T.C. 1489 (1951); Moro Realty Holding, 25 B.T.A. 1135 (1932); Stewart Forshay, 20 B.T.A. 537 (1930).

7. Moline Properties v. Commissioner, 319 U.S. 436 (1943); Commissioner v. State-Adams Corp., 283 F.2d 395 (2d Cir. 1960); Abraham S. Halprin, 154 F.2d 112 (2d Cir. 1946); Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945); Love v. U.S., 96 F.2d 919 (Ct. Cl. 1940).


In jurisdictions where this approach is followed, the critical question is to what extent the lender is permitted to know of and to participate in the new corporation's formation. If a borrower knows that he will be unable to secure a loan within the statutory limit as an individual and consequently presents himself to the lender in corporate form, the lender obviously
avoid personal liability on a loan to his corporation must see that the loan is in fact and substance one to his corporation,\textsuperscript{11} which actually receives and expends the proceeds. For the same reason a shareholder will not be able to avoid all personal responsibility for construction accidents unless the construction was indeed carried out by a valid and subsisting corporate entity.\textsuperscript{12}

Upon the completion of construction and the closing of the permanent loan, the corporate framework will have outlived its usefulness. The shareholders will then wish to hold the completed property in such manner as to give them direct access to the cash flow and operating losses it can be expected to engender.

\textit{Section 333}

There will be no hope that the corporation will be regarded as a mere nominee for tax purposes. Consequently, in order to place the rental property in individual or partnership hands, a distribution subject to the provisions of Subchapter C of the Internal Revenue Code will have to be made.\textsuperscript{13} If there has been no appreciation in the value of the property, such a distribution, whether by corporate liquidation or otherwise, will present no problem. However, absence of appreciation is unlikely. In all probability the property will be worth somewhat more than the amount of cash put into it. As a result, the distribution, if one is dared, will have to be one in complete liquidation qualifying under section 333, the one-month liquidation provision.

\textsuperscript{11} Cannot be charged with cloaking an individual loan as a corporate loan in order to evade the usury laws: he knows nothing about it. Where the borrower appears at the lender's office as an individual and suggests that he is looking for a loan for a corporation which he intends to form, this transaction would probably, although not certainly, escape condemnation. . . . In any case where the suggestion of incorporation comes from the lender, the transaction is unquestionably in danger in those jurisdictions which indicate that they will not permit the use of a corporate form to shield from the usury laws a loan made in substance to an individual borrower.


\textsuperscript{12} See 1 \textit{Fletcher Cyclopaedia Corporations}, §§ 41-46 (1931).

\textsuperscript{13} See 13a \textit{Fletcher Cyclopaedia Corporations}, § 6214 (1931).

\textsuperscript{11} In all probability, a purported "sale" by a corporation to its shareholders of rental property constituting substantially all of its assets would be regarded as a sham. The transaction would be treated as being in reality a liquidation of the corporation productive (by virtue of the collapsible provision) of ordinary income to the distributees.
Section 333 provides for the substantially tax-free liquidation of corporations having little or no earnings, and assets consisting for the most part of property which is not cash or securities acquired since 1953. Gain recognition is imposed only to the extent the corporation has earnings and profits and/or cash and post-1953 securities. If none of these exist, the distributee recognizes no gain and takes the property received at the same basis he had for the shares surrendered. To the extent the distributee is forced to recognize gain because the liquidating corporation held cash or post-1953 securities, he is allowed an increased basis for the non-cash property received. If he receives cash, his basis for other property is reduced by that amount. For example, X Corporation owns a tract of land worth $1,000, no securities, and $100 in cash, and has accumulated undistributed earnings of $50. Y, its sole shareholder, has a basis of $500 for his shares. Thus, on liquidation Y will realize a gain of $600 ($1,000 worth of land plus $100 in cash minus $500 basis). However, because of the nonrecognition provisions of section 333, he will recognize only $100 of his gain [larger of cash ($100) plus post-1953 securities (none), or earnings and profits ($50)]. The recognized gain on such liquidations may be either ordinary or capital. In the case of the X Corporation liquidation, $50 of Y's gain will be ordinary income because his ratable share of X's earnings and profits are in that amount. The remaining $50 of Y's gain, representing the excess of cash and post-1953 securities over Y's earnings and profits, is capital. Y's basis for the tract of land will be $500 [basis of shares surrendered ($500) plus gain recognized ($100) minus cash received ($100)].

Not only is a one-month liquidation advisable because it will make possible the transfer at minimum immediate tax cost, but its choice is compelled by other provisions of the Internal Revenue Code. The remainder of this paper will be devoted to explaining why the choice is so limited and with what success section 333 can be employed.

**Collapsible Corporations**

The major limitation is section 341, the collapsible corporation provision. The background against which this section was enacted is too well-known and too well-chronicled elsewhere to justify any lengthy discussion here. The law was passed to prevent the use of the cor-
porate form as a device for the conversion of ordinary income into capital gain. This transmutation of the base into the rare and precious was accomplished by using a corporation for the carrying out of activities such as the construction of real property improvements or the filming of a movie. These endeavors would have produced ordinary income if performed by the individual proprietor (or by the corporation as well, if the corporation carried through and sold or operated the constructed asset). When the corporation had completed its productive activities, its shareholders would take advantage of the capital gain provisions by selling their stock or liquidating the corporation. Section 341 prevents this alchemic mutation by reconverting to ordinary income what would otherwise be capital gain on such sales or liquidations.

Subsection (b), the definitional part of section 341, states that a collapsible corporation is one

... formed or availed of principally for the manufacture, construction or production of property ... with a view to ... 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 [or] producing ... the property of a substantial part of the taxable income to be derived from such property, and ... the realization by such shareholders of gain attributable to such property.17

Subsection (a), the operational part, provides that gain from the sale or exchange of stock in, or a distribution in partial or complete liquidation of, or a dividend distribution made by, 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 otherwise provided in this section, be considered as gain from the sale or exchange of property which is not a capital asset.

By its terms, subsection (a) acts only to convert what would otherwise be capital gain into ordinary income, and not to create gain or

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17. Collapsible property may also have been purchased by the corporation as well as manufactured, constructed or produced, provided the purchased property fits within the definition set forth in Section 341(b)(3).
to impose its realization. For this reason, prior to 1954 a one-month liquidation carried out under section 333’s 1939 Code predecessor was, unless it produced capital gain, outside the ambit of collapsible treatment. In 1954, the statutory provision for one-month liquidations, theretofore enacted only for short periods at irregular intervals, was for the first time made a permanent part of the Internal Revenue Code. Simultaneously, the section, renumbered 333, was amended by the insertion of a parenthetical phrase limiting its application to domestic corporations “(other than a collapsible corporation to which section 341(a) applies).”

In consequence of the parenthetical limitation, real estate operators who wish to end the inconvenience of an interposed corporate entity by means of a one-month liquidation must reckon with section 341. The corporation to be abolished, if originally created for one of the reasons outlined above, would certainly have been availed of principally for the construction of property. In many cases the shareholders will have incorporated with the intention of liquidating at the earliest opportunity. Here the existence of the necessary “view” will be irrefutable. Even

18. INT. REV. CODE OF 1939, § 112(b)(7).
20. Legislative history gives no inkling as to whether more than coincidence was behind the fact that section 333 was, by virtue of the enactment of the 1954 Code, simultaneously made a permanent feature of the Code and subjected to collapsible treatment. See S. REP. No. 1622, 83rd Cong., 2d Sess., 256 (1954) and H. REP. No. 2543, 83rd Cong., 2d Sess. 41 (1954). The writers can only speculate that prior to 1954, the one month provision was available on too limited and irregular a basis to be a dependable vehicle for long-term tax planning, with the result that, regardless of the inapplicability of the collapsible provision, it posed no threat to the fisc; but upon its becoming a permanent part of the Code, collapsible treatment was dictated.
21. Note that section 333 is not available to a “collapsible corporation to which section 341(a) applies.” Compare section 337(c)(1) which makes section 337 inapplicable to “a collapsible corporation (as defined in section 341(b)).”
22. In what sense can the shareholders of a putative collapsible corporation, in contemplating a one month liquidation, be said to have had “a view to . . . the realization . . . of gain”? What they have a view to doing (assuming the corporation has no cash or securities acquired after 1953) is merely changing the legal mode in which they hold their property, without the slightest expectancy of gain in the conventional sense or in the sense of taxable income. Any gain involved would be imposed by the tax collector, much against the will of the shareholders. This argument, unfortunately, runs afoul of section 1001, one of the Code’s most fundamental provisions. Section 1001 makes it clear that gain is “realized” whenever one asset is exchanged for another, the “gain” being measured by the excess of the fair market value of the asset received over the basis of that surrendered. The provisions are perfectly applicable to an exchange of shares for the assets of a close corporation. Section 1001’s sister provision, is
where liquidation has been carried out as an afterthought, it will be
difficult to escape the Commissioner's regulations to the effect that the
necessary "view" has existed if the liquidation "was contemplated, un-
conditionally, conditionally, or as a recognized possibility,"23 at any
time during the construction of the property, and, further, that

... if the sale, exchange or distribution is attributable to circum-
stances present at the time of the manufacture, construction, pro-
duction, or purchase, the corporation shall, in the absence of comp-
pelling facts to the contrary, be considered to have been so formed
or availed of.24

If there is any appreciation in the value of the property, any view to
the liquidation of its corporate owner would of necessity be equivalent
to a view to the realization of gain.25

The conditional clause of section 341, requiring the sale or distribu-
tion to have been made "before the realization by the corporation ... of
a substantial part of the taxable income to be derived from [the]
property," will be of small comfort to the shareholder of a rental prop-
erty corporation. Because of the heavy shifting of deductible expenses
to the early years of a rental operation, the property will have to be
held and operated a lengthy period before a "substantial part of the ... income to be derived" will have been recognized as taxable income.26

section 1002 which provides that gain realized shall be gain recognized for tax purpose "[e]xcept as otherwise provided in the Code." Thus, it appears that the phrase "reali-
zeation of gain" is a term of art as used in the Internal Revenue Code and has a meaning
distinct from any given it in conventional usage.

