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Taxation

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TAXATION

SALE OF STOCK IN A COLLAPSIBLE CORPORATION

Section 341 of the Internal Revenue Code of 1954 was recently amended.[1] Section 341 was originally enacted in 1950[2] to deny to "collapsible" corporation shareholders the normal tax advantages of the corporate form which existed under the Code. The "collapsible" corporation has been defined as a device used to convert ordinary income into long term capital gain by the use of a "temporary" corporation.[3] The "temporary" corporation would collapse before any income had been received. Upon collapse by liquidation no gain would be recognized to the corporation on the distribution of its property to its shareholders.[4] The property distributed to the shareholders on liquidation would be treated as an exchange in full for the stock in the corporation,[5] and since the stock is a capital asset,[6] capital gains rates would apply to the exchange. Income from non-capital assets had become long-term capital gain to the shareholders rather than ordinary income to the shareholders if there were no corporation, or to the corporation if it had continued in business.

In its usual and most effective form the "collapsible" corporation would be organized to produce or construct a product which would otherwise be treated as a non-capital asset in the hands of individuals. Upon completion, the product, *e.g.*, a motion picture or building development, would be valued at substantially more than its cost of production. The appreciated value of the property would not be realized as income to the corporation until its sale, exchange, or rental. Before this occurs, but after six months have elapsed, the corporation would collapse or liquidate itself. Since the corporation had not received any income from the product there would be no corporate income which could be taxed, and there would be no gain recognized to the corporation on distribution of its property to its shareholders in complete or partial liquidation. Thus, there would be no tax at the corporate level. Upon liquidation the assets would be distributed to the shareholders in exchange for their stock. On the exchange long-term capital gains rates would apply to the shareholders' recognized gain. The asset in the hands of the shareholder would acquire a basis equal to its fair market value at the time of the distribution.[7] This basis would be determinative of gain realized on any subsequent disposition of the asset by the shareholder. It can be seen that a non-capital asset which would have been taxed at ordinary income rates on disposition by an individual has

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1 78 Stat. 596 (1964).

2 Int. Rev. Code of 1939, § 117(m), 64 Stat. 994 (now Int. Rev. Code of 1954, § 341).

3 S. Rep. No. 2375, 81st Cong., 2d Sess. 45 (1950).

4 Int. Rev. Code of 1954, § 336. Although section 336 did not appear in the Code until 1954 there was a long established practice that no gain was recognized to a corporation on the distribution of property in partial or complete liquidation. Treas. Reg. 118, § 39.22(a)-20 (1952).

5 Int. Rev. Code of 1954, § 331.

6 Int. Rev. Code of 1954, § 1221.

7 Int. Rev. Code of 1954, § 334(a).

received capital gain treatment on its appreciated value through the utilization of the corporate form.

Remedial tax legislation was called for and Congress provided this in the Revenue Act of 1950.[8] This act created section 117(m) dealing with "collapsible" corporations. Section 117(m) declared that gain to the shareholders derived from a sale or exchange of stock, distribution in complete or partial liquidation, or certain partial distributions[9] of a "collapsible" corporation would be treated as gain from the sale or exchange of property which is not a capital asset. Thus, any gain realized by the shareholders in such sales or exchanges would be taxed as ordinary income. Without capital gain treatment to the shareholders in these situations the "collapsible" corporation would offer no tax advantage. The Internal Revenue Code of 1954, section 341, is substantially the same as section 117(m) of the 1939 Code.

The greatest difficulty in applying section 341 lay in the application of the definition of a "collapsible" corporation.[10] The difficulty arose from the interpretation of the words "with a view to." These words injected an intent element into the definition.[11] The Internal Revenue Service has taken the position that if there is a "recognized possibility" that the corporation will collapse then the sale of stock in such corporation will be subject to section 341(a)(1).[12] As a result of this interpretation of the statute, it was possible that shareholders, upon sale of their stock in the corporation, would be denied capital gain treatment on the sale, yet the corporation would continue in business. This result has been supported in the courts. In *Raymond G. Burge*[13] the court stated that section 341 may apply even

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[8] Int. Rev. Code of 1939, § 117(m), 64 Stat. 994 (1950).