23. Treas. Reg. § 1.341-2 (a) (2) (1968), which also provides that:
The existence of a bona fide business reason for doing business in the
corporate form does not, by itself, negate the fact that the corporation may
also have been formed or availed of with a view to the action described
in section 341 (b).
25. See footnote 22, supra.
26. Must the corporation have realized a substantial part of the potential incometo be realized or all but an insubstantial part of the property's income potential? The
circuits appear to be split on this question with the Court of Appeals for the Fifth
Circuit holding one way, and the Tenth Circuit the other. Commissioner v. Zongker
334 F.2d 44 (10th Cir. 1964); Heft v. Commissioner, 294 F.2d 795 (5th Cir. 1961); Com-
missioner v. Kelley, 293 F.2d 904 (5th Cir. 1961). In regard to this question, th
Service's position, as might be expected, is that the "all but an insubstantial part" interpre-
tation is the correct one, as expressed, for example, in Rev. Rul. 62-12, 1962-1 CUM
BULL. 321. According to Bittker and Eustice, FEDERAL INCOME TAXATION OF CORPORA-
TIONS AND SHAREHOLDERS 430 (2d ed. 1966). "... It is understood that the service wil
Section 341(d)

The only other limits to the application of section 341 are to be found in subsections (d), (e) and (f). Subsection (d) offers three possible alternatives. Section 341 "shall not apply" to a shareholder unless he owns more than five percent "in value of the outstanding stock of the corporation." Nor shall it apply to "gain recognized during a taxable year (with respect to stock in a collapsible corporation), unless more than 70 percent of such gain is attributable to . . . [collapsible] property." Finally, subsection (d) makes section 341 inapplicable to "gain realized after the expiration of 3 years following the completion of . . . construction." Unfortunately, none of the relief provisions offered by subsection (d) give any real assistance to the rental property operator who has to cope with the problem herein sketched.27

Section 341(d)(1) can be ruled out at the start. It will not often be the case that any substantial part of the stock of a corporation set up for the construction of rental property will be held in blocks of five percent or less.28

Paragraph (2), which provides that collapsible treatment will not apply unless more than seventy percent of the shareholder's gain for the year "with respect to his stock in a collapsible corporation" is attributable to the "property so manufactured, constructed, produced, or purchased . . .," has little more to offer. We are concerned with the fairly common situation of a corporation created for the construction (and in some cases the operation) of a single integrated rental project, such as a shopping center, an apartment or office building, or a complex of apartment units. Typically, the corporation will own no assets of any substance other than the property constructed and the land on which it rests. Reliance on paragraph (2) may prove dangerous since the Commissioner would undoubtedly argue that the gain on liquidation is attributable entirely to constructed, and therefore clearly collapsible, property.29

27. For a thorough discussion of the shortcomings of section 341(d) see Goldstein, Section 341(d) and (e)—A Journey Into Never-Never Land, 10 Vill. L. Rev. 215 (1965).

28. Each of the shareholders having five percent or less in value of the shares of the putative collapsible corporation would, of course, be protected, but those holding more would still be in danger.

29. It is not the purpose of this discussion to delve into the questions of whether
In order to take advantage of section 341(d)(3) the taxpayer will have to wait at least three years after he completes "such manufacture, construction, production, or purchase." Its protection will thus entail the loss of at least three years of tax benefits (particularly the deduction or carry-over of the operating losses) which would have accrued to an individual or partnership, often a substantial portion of the total of such tax benefits to be derived.

The determination of when the three-year period is to commence is no easy matter. The concept of "completion" as applied to a construction project is an intractable and vexing one at best. Cases decided and Revenue Rulings promulgated, respecting the time when construction is deemed to have ended, have held, to cite a few examples, that the construction of a shopping center is not complete until rezoning litigation is concluded favorably, successful rezoning being "an integral step" in its construction; that an apartment project has not been finished, the "property so constructed" encompasses the land as well as the improvements thereon or whether a distinction should be made as to gain attributable to a general rise in land value without regard to the construction activities. On this, see Treas. Reg. § 1.341-4(c)(2) (1968), Bittker and Eustice, supra note 36, at 433; Short v. Commissioner, 302 F.2d 120 (4th Cir. 1962); Mintz v. Commissioner, 284 F.2d 554 (2d Cir. 1960); Payne v. Commissioner, 268 F.2d 617 (5th Cir. 1959); Glickman v. Commissioner, 256 F.2d 108 (2d Cir. 1958). Cf. Wheeler Kelly and Hagney Investment Company v. The United States (64-1 U.S.T.C. Para. 9260, U.S.D.C., Kan.), wherein one of the judge's instructions to the jury was . . . the principal question in this case is whether Midland Industrial Properties, Inc., was a collapsible corporation. In addition to this, however, there is one collateral issue. This issue is whether at least 30% of the total gain realized by plaintiff was due to general appreciation in market values of land unaffected by anything done to the land in question by Midland Industrial Properties, Inc. A special question on this matter will be given to you to answer.

The jury answered the special question in the affirmative. The case was not appealed.

30. As an illustration, assume the following facts to exist with regard to an apartment building owned by an individual: the building has a useful life of forty years; it cost $1,000,000 to build; it was financed entirely by a twenty-five-year mortgage loan at seven percent; depreciation deductions are computed under the double declining balance system.

During the twenty-five-year period over which the mortgage will be paid, interest expense deductions totaling $1,121,000 will become available. Of this amount, $205,120, or about 18.3 percent, will be incurred during the first three years following the closing of the permanent loan. Of the $1,000,000 in depreciation deductions which the original owner will be able to take if he retains the property for its entire useful life of forty years, $142,625, or better than fourteen percent, will be available the first three years.

even though physical construction is substantially complete and a certificate of occupancy has been issued by the local authorities, so long as much of the landscaping remains to be done and the Federal Housing Administration has not made its final inspection; and that a shopping center has not been completed when a planned retaining wall has not been erected and the parking lot and driveways have not been black-topped.

The general position of the Internal Revenue Service in this regard seems to be that particular activities will constitute "construction" if the result of such activities is an increase in the area available for rental, a change in the character of the structure, an appreciable increase in its fair market value, or an increase in the net income that can be realized from the project.

If the activities of the corporation to be liquidated have encompassed the construction and serial completion of a group of separate units comprising a unified project, and the first completed goes into operation well before the completion of the last, the requisite three year period would run, nonetheless, from the latest completion date.

If the property concerned is a shopping center, it would not be at all uncommon for the owner, at the instance of a prospective tenant, to engage in substantial new construction activity, such as remodeling, with an increase in the fair market and rental value of the property as a probable result. This could occur long after the construction of the building was thought to be complete in any conventional sense. Nevertheless, the running of the three-year period will not begin until the later completion of the reconstruction.

Subsection (d) having in large measure failed him, the taxpayer has only subsections (e) and (f) left to rely on. The latter is clearly of no benefit, pertaining only to stock sales. Consequently, subsection (e) may well be the only practical avenue for avoidance of collapsible treatment.

35. Treas. Reg. § 1.341-2(a) (4). While the regulation has specific relation to whether a substantial part of a project's potential income has been realized, it would also appear to be pertinent to the fixing of a completion date.
II. SUBSECTION (E): SOLUTION OR DELUSION?

The enactment of subsection (e) was for a remedial purpose. The effect of the collapsible provision as originally enacted went far beyond its original intent. Not only was an avenue of tax avoidance through the conversion of ordinary income into capital gain foreclosed, but persons who would otherwise have been entitled to capital gains treatment regardless of the use of a corporate entity were penalized by the imposition of the ordinary rate.\footnote{S. Rep. No. 1983, 85th Cong., 2d Sess. 31 (1958), states in part that:}

Our rental property builder and operator clearly falls within the class intended to be benefited by subsection (e). He has elected a corporate entity solely for nontax reasons. By so electing he has in fact incurred unfavorable tax consequences. In liquidating his real estate corporation he will merely be attempting to retrieve the tax advantages of individual ownership which he is forced to forego as the result of a corporate election imposed upon him by construction period circumstances. If such a taxpayer seeks to restore his position by means of a one-month liquida-

\footnote{The collapsible-corporation provisions of the present law . . . both by their terms and as interpreted, are so broad that in any number of situations they 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. The applicability of the provisions of present law, moreover, depends upon the subjective intent of the parties, a matter which is obviously difficult to determine. Furthermore, if the collapsible-corporation provisions do apply, the entire gain of the shareholder is taxed at ordinary income rates, notwithstanding the fact that had the shareholder not employed the corporate entity a large part of his gain might have been taxed at capital-gain rates. For these reasons, the collapsible-corporation provisions of present law frequently impede or prevent legitimate business transactions and in some cases even result in the imposition of ordinary income taxes which would not be imposed if the shareholders of such corporations had not employed the corporate method of doing business . . . . [The limitations set forth in Section 341(d)] do not eliminate the problems described above. For example, in the case of corporations engaged in the development of natural resources, which have continued development activity, the shareholders of such corporations can never be certain that their stock interests in such corporations will not be regarded as stock interests in a collapsible corporation, notwithstanding the fact that their corporations have little or no inventories and that the properties of such corporations (if sold by the corporation or by the shareholders) would be regarded as properties the sale of which would result in capital gain. Similarly, real-estate corporations established by investors (as distinguished from dealers) holding rental property for investment only may be regarded as collapsible corporations under present law. [Emphasis supplied]}
tion under section 333, but in doing so runs afoul of the collapsible provision, the bitter consequence is not only the conversion of capital gain into ordinary income but the creation of ordinary income where otherwise there would have been no taxable income at all.

In enacting subsection (e), Congress was sympathizing with the investor rather than the dealer. The subsection is in essence an elaborate system by means of which the one is to be sorted from the other. In keeping with the older portions of section 341, it is at once very mechanical and highly subjective. The relief provided by section 341(e) is available only in regard to an outright stock sale pursuant to subsection (e)(1), a liquidation under subsection (e)(2) in which section 337 applies pursuant to subsection (e)(4), or a one-month liquidation under section 333 pursuant to subsection (e)(3). Other liquidations, whether complete or partial, as well as distributions subject to section 301 and stock redemptions, are unprotected.

Of the three privileged transactions, only the one-month liquidation will be of any assistance to the rental property owner and operator described in this paper. A sale of stock under subsection (e)(1) is obviously irrelevant. While, taken together, subsections (e)(2) and (e)(4) permit a section 337 liquidation free of collapsible treatment, they do so only if substantially all the corporate property is sold to outsiders within the twelve-month period. Moreover, under subsection (e)(4), following the adoption of a plan of liquidation pursuant to section 337, no distribution of depreciable property (which clearly would include the apartment project) may be made by the corporation to any stockholder. Accordingly, any hope of divesting the rental project of its corporate jacket is completely frustrated if subsection (e)(2) must be relied on.

On the other hand, given the essential happy circumstances, the reluctant incorporator may, under section 333, liquidate his corporation and, section 341 notwithstanding, be free of any gain as a result of appreciation in the value of the project. Subsection (e)(3) is his source of succor. Under that short, ostensibly simple subsection, for purposes of section 333, a corporation is not considered a collapsible corporation if at all times after the adoption of a section 333 plan of liquidation, the net unrealized appreciation in "subsection (e) assets" of the corporation does not exceed an amount equal to fifteen percent of the net worth of the corporation.
Both "net unrealized appreciation" 38 and "net worth" 39 are defined in the statute. Both are apparently simple terms. Yet the computation of each depends on the valuation of corporate properties. The fixing of market values thus called for is an inherently inexact and debatable process with the result that it is difficult to foresee what valuation the Internal Revenue Service will accept or seek to impose. Consequently when reliance is to be placed on a given ratio of net unrealized appreciation to net worth, a wide margin for error must be allowed.

Moreover, it is likely that, at the time the liquidation is to be accomplished, the net unrealized appreciation in the typical project will exceed fifteen percent of the net worth of the corporation (particularly in view of the fact that the debt/equity ratio in such a corporation is normally very high), or that the risk inherent in establishing a value for the property will be greater than the taxpayer is willing to assume.

Accordingly, the real question—the one whose answer may provide a solution—is not whether the project has appreciated too much, but whether it is a "subsection (e) asset." For if the project is not a subsection (e) asset, there is nothing on which to compute unrealized appreciation, there can be no net unrealized appreciation in subsection (e) assets and there can be no problem. The corporation may be liquidated comfortably under section 333 irrespective of the amount of appreciation in the non-subsection (e) rental project. This is true even if there is excess mortgage money in the corporate till. The liquidating distribution of the money may result in the recognition of gain under section 333, but, absent subsection (e) assets, the corporation will not be considered collapsible.

"Subsection (e) assets," relative to one-month liquidations purporting to qualify under subsection (e) (3), are, in general, those assets of the corporation which, if sold at a gain by the corporation or by any actual or constructive shareholder who is considered to own more than five percent in value of the outstanding stock, would result in the realization of ordinary income. 40 Although oversimplified, the foregoing definition contains two concepts which may not be apparent, but which, at this juncture, should be absorbed and thereafter respected. It is not enough

38. INT. REV. CODE OF 1954, § 341(e) (6).
40. INT. REV. CODE OF 1954, § 341(e) (5). Section 341(e) (12) provides that section 617(d) (1), 1245(a) and 1250(a) are to be disregarded only for the limited purpose therein stated and does not preclude the recognition of ordinary income by the corporation pursuant to those sections.
for the property to be a non-ordinary income asset in the hands of the
corporation; it must be assumed to be owned by each more-than-five-
percent shareholder. If any such shareholder is a dealer in the type of
property involved, it is probably a subsection (e) asset, and if there is
a more-than-fifteen-percent-of-net-worth appreciation in all subsection
(e) assets, the benefits of section 333 will not be available to any of the
shareholders. It is an all or none proposition. Moreover, as will be dis-
cussed below in more detail, a property may suffer the subsection (e)
taint as a result of the dealer status of a "constructive shareholder."

The nature of subsection (e) assets is illustrated by the following
example. The outstanding stock of X Corporation is owned 75% by A,
15% by B and 10% by C. The corporation owns no property except
an apartment house on which unrealized appreciation is $20,000. The
net worth of the corporation is $100,000. In the hands of B, but not in
the hands of A or C, the apartment house would be property held pri-
marily for sale to customers in the ordinary course of his trade or busi-
ness. The shareholders of X Corporation wish to avail themselves of
section 333. Since, in the hands of B, a more-than-five-percent share-
holder, the apartment house would be held primarily for sale to cus-
tomers in the ordinary course of his trade or business, it is a subsection
(e) asset. Therefore, since the net unrealized appreciation in subsection
(e) assets ($20,000) exceeds fifteen percent of net worth ($15,000),
no shareholder of the corporation may qualify under section 341(e)(3)
for the use of section 333. However, if B were not a more-than-five-
percent shareholder of the corporation, or if in his hands the apartment
house would not be held primarily for sale to customers in the ordinary
course of his trade or business, then all shareholders of the corporation
could qualify under section 341(e)(3) for use of section 333 since the
apartment house would not be a subsection (e) asset.

For the purposes of section 333, the detailed statutory definition of
subsection (e) assets extends to four categories of property held by a
corporation described respectively in clauses (i), (ii), (iii) and (iv) of
section 341(e)(5)(A), as modified by section 341(e)(5)(B). Section
341(e)(5) is difficult and burdensome to read, much less to comprehend
and retain. Nonetheless, escape from classification thereunder often be-
ing the sine qua non of qualification under subsection (e), it is essential
to examine and mentally digest the categories. The fourth category
[clause (iv)] involves copyrights and similar artistic properties and is
not pertinent to this discussion.
Three Categories of Subsection (e) Assets

(i) The first category consists of all property (except property described in section 1231(b), without regard to any holding period prescribed therein) which in the hands of the corporation is, or, in the hands of any actual or constructive shareholder who is considered to own more than five percent in value of the outstanding stock of the corporation (such a shareholder hereafter called a "pertinent shareholder") would be, property gain from the sale or exchange of which, under any provision of Chapter 1 of the Code (other than section 1245, 1250 or 617(d)(1)), would be considered in whole or in part as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).

In the case of our incorporated apartment project (or shopping center or similar venture), any question of classification as a category (i) subsection (e) asset can be dismissed at the outset as to any property which can be shown to be described in section 1231(b), without regard to holding period, irrespective of the capacity in which a shareholder hypothetically might be deemed to hold it. On the other hand, if the corporation holds any property for sale in the ordinary course of its business, then such property falls in category (i) as a subsection (e) asset with equal disregard to any shareholder's assumed holding. If, however, the corporation holds the property neither for sale in the ordinary course of its trade or business nor for use in its trade or business, the activities of each pertinent shareholder become highly relevant in testing its status under category (i). A property held by a corporation neither for sale nor use (with certain exceptions) would be a capital asset.41 Under such circumstances, the question is whether the same property, hypothetically projected into the hands of any pertinent shareholder, is a capital asset or property described in section 1231(b). If it is neither, it is a subsection (e) asset.

Where the corporation is an active rental property corporation, the "shareholder reference test" [as the regulations have designated the determination of subsection (e) status by reference to how each pertinent shareholder would have held the property had he held it]42 becomes moot for purposes of the category (i) definition. The corporation certainly will be found to hold the apartment building (or shopping center

42. Treas. Reg. § 1.341-6(b)(4).
for use in its trade or business within the meaning of section 1231(b), in which case it will not be within the purview of category (i).

(ii) This category of subsection (e) assets is confined to property which in the hands of the corporation is property described in section 1231(b) (without regard to any holding period prescribed therein), but only if there is net unrealized depreciation on all such property.

The shareholder reference test is never pertinent to the category (ii) determination. All property used in the corporation's trade or business must be examined to determine whether "unrealized depreciation" on all such properties having unrealized depreciation exceeds "unrealized appreciation" on all such properties having unrealized appreciation. Unrealized depreciation exists in the case of such properties with fair market values less than their adjusted bases; unrealized appreciation exists in the case of such properties with fair market values larger than their adjusted bases. If unrealized depreciation does exceed unrealized appreciation, then all properties used in the corporation's trade or business are subsection (e) assets under this category, whether appreciated or depreciated. If unrealized appreciation exceeds unrealized depreciation, category (ii) is simply inapplicable.

An apartment building or similar property used in the trade or business of a corporation is scarcely likely to have "depreciated" to a fair market value below its adjusted basis at the time a one-month liquidation of that corporation under the umbrella of section 341(e) is contemplated. Absent such depreciation, the apartment or other such property will not be a subsection (e) asset under category (ii).

(iii) The third category of subsection (e) assets applies only if there is net unrealized appreciation on all property which in the hands of the corporation is property described in section 1231(b) (without regard to any holding period prescribed therein). If category (iii) so applies, any such property (whether appreciated or depreciated) is a subsection (e) asset if a sale or exchange thereof by any pertinent shareholder would produce ordinary income.

Category (iii) requires two independent inquiries. The first involves the threshold question of applicability and necessitates the identical computation used in determining the pertinence of category (ii). If unrealized depreciation exceeds unrealized appreciation, category (ii) applies and category (iii) is disregarded. If the reverse, only category (iii) is considered. But if category (iii) is pertinent, the shareholder reference test, which is ignored under category (ii), must be made.
Consequently, under category (iii), not all appreciated and depreciated assets used in the corporation's trade or business will enter into the ultimate computation of the critical fifteen percent. Only those which become subsection (e) assets by virtue of the shareholder reference test, whether bearing unrealized appreciation or depreciation, will be considered. This may lead to some rather peculiar results.

For example, assume that a corporation owns (in addition to certain other properties found under category (i) to be subsection (e) assets) an apartment building on which there is unrealized depreciation of $9,000; in addition, the corporation owns a parcel of land which has a fair market value of $30,000 and an adjusted basis of $20,000 and which in the corporation's hands is property described in section 1231(b). Since the corporation's property bears net unrealized appreciation of $1,000, category (iii), and not category (ii), is applicable. Assume further that the sole shareholder holds land, but not rental properties, primarily for sale to customers in the ordinary course of his trade or business. Therefore, the apartment building is not a subsection (e) asset. However, since in the hands of the shareholder, the land would be productive of ordinary income, the land is a subsection (e) asset. Consequently, the net unrealized depreciation on the apartment building is ignored, but the entire $10,000 unrealized appreciation on the land will be taken into account in computing the net unrealized appreciation (if any) in all the corporation's subsection (e) assets.

Reverse the arithmetic and assume that there is unrealized appreciation of $10,000 on the apartment building and unrealized depreciation of $9,000 on the land. Since there is net unrealized appreciation, category (iii) is again applicable and the shareholder reference test must be made. Again, only the land will be a subsection (e) asset. Unrealized appreciation in the apartment building will, as a result, be entirely disregarded, while the unrealized depreciation in the land will be available in full as an offset to unrealized appreciation on the corporation's other subsection (e) assets.

Generally, the incorporated apartment project or similar venture is safe under category (iii) unless a pertinent shareholder is a dealer in such projects. However, even if no such shareholder is a dealer, there appears to be a question whether the contemplated section 333 liquidation will bring the desired results if improperly timed. Several questions may be asked: Is it necessary that the corporation hold the apartment project for any particular length of time before adopting a plan o
liquidation under section 333? Must each pertinent shareholder have a minimum holding period for the project? If the answer to the latter question is in the affirmative, must the holding period be an actual one or a hypothesized one, and if hypothesized how is it to be determined?

It seems clear that (unless it is necessary from the shareholder point of view) the corporation does not need any particular holding period. At the corporate level, category (iii) relates to “all property used in the trade or business (as defined in paragraph (9));” and section 341 (e)(9) expressly refers to property used in the trade or business “without regard to any holding period.”

Unfortunately, the answer is not so clear with respect to a pertinent shareholder. In order to avoid subsection (e) asset classification under category (iii), the property in the hands of the pertinent shareholder must be property gain from the sale or exchange of which would be considered gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). In the hands of the pertinent shareholder, the project will be either property held for sale to customers in the ordinary course of the shareholder’s trade or business, or a capital asset, or property used in the shareholder’s trade or business. For purposes of this discussion, we will assume that the apartment project is neither property held for sale to customers in the ordinary course of the shareholder’s trade or business nor a capital asset. By elimination, therefore, it must be property used in the shareholder’s trade or business. However, under the literal language of the statute, being property used in the shareholder’s trade or business will

43. Property other than real estate can fall into additional categories. For example, section 1221(1) defines a capital asset as excluding not only property held primarily for sale but also “stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer. . . .” However, in the case of an apartment project, the stock in trade and inventory categories undoubtedly would be academic and will be disregarded.

44. If the apartment project is considered to be a capital asset, no holding period is required under category (iii).

45. If so used, the apartment project would not be a capital asset. See Int. Rev. Code of 1959, § 1221(2).

46. It would perhaps be more accurate to assume, in the first instance, that the project is property used in the shareholder’s trade or business, thereby eliminating it as a capital asset, rather than first to assume that it is not a capital asset, for in all likelihood (the pertinent shareholder not being in the business of selling apartment projects) the project will be considered property used in his trade or business rather than a capital asset. The intent to develop an apartment project for rent would seem sufficient to so characterize the project even prior to the commencement of rental activities. See, e.g., Rev. Rul. 58-133, 1958-1 Cum. Bull. 277.
not suffice—it must be property described in section 1231(b); and property described in section 1231(b) is property used in the trade or business “held for more than 6 months.” Thus a literal reading of the statute suggests that a more-than-six-months’ holding period is required, although nothing else in the statute or in the regulations offers any words of wisdom respecting this problem.\(^{47}\)

If such a holding period is necessary, it would seem manifest that it must be a hypothetical, rather than an actual, holding period. In the case of a stock sale under section 341(e)(1), or a section 337 sale and liquidation under section 341(e)(2) and (4), there can be no actual holding period in the hands of a pertinent shareholder for the reason that the pertinent shareholder never actually holds the property. Nor in the case of a section 333 liquidation will a constructive shareholder actually hold the property. Nevertheless, the category (iii) definition of subsection (e) assets must be applied in all such cases. Accordingly, if such a holding period is in fact necessary, then not only must the property be imagined in the hands of each pertinent shareholder but it must be imagined there for more than six months. In determining the imaginary period, it would be reasonable to suppose that the property has been in the hands of each pertinent shareholder for the same length of time it has been in the hands of the corporation.\(^{48}\) If this is so, it would seem possible to avoid the problem by having the corporation defer the adoption of a plan of liquidation pursuant to section 333 to a date more than six months after the completion of the project.\(^{49}\)

\(^{47}\) Treas. Reg. § 1.341-6(b) states that included in category (iii) is property which in the hands of a pertinent shareholder would be property used in his trade or business “held for not more than 6 months,” possibly suggesting thereby that the Commissioner regards a holding period as necessary. However, the example given by the Commissioner as an illustration contains no reference to a holding period.

\(^{48}\) Query: What is the shareholder’s holding period if his shares of stock in the corporation have been held for a longer or shorter period than the corporation’s holding period for the property?

\(^{49}\) Thus, if a corporation buys a tract of land and constructs a store thereon, completing it on April 1, 1968, it could be unsafe for the corporation to adopt a plan of liquidation under section 333 prior to October 2, 1968. The holding period for the land would run from the date of acquisition, but for the building the holding period would run on a piecemeal basis, depending upon how much of the store had been completed and how much remained incomplete on April 1, 1968. Commissioner v. Williams, 256 F.2d 152 (5th Cir. 1958); Paul v. Commissioner, 206 F.2d 763 (3d Cir. 1953); Draper v. Commissioner, 32 T.C. 545 (1959); DiZeno v. Commissioner, 23 T.C.M. 677 (1964). If any portion of the store failed to meet a holding period requirement, the store would be a subsection (e) asset, but only the unrealized appreciation on the portion of the store held for six months or less would have to be taken into account—presumably on
The “Constructive Shareholder”

As previously stated, for purposes of determining whether an asset is a subsection (e) asset, such asset must be examined not only as if owned by each actual more-than-five-percent shareholder, but also as if owned by each person who owns the requisite percentage by virtue of attribution from another actual or constructive shareholder. This attribution of stock from one shareholder to another extends in two directions. It can cause an actual-but-five-percent-or-less shareholder to become a more-than-five-percent shareholder. For example, if A and his grandfather each actually owns three percent in value of the stock of an apartment house corporation, A will be considered to own his grandfather’s shares and thus will be a six percent shareholder; his activities may cause the apartment house to be a subsection (e) asset for purposes of section 341(e)(3). Moreover, attribution can cause a nonshareholder to be regarded as an actual shareholder. For example, if in the same corporation H(husband), a dealer in apartment houses, owns no stock, but W(wife) actually owns more than five percent in value of the corporation’s stock, W’s shares will be attributed to H. Thus, nonshareholders’ activities may taint the property.

The mechanics of constructive ownership are not apparent to the cursory reader. The subsection (e) asset definition sections [341(e)(5)(A)(i) and (iii)] merely refer to “a shareholder.” The researcher must look five paragraphs beyond, to section 341(e)(10), to find that for purposes of “this subsection [i.e., section 341(e)], the ownership of stock shall be determined in the manner prescribed in subsection (d) [i.e., section 341(d)].” Subsection (d) prescribes rules for determining stock ownership; and it is by this prescription that a bitter pill is compounded for those seeking the remedy of subsection (e). It not only incorporates all the rules for imputed stock ownership set forth in section 455(a) (relating to personal holding companies) but supplements them. The result is probably the most expansive constructive ownership provision in the Code.

Shareholders, partners and beneficiaries constructively own proportionate parts of shares owned by corporations, partnerships, trusts and estates. Partners constructively own shares owned by their partners. An individual constructively owns shares held by his spouse, lineal desce-
dants, ancestors, brothers, sisters, spouses of brothers or sisters, or spouses of lineal descendants. An optionee constructively owns the shares subject to his option. There may also be reattribution under some circumstances.

The consequence is that each shareholder must consider not only his own dealership status, but that of family members and partners, and, in addition, that of his fellow shareholders, their business associates and relatives. If a shareholder is an artificial person, its owners and beneficiaries must all be examined for the taint of dealership. Thus it appears that in order to take advantage of subsection (e) a shareholder will have to be on intimate terms with the family and business affairs of all the other people who own stock in his corporation. And the results in some circumstances may be bizarre indeed. If one shareholder's grandson, of whose very existence the other shareholders are completely ignorant, is subject to classification as a dealer, the result might well be the disqualification of the transaction as to all.

III. A Case Study

Some of the concepts which have been discussed can best be illustrated by the story of A-E Corporation. A-E Corporation so recently completed the construction of a small shopping center that it has not yet gone into operation. Having expended its entire capital and mortgage money on land and buildings, A-E Corporation has no asset other than the shopping center, and no liability other than the $490,000 mortgage indebtedness to which the shopping center is subject. The property has a cost basis of $500,000 and is now worth $600,000. The net worth of the corporation [as defined in section 341(e)(7)] is $110,000. All the stock of A-E Corporation is owned in five equal shares by four individuals, Alpha, Beta, Delta and Epsilon, and a trust established under the will of one Gamma, deceased.

Alpha, a nonentity if ever there was one, has no interest in any real estate venture of any sort, either as a partner, shareholder or individual, other than his interest in A-E Corporation. He is unmarried and has no living relatives. He owns no corporate shares, other than his shares in A-E, and holds no options to acquire any corporate shares. He is not the beneficiary of any trust or estate and is not a member of any partnership. In short, circumstances completely insulate him from the effects of constructive ownership, other than as applied to his fellow shareholders.
Beta has a wife and relatives but none is engaged in any real estate activities. He is a physician and a member of a partnership organized solely for the practice of medicine. However, one of his partners, another physician, has a son who is extensively engaged in the real estate business, selling various types of property including shopping centers.

Gamma, deceased, provided in his will for the creation of a trust, the sole beneficiary of which was to be his granddaughter. He died shortly after the incorporation of A-E, about two years ago. Since then his estate has been wound up and the trust has been established. All Gamma’s shares in A-E were transferred from his estate to the trust. Also, subsequent to Gamma’s death was the marriage of his granddaughter to Sigma, an extremely active buyer-builder-and-seller of commercial property, including shopping centers.

Neither Delta nor his relatives or business associates are subject to classification as dealers unless the activities of Delta’s three wholly-owned corporations are attributed to him. Each of the three corporations is active in the construction and sale of commercial property.

Epsilon is a member of a partnership actively engaged in the business of developing residential subdivisions and selling lots and houses. The partnership has never dealt in commercial property.

All the shareholders wish to liquidate A-E Corporation under section 333. Indeed the venture was undertaken with the mutual understanding that it would be liquidated at the earliest possible time. On dissolution the property will be transferred to a partnership formed by the five shareholders (trading as ABGD & E) which will hold and operate the property.

The question is, then, whether section 341(e) will permit the shareholders to effectuate a one-month liquidation under section 333? Did the draftsmen of section 341(e) propose fair terms with a villain’s mind? Is the shopping center subsection (e) property, or is it not?

Status In Hands of Corporation

Before delving into the shareholder reference test, we must consider in what capacity A-E Corporation itself holds the shopping center. A-E Corporation must hold it either as a dealer for sale to customers in the ordinary course of its business or, in the language of sections 1221 and 1231, as “property . . . used in [its] trade or business,” or as a capital asset.

If the first, a sale of the shopping center by A-E Corporation would
produce ordinary income, and the shopping center is a subsection (e) asset. The cases in which this type of question has been considered have invariably involved situations in which the property had in fact been sold. If we are to apply the principles of those cases to A-E Corporation, it is necessary to speculate on what A-E Corporation would have done had it continued to hold the property rather than distribute it to the shareholders.

The factors given most weight in determining whether an asset is held for sale, for use in a business or as a capital asset, both for and against the taxpayer, do not ordinarily come into existence until the property owner has established some substantial experience in its operation or until a sale has actually been made. Generally speaking, two factors are determinative: the manner in which the taxpayer used the property while he owned it, and the circumstances surrounding its sale, the latter generally being given somewhat greater weight.\(^{50}\) Some pertinent questions are: Was the property rented for a substantial period and was it productive of substantial income during that period?\(^ {51}\) Was the property sold on account of some supervening and unforeseen event such as the imposition of rent control, or a drastic decline in the number of people interested in renting rather than buying property?\(^ {52}\) Was the sale solicited by the buyer from a passive seller?\(^ {53}\) Had the seller, in fact, rejected previous offers for the property?\(^ {54}\) Was the property unsuitable as investment property?\(^ {55}\) Did the property yield only nominal income, indicating that it was rented by the owner only as a temporary expedient, perhaps to protect the property from vandals pending the

\(^{50}\) This follows from the well-established principle that an owner's motive towards his property may change and that it is his intent at the time of sale which is determinative. No matter how clearly a taxpayer establishes the fact that he has held an asset as an investment until shortly before its sale, if the circumstances surrounding the transaction are such as to indicate that the property had been held at that time for sale in the ordinary course of the owner's business, ordinary income treatment will be the result. See American Can Company v. Commissioner, 37 T.C. 198 (1961), Mauldin v. Commissioner, 28 T.C. 42 (1957), Johnson-McReynolds v. Commissioner, 27 T.C. 300 (1956).

\(^{51}\) Rouse v. Commissioner, 39 T.C. 70 (1962).

\(^{52}\) Farry v. Commissioner, 13 T.C. 8 (1949).

\(^{53}\) Phillips v. Commissioner, 24 T.C. 435 (1955). However, the fact that the purchaser was the aggressive party to the transaction standing alone is no guarantee of success in litigation of this sort. E.g., see Rollingwood v. Commissioner, 190 F.2d 263 (9th Cir. 1951).

\(^{54}\) Crabtree v. Commissioner, 20 T.C. 841 (1953).

\(^{55}\) Municipal Bond Corp. v. Commissioner, 341 F.2d 683 (8th Cir. 1965).
appearance of a buyer? Was a vigorous sales effort made? Did the seller make any overt display, prior to the sale and while he was renting the property, of a substantial sales motivation?

A-E Corporation has not yet gone into operation. It may not be necessary that the corporation actually have begun rental operations in order for the property to be deemed an asset used in its business. But the fact that such operations (including such preliminary efforts as advertising and employing rental agents) have not begun will deprive A-E's shareholders of the most persuasive evidence of a holding for use rather than sale in A-E's business. Aside from actual rental activities carried on by A-E Corporation, the only evidence of A-E's motive in holding the shopping center will be the testimony of the shareholders themselves and perhaps self-serving statements in the corporation's minute book.

But what of the acknowledged intention of the shareholders to liquidate A-E at the earliest feasible moment? Does this make it impossible to classify the shopping center in the hands of A-E Corporation as one held either for sale in the ordinary course of, or for use in, its business? If so, do we have a new species of asset for purposes of tax classification? An asset thus held by a corporation purely for distribution to its shareholders at a propitious moment could not be said to be held by that corporation as an investment. Neither could the asset be said to be held for sale or use in the corporation's business. But section 1221 defines what is a capital asset by stating what it is not. A capital asset is

56. Id.
57. Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952); Rollingwood v. Commissioner, 190 F.2d 263 (9th Cir. 1951); American Can Company v. Commissioner, 37 T.C. 198 (1961); Johnson-McReynolds v. Commissioner, 27 T.C. 300 (1956).
58. Harrah v. Commissioner, 30 T.C. 1236 (1958), and Rollingwood v. Commissioner, 190 F.2d 263 (9th Cir. 1951): in both cases the granting of a purchase option to a lessee in connection with the lease of property was considered significantly indicative of a sales motivation on the part of the lessor. The Tax Court seems especially disposed to seize on the insignificant as substantial evidence of sales motivation. See, e.g., Heller Trust v. Commissioner, 65,302 P-H Tax Ct. Mem. (1965). The taxpayers, in filing an application for mortgage insurance from the Federal Housing Administration in connection with a proposed rental property project were required to answer, among others, two questions phrased as follows: "Do you intend to occupy, rent, or sell this property?" and, if for sale, what is the "proposed sale price?" The applicant answered "Rent" to the first, provided the figure $15,750 as the answer to the second (at 1824). The court appears to have attached considerable importance to this minimal display of a propensity to sell, finding it "clear from this record (at page 1668) that they (the taxpayers) also contemplated the profitable sale of these duplexes if it turned out to be the more desirable course of action." (at 1827).
any asset other than inventory-type property, property held primarily for sale in the ordinary course of business, depreciable property and real property used in the owner's business, copyrights and similar artistic properties, or certain accounts, notes or obligations receivable. Arguably, property held solely for distribution on liquidation fits none of the excluded categories and must be a capital asset.

In summary, if the shopping center is not held by A-E Corporation for sale, it could not be a subsection (e) asset vis-a-vis A-E Corporation, whether it be deemed held for use in its business or as a capital asset. However, before abandoning our inquiry as to the shopping center's status in the hands of A-E Corporation, we must consider the possibility that such status will be contaminated by post-distribution activities of its shareholders and the application of hindsight.

**Application of Hindsight**

There appears to be some authority for the proposition that the post-distribution activities of the partnership, ABGD & E, in regard to the shopping center should be given some consideration in determining what A-E Corporation would have done with the property had it continued to hold it. The partnership would have an opportunity following the liquidation to put the shopping center into operation, obtain substantial income from it, and clearly establish an investment motive toward it, refraining all the while from betraying any inclination to sell the property. This grace period would result from the necessary time lag between the date of liquidation and the respective dates on which the shareholders' income tax returns, reporting the liquidation, are audited, the assessments proposed, and the matter finally resolved.

An examination of post-distribution activities requires a consideration of the admissibility of hindsight evidence, which is what an accounting of the partnership's post-distribution handling of the property would constitute. Ordinarily such evidence is inadmissible. In regard to A-E Corporation, the determination to be made is the state of mind of the controlling shareholders (investment or dealership intent toward the property) during the period ending on the date of distribution. But all real evidence of that state of mind may come into existence only subsequent to the last critical date. To ignore such evidence as inadmissible

59. Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966); Browne v. United States, 356 F.2d 546 (Ct. Cl. 1966); Burgher v. Campbell, 244 F.2d 863 (5th Cir. 1957).

hindsight would be to substitute "a blank slate and untested specu-
lation" for "what actually happened." 61

The rule barring hindsight evidence is subject to some exceptions. One is applicable where "a resort to such evidence is rendered necessary by the nature of the fact to be proven in that a confinement to con-
temporary events would result in grave injustice," 62 as, indeed, strict adherence to the general rule would in the case of a one-month liquidation of A-E Corporation. A rigid application of the general rule might, in fact, make the purported remedy offered by subsection (e) a useless and unworkable one, as it may well be in regard to stock sales and section 337 liquidations in any event. 63

In at least four tax cases in which ordinary versus capital gain was the issue, courts have given consideration to events which occurred after the critical date or the end of the critical period with reference to which the determination sub judice was to be made. 64 Three of the four cases concerned the treatment of gain to a shareholder on his sale of raw land to a controlled corporation. The post-transfer activities of the corporation in subdividing, improving and selling off numerous lots were considered by the court as evidence of the nature of the shareholder's pre-transfer holding of the property. A determination of the nature of A-E Corporation's holding of the shopping center by reference to the post-liquidation activities of the ABGD & E partnership may necessitate application of the principles enunciated in the foregoing cases.

Even if testimony in regard to the partnership's post-distribution op-
erations is admitted, the government may still argue that such evidence should be discounted in at least some degree as having been, in a sense, "manufactured." In other words, the government might contend that the activities of the partnership had been tailored to conform to stat-
tutory and case law requirements for the tax consequences desired. How-
ever, while the government has enjoyed some degree of success with

61. Federal Trade Com. v. Consolidated Foods Corp., 380 U.S. 592, 602 (1965) (con-
curring opinion).
63. See Goldstein, Sections 341(d) and (e)—A Journey Into Never-Never Land, 10 VILL. L. REV. 215 (1965), and Axelrad, Recent Developments in Collapsible Corpora-
tions, 36 TAXES 893 (1958). Both writers are indeed pessimistic in regard to the utility of subsection (e).
64. Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966); Browne v. United States, 356 F.2d 546 (Ct. Cl. 1966); Burgher v. Compbell, 244 F.2d 863 (5th Cir. 1957); Bernard v. Commissioner, ¶ 67,176 P-H Tax Ct. Mem. (1967).
this approach in other areas of the law, it could be expected at most to weaken rather than negate the evidentiary value of post-distribution events.

Merely by not disposing of the shopping center, ABGD & E will deny the Internal Revenue Service the most conclusive evidence it could obtain of dealer motivation—an actual sale and the circumstances surrounding it. If the activities of the partnership subsequent to the liquidation are carried out judiciously, and are considered as if performed by A-E Corporation, the former shareholders should have no trouble in establishing that the shopping center would not have been an asset the sale of which would have produced ordinary income in the corporation's hands.

Shareholder Reference Tests

Assuming A-E Corporation itself to have demonstrably clean hands, we will now examine Alpha. Since in his case none of the dealership criteria are present and he has no guilt-by-association, his holding or putative holding of the shopping center will not stigmatize it as a subsection (e) asset.

On the other hand, even if Alpha were a dealer in commercial rental properties including shopping centers, this would not necessarily foreclose the benefits of subsection (e). The chance of qualification in spite of dealership is made possible by the well-established principle that a dealer in property can also be an investor in the same or a similar type

65. Federal Trade Comm. v. Consolidated Foods Corp., 380 U.S. 592 (1965). In this case the dispositive issue, in an action brought pursuant to Section 7, of the Clayton Act 15 U.S.C. § 18 (1958), was the probability of an adverse effect on competition as a result of the defendant's acquisition of a competitor. The critical date in such a determination is the date of merger. As of such date, and in view of contemporaneous circumstances, can it be said that the effect of the acquisition "may be substantially to lessen competition, or to tend to create a monopoly?" The Court of Appeals for the Seventh Circuit, in holding that the acquisition was not productive of the forbidden probability, relied heavily on the post-acquisition activities of the defendant (329 F. 2d 623). On appeal to the United States Supreme Court, Mr. Justice Douglas, in delivering the opinion of the Court, conceded that the Court of Appeals "was not in error in considering the post-acquisition evidence in this case," but concluded that it had been given too much weight.

Probability of the proscribed evil is required, as we have noted. If the post-acquisition evidence were given conclusive weight or allowed to override all probabilities, then acquisitions would go forward willy-nilly, the parties biding their time until [the forbidden result] was allowed fully to bloom . . . . [T]he force of [Section] 7 is still in probabilities not in what later transpired. (at 598).
Ordinarily, where a dealer can show that certain of his property is held by him as an investment for the production of current revenue or as a speculation, such property will not be classed as stock in trade. The standards the courts have developed in determining whether a dealer is an investor as to certain of his property are similar to the criteria used in distinguishing assets held for sale from capital assets or assets held for use in the owner's business. But the possibility that exists, by virtue of these criteria, of segregating dealer and investor property in the hands of a single owner, is severely curtailed by the Commissioner's regulations. It is provided therein that for the purposes of determining whether any property of the corporation would, in the hands of a particular actual or constructive shareholder, be property gain from the sale or exchange of which would be considered in whole or in part gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b), all the facts and circumstances of the direct and indirect activities of the shareholder must be taken into account. If the particular shareholder holds property primarily for sale to customers in the ordinary course of his trade or business and if similar property is held by the corporation, then in the hands of the shareholder such corporate property will be treated as held primarily for sale to customers in the ordinary course of his trade or business.

What is "similar" property? The regulations give no explicit example. In the two examples given in the regulations of fact situations in which corporate property will be deemed to be subsection (e) assets because of a shareholder being a dealer, the property in which the shareholder deals is not merely similar, but identical, to the property the corporation holds.

The only relevant case law would appear to be that interpreting "similar or related in service or use" as employed in section 1033. The expression has been given a restrictive meaning in the various opinions

66. Eline Realty v. Commissioner, 35 T.C. 1 (1960); Meig v. Commissioner, 32 T.C. 1314 (1959); Farry v. Commissioner, 13 T.C. 8 (1949).
67. Treas. Reg. § 1.341-6(b) (4) (emphasis supplied).
68. Example (2) under Treas. Reg. § 1.341-6(a) (4); Treas. Reg. § 1.341-6(c) (4).
69. No case has been decided thus far involving the interpretation of "similar or related in service or use" as used in the Hypothetical Dealer formula appearing in Sections 341(e) (1) (C) and 341(e) (2) (C).
construing it. For example, a warehouse and an apartment building may not be "similar or related in service or use." 70

Even if a narrow construction is extended to the above-quoted regulation, the italicized portion would still clearly conflict with well settled case law. The automatic equivalency imposed by the regulations between the dealer's motive in holding his own stock in trade and the hypothetical motive behind his hypothetical holding of the corporation's property is clearly at odds with the many judicial opinions which recognize the fact that dealers in certain property can hold the same type of asset as an investment. 71 There is nothing in the language of section 341(e) to support such a departure from firmly established legal principles. It would be particularly difficult to justify the application of this regulatory provision where the shareholder has, for some time subsequent to the period with reference to which the determination is to be made, actually held and operated the property as an investment productive of substantial income.

Nonetheless, if Alpha held other commercial rental properties as stock in trade at any time during the critical period, it would be a mistake to rely on subsection (e) to immunize the transaction against collapsible treatment. If he held other shopping centers for sale, such a reliance would be foolhardy. The Service can be expected to enforce the regulation no matter how invalid it may appear to be. Although litigation may lead to a holding of invalidity, involvement in such a controversy is not generally thought to be a part of acceptable tax planning.

Suppose Alpha were presently holding for sale no shopping center or similar property, but had frequently bought and sold such property in the past. The regulations make special provision for such a situation. Even if the shareholder does not hold similar property during the critical period, it

... may be determined under the particular facts and circumstances (taking into account ... if applicable, the fact that he previously so held similar property) that he would hold the corporate property primarily for sale to customers in the ordinary course of his trade or business. 72

Thus, it appears that where the shareholder's dealings in similar property have all been in times past, the Commissioner's regulations will

70. S. E. Ponticos, Inc. v. Commissioner, 40 T.C. No. 11 (1963).
71. See footnote 66, supra.
72. Treas. Reg. § 1.341-6(b)(4).
apply in a less draconian fashion. Room seems to be allowed under such circumstances for an evaluation in the light of the many cases which recognize the coexistence of dealer and investor motives in the bosom of the same taxpayer.

In the case of a stock sale or a liquidation under section 337 which the participants hope to shield from collapsible treatment by means of subsection (e), the nature of each hypothetical holding will have to be determined on the basis of sheer surmise. This evaluation of the imponderable called for by subsection (e) has been the source of the severest criticism levelled at the provision. The statutory formula of subsection (e), according to one writer, "precipitates literally insoluble problems." A taxpayer in the position of having to satisfy the requirements of this formula may have no evidence to offer in his behalf other than his own unsupported assertions. Would the taxpayer's self-serving and uncorroborated testimony be sufficient to rebut the presumption enjoyed by the Commissioner in his findings? The Commissioner may have no evidence whatever, and hence may wonder: "How does one refute testimony concerning a hypothetical state of mind about hypothetical property by the person whose hypothetical intention is at issue?"

But such criticism does not hold true in regard to a section 333 distributee. This taxpayer's holding of the property will be actual rather than hypothetical. He will have ample opportunity to demonstrate an investor attitude towards the property, avoiding all the while any word or deed suggesting an inclination to sell. He may in fact be especially advantaged relative to the taxpayer in the more typical case who has to explain away the awkward fact that a sale has actually taken place.

In the case of Beta, it is necessary that his partner in the practice of medicine (whose son is an active buyer-and-seller of commercial rental property, including shopping centers) be able to bear scrutiny. We have already hypothesized Beta's partner to be a non-dealer. However, we must consider the effects of reattribution. Happily for the A-E shareholders, the reattribution rules will not reattribute shares held by Beta's partner (because of the partner-to-partner rule) to Beta's partner's son (because of the family member rule), the fortunate consequence being that the son of Beta's partner will not be a constructive share-

73. See footnote 63, supra.
74. Axelrad, supra note 15, at 386.
75. Axelrad, Recent Developments in Collapsible Corporations, Taxes 893, 914 (1958).
holder of the corporation and will not have to suffer the humiliating shareholder reference test.\(^{76}\)

On the other hand, if the A-E shares had been owned by the partnership itself, there would be attribution from it to the partners in amounts proportionate to their partnership interest. Reattribution would then apply to make a portion of the shares the constructive property of Beta's partner's son, and the son would be deemed a constructive shareholder of A-E Corporation, with the result that his activities would probably cause the shopping center to be a subsection (e) asset.\(^{77}\)

In regard to the Gamma Trust and its sole beneficiary the deceased Gamma's granddaughter, the owners of A-E Corporation are less fortunate. Here reattribution applies.\(^{78}\) The trust's shares become successively the beneficiary's, then her spouse's. As a result, Sigma, the real estate dealer, becomes a constructive shareholder. Here, criticism of the hypothetical nature of the determination which has to be made strikes home with full force. In evaluating the status of a shopping center in the hands of Sigma, hypothetical ownership of the property of the corporation is piled on hypothetical ownership of stock in the corporation.

It may seem unfair to disqualify the liquidation of A-E Corporation on account of Sigma's activities, since the highly conjectural nature of his holding may make it impossible to show that Sigma would have held the property, if he had held it, as an investment. However, the literal language of the statute seems clearly to call for it. The problem may well be an insoluble one. As a result, it seems advisable for anyone having such a relative, or a fellow shareholder who has such a relative, to forego reliance on subsection (e).

If Delta, who wholly owns the three active real estate corporations,

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76. Paragraph (2) of Section 554(a) provides that "An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner." Paragraph (5) further provides that

\[ \ldots \text{ stock constructively owned by a person by reason of the application of paragraph (1) [pertaining to the attribution of shares held by a corporation, partnership, trust or estate, to its shareholders, partners and beneficiaries in proportionate amounts] or (3) [which makes an option to acquire shares in a corporation equivalent to ownership of the shares] shall for purposes of applying paragraph (1) or (2), be treated as actually owned by such person; but stock constructively owned by an individual by reason of the application of paragraph (2) shall not be treated as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.} \]

77. See footnote 76, supra.

78. See footnote 76, supra.
has engaged in no dealership activities himself, and is not afflicted with any relatives or business associates who are themselves dealers in real estate, the shopping center will not be tainted as a result of his interest. There is no back attribution under section 544(e)(1) or any other constructive ownership provision applicable to subsection (e). Consequently, none of the three corporations will be a constructive shareholder in A-E Corporation, unless some principle of case law requires or allows an imputation of these corporate activities to Delta for this purpose. No such principle appears to be applicable here.

The law is quite well settled that ordinarily the separate taxable entities of corporation and shareholder will be respected. Except under certain special circumstances, the activities of the one will not be attributed to the other, providing, of course, that the corporation is not treated as a sham and its separate entity disregarded in consequence.

There appear to be four legal theories by virtue of which the separate corporate entity, though not a sham, may to some extent be disregarded in determining whether activities are to be imputed from the corporation to the shareholder or vice versa. In some cases, corporate activities have been attributed to a shareholder because the corporation could fairly be regarded as the shareholder's agent. An example is presented by the shareholder who enters into a contract with his corporation whereby the latter undertakes to construct houses on lots to which the shareholder himself retains title, the shareholder subsequently having the corporation act as his sales agent for the lots after they have been improved.

In other cases a corporation-to-shareholder imputation has been made because of the interrelated and coordinated manner in which the corporation and individual have conducted their activities; that is to say, where neither can be said to be agent of the other but the two have acted somewhat like joint venturers, e.g., where an individual acquires a parcel of land for development and deeds a portion of it to his wholly-owned corporation, retaining the remainder, the two then cooperating in such matters as accomplishing necessary rezoning, providing for sewage and water, and proceeding to develop the adjacent parcels pursuant to a uni-


80. See footnote 5, supra. See also Haberman Farms, Inc. v. U.S., 305 F.2d 787 (8th Cir. 1962) and the cases cited and discussed therein.

form plan. As previously discussed, courts have given consideration to the subsequent activities of a corporation as an aid in determining what the purpose of its majority shareholders had been in holding real property prior to its transfer to the corporation, more particularly, whether or not the shareholders held land as an investment or for sale in the ordinary course of their business.

Finally, there have been decisions in which corporate activities have at least been mentioned in determining whether or not a shareholder is a dealer in real estate. However, substantial personal real estate activity on the part of the shareholder under scrutiny was involved in such cases.

A major limitation on the applicability of all the foregoing theories, other than the last stated, is the fact that without exception they have been applied in litigation relating to transactions in which the corporation has had a direct involvement, either as joint venturer, agent or transferee. In none of the cases applying any of the first three theories has the corporation's activities been unrelated to the transaction in question and relevant only because of the taxpayer's ownership and control.

We have already hypothesized Delta to have engaged in no personal dealer activities. We further assume that none of the three corporations is so insubstantial as to be disregarded as a mere sham. Consequently, if none has acted as Delta's agent or joint venturer with regard to the activities of the A-E Corporation, the shopping center will not be an ordinary asset in Delta's hands.

Epsilon will have to establish that the property in his hands would be an investment rather than a part of his residential dealership business. This is true regardless of his carrying on no dealer activities as an individual other than through the partnership to which he belongs. The entity concept as applied to partnerships for tax purposes has been called a "skin deep accounting expediency." The independent existence of the partnership entity, as distinct and separate from that of the partner, is accorded much less deference by the courts than the more religiously observed concept of the corporation as a person distinct from its share-

82. While the precise facts stated were not present in either case, Tibbals v. U.S., 362 F. 2d 266 (Ct. Cl. 1966) and Burgher v. Campbell, 244 F.2d 863 (5th Cir. 1957) are both suggestive of this approach.


holders.\textsuperscript{85} The partner is generally regarded as being individually in the business of his partnership.\textsuperscript{86}

Does a single isolated sale of commercial property by a dealer in residential property escape being a sale in the ordinary course of business solely because of the difference in character between the residential property in which he customarily deals and the single commercial property he sold? On this point the law is at best unclear. Unsurprisingly, no court ever appears to have been confronted with a fact situation presenting this problem in its pure form, uncomplicated by other, usually weightier, factors. Consequently, such authority as exists on this question is little more than dicta. There is, however, some authority, admittedly flimsy and by implication only, to the effect that a single sale of unimproved land by a seller who otherwise deals only in improved realty is not in the ordinary course of his business, provided the unimproved land was not acquired by him for the original purpose of improvement prior to sale, and was not a portion of a larger parcel the remainder of which was improved and then sold.\textsuperscript{87}

We can, however, find no decision favorable to a taxpayer solely on the ground of a difference in nature between the property in which he had normally dealt and a single piece of another type that he had sold.

No fixed formula exists for determining which property is held primarily for sale to customers in the ordinary course of a taxpayer's business. Rather, a congeries of factors is to be considered and weighed, no one factor being necessarily decisive.\textsuperscript{88}

In many cases won by taxpayers, where the dispositive issue was whether the taxpayer had held certain property for sale in the ordinary course of business, an important factor was a strong element of dissimilarity between the property sold and other property held by the taxpayer as a dealer. This element was always accompanied by other factors indicating an investment motive towards the property sold, such as past refusals to sell or substantial rental income from the property. Nonetheless, such a dissimilarity is a point in favor of the tax-

\textsuperscript{85} MERTENS, LAW OF FEDERAL TAXATION, § 30.26 at 68. Welch v. Commissioner, 19 B.T.A. 394 (1930).
\textsuperscript{86} Id.
\textsuperscript{88} Cashvan v. U.S., 67-2 U.S.T.C. Para. 9513 (E.D., Va.).
payer and it will be of assistance to Epsilon under the facts hypothesized. It will emphasize the segregation he must establish (and demonstrate to a court if necessary) between the residential property in which he deals and the shopping center which he asserts he holds as an investment. Moreover, dissimilarity will make inapplicable the Commissioner's regulation, previously discussed, to the effect that an item of corporate property, hypothesized to be in the hands of a particular shareholder who is a dealer in that or "similar" property, is a subsection (e) asset per se.

IV. EPilogue

It has been said that "life is the art of drawing sufficient conclusions from insufficient premises." By resorting to hypothesis we have endeavored to generate sufficient premises to support our conclusions. However, premises are variable and unlimited, and there are other questions and, hopefully, other answers.

One such variation raises the possibility that a distributee may under some circumstances recognize capital gain or ordinary income in a one-month liquidation, while at the same time receiving a stepped-up basis for any depreciable property he receives. This would not be true under the facts hypothesized above for A-E Corporation. But suppose, contrary to the example, A-E Corporation found it necessary to invest only $400,000 in purchasing land and constructing the shopping center which now has a value of $500,000. Its balance sheet, after construction, and before going into operation, would then read as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage</td>
<td></td>
</tr>
<tr>
<td>Shopping Center</td>
<td>400,000</td>
</tr>
<tr>
<td>Indebtedness</td>
<td>$490,000</td>
</tr>
<tr>
<td>Capital Stock</td>
<td>10,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$500,000</td>
</tr>
<tr>
<td>Net Worth</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

On liquidation each of the five shareholders would realize gain in the amount of $20,000 ($100,000 in cash and other property with a fair market value of $500,000, minus indebtedness to which the property is subject in the amount of $490,000, divided by five, the number of distributees, minus $2,000, the basis of each shareholder's shares in the corporation). Because of the $100,000 cash distribution, all of the gain

89. For an example of how such a dissimilarity facilitates the establishment of the required degree of segregation, see Grace v. Commissioner, 20 Tax Ct. Mem. 1313 (1961).
90. Regulations Section 1-341-6(b)(4). Treas. Reg. § 1-341-6(b)(4).
realized would have to be recognized. But since the liquidating corporation would have no earnings history, all can be recognized at the capital gains rate, absent the application of section 341(a).

On liquidation, the basis for each one-fifth undivided interest would be increased from $80,000 to $100,000 ($98,000, the proportionate part of the total indebtedness on the property applicable to each one-fifth interest, plus $20,000, the amount of gain recognized, minus $20,000, the amount of cash received, plus $2,000, the basis of each shareholder for his shares). The same basis would carry over to ABGD & E. In other words, the basis of the property in the hands of A-E Corporation in the amount of $400,000 would be increased to a basis of $500,000 in the hands of the partnership. Taxes on a total of $100,000 would be paid at the capital gains rate by the shareholders, and an additional $100,000 in basis would be available to charge off in the form of depreciation deductions against future ordinary income. The same result would obtain if the shopping center had become subject to an indebtedness in excess of its basis as a result of subsequent borrowings rather than the initial financing or as the result of the taking of accelerated depreciation.

This type of transaction, by which an increased basis for depreciable property is obtained at the cost of a capital gains tax, is illustrative of what section 341 is said to have been intended to prevent. However,

91. Sections 333(e)(1) and (2) provide in substance that gain realized by a noncorporate recipient shall be recognized to the extent of his "ratable share" of the liquidating corporation's earnings and profits, and if he receives cash and/or securities acquired by the corporation after December 31, 1953, in excess of such ratable share, to the extent of such excess.

92. Section 333(e)(2) prescribes capital gains treatment for cash and post-1953 securities received by a noncorporate shareholder in excess of his "ratable share" of the liquidating corporation's earnings and profits.

93. Basis in the hands of a recipient in a Section 333 liquidation is determined by Section 334(c), which states that the basis of such property "shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him." No provision is made in the statute for indebtedness, either assumed by the distributee or subject to which he receives the property. However, Regulation Section 1.334-2 provides that the basis of property received in a one-month liquidation shall be determined by subtracting from the basis of the shares surrendered the amount of any cash received, and by adding recognized gain and "the amount of the unsecured, liabilities assumed by the stockholders," and, further, to the basis thus determined "for each property against which there is a lien, [there] should be added the amount of such lien . . . . Whether the mortgage indebtedness is assumed by the shareholders or the property is taken subject to the mortgage is immaterial."


95. See Boland, Collapsible Corporations Under the 1958 Amendments, 17 Tax L.
there is nothing whatever in the language of subsection (e) to preclude its applicability to one-month liquidations which are productive of capital gains. Nonetheless, at least until a few decided cases make it possible to predict how subsection (e) will be applied to a given fact situation, it would seem advisable not to lend added incentive to the Internal Revenue Service to press for the application of section 341(a), or, should the matter wind up in litigation, to so flavor the decisional context as to unfavorably influence the court's findings of fact, particularly where one or more of the shareholders is on the interpretive verge of dealership.

It is hoped that the foregoing account of subsection (e) prospects has not been unduly optimistic. The purported amnesty of the subsection must be viewed as through a glass darkly. It should probably not be relied upon other than in a very simple fact situation such as we have hypothesized here. Our analysis of subsection (e) in terms of its application to a one-asset corporation with an unusually high debt-equity ratio has obviated the necessity of wrestling with the concepts of net unrealized appreciation and net worth as used in the subsection. The one asset is either a subsection (e) asset or it is not. We have assumed that, if it is, the critical percentage of net worth has been exceeded and that the only way A-E Corporation can avoid collapsible corporation treatment is by a determination that its sole asset is not a subsection (e) asset.

No corporation should undertake a one-month liquidation in reliance on subsection (e) without a careful analysis of the factors outlined above as applied to the facts peculiar to the predicament in which it finds itself. Because of the present lack of any case decided or revenue ruling promulgated under the subsection, the preceding discussion has been highly speculative. It would be rash for anyone other than the most favorably situated group of shareholders—a group (including its constructive members) found upon careful study to include no dealers—to place major reliance on subsection (e). A real estate investor confronted with a problem of this nature can only console himself with Mr. Justice Holmes' stoic dictum: "Certainty generally is illusion, and repose is not the destiny of man."

Rev. 203; and Tax Management Portfolio No. 49, Collapsible Corporations—Special Exceptions, at A24.

96. Because of its "unforgivable complexity," subsection (e) "cannot be considered a significant contribution to the resolution of problems posed by collapsible corporations since its utility is necessarily limited to the most simple of factual situations." Tritt, Recent Developments in Collapsible Corporations, 19th So. Cal. Tax Inst. 143, 156 (1967).