[9] Partial distributions concern non-dividend distributions of corporate property to the shareholders. Under Int. Rev. Code of 1954, § 301(c), the amount distributed would be "applied against and reduce the adjusted basis of the stock." Any excess over the adjusted basis would be treated as gain from the sale or exchange of property. Thus capital gains rates would be applicable.

[10] A collapsible corporation is defined as:

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

Int. Rev. Code of 1954, § 341(b).

[11] Cf. Gluckman v. Comm'r, 256 F.2d 109 (2d Cir. 1958).

[12] Int. Rev. Code of 1954, § 341(a)(1) provides that gain from:

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

See Treas. Reg. § 1.341.2 (1955).

[13] 28 T.C. 246, aff'd, 253 F.2d 765 (4th Cir. 1958).

though a corporation is not "temporary" but continues in business. The result would be double taxation at ordinary income rates. The shareholder was taxed at ordinary income rates on the sale of his stock and the corporation would be taxed on the realized appreciated value of the produced asset at ordinary income rates. In such a situation the sale of stock may have incurred section 341 tax treatment unnecessarily.[14]

The latest amendment to section 341 is designed to alleviate this problem.[15] It is intended to apply to corporations which hold produced or constructed property worth substantially more than its original cost, and from which a substantial part of the income is yet to be realized. Hence, the corporation fits the definition of a "collapsible" corporation under section 341(b). Moreover, the corporation cannot qualify for any of the exceptions to section 341.[16] The fact that the corporation has no prior business history weighs against it on the question of intent to collapse.[17] Although the corporation intends to continue in business, the shareholders are deprived of capital gain treatment on the sale or exchange of their stock.

The amendment will allow such shareholders an opportunity to realize capital gain treatment on the sale or exchange of their stock. This will be accomplished if the corporation consents to a special tax treatment.[18] If the

[14] It should be noted that the tax treatment imposed on the sale of stock of a corporation which continues in business is not always inequitable. For example, if an individual held non-capital assets, such as a large block of inventory, and he was in a high tax bracket, he might attempt to set up a corporation and transfer the inventory to the corporation in exchange for stock. No gain would be recognized at this point. Int. Rev. Code of 1954, § 351(a). He could then sell the stock and receive capital gains treatment on the transaction. Even though the purchaser of the stock would continue the business of the corporation and be taxed on the income from the disposition of the inventory, the seller had converted an ordinary income transaction into one in which he received capital gain treatment.

[15] See S. Rep. No. 1241, 88th Cong., 2d Sess. 2 (1964).

[16] Section 341 would not apply if the shareholder owned less than 5% in value of the outstanding stock of the corporation; or if less than 70% of the gain recognized during the taxable year upon the stock in a "collapsible" corporation is attributable to such manufactured, constructed, or produced property; or if the portion of gain of a shareholder is realized more than three years after the actual completion of the manufacture, construction, production, or purchase of the property to which such portion is attributable. Int. Rev. Code of 1954, § 341(d)(1), (2), and (3).

Int. Rev. Code of 1954, § 341(e) may except a corporation from the section with respect to the sale or exchange of stock of the corporation by a shareholder if the net unrealized appreciation in "subsection (e) assets" (neither a capital asset nor property described in section 1231(b)) does not exceed an amount equal to 15% of the net worth of the corporation at the time of the sale or exchange.

[17] 1950-2 Cum. Bull. 546.

[18] Int. Rev. Code of 1954, § 341(f)(2):

> . . . if a subsection (f) asset . . . is disposed of at any time by a consenting corporation . . . , then the amount by which—
>
> (A) in the case of a sale, exchange, or involuntary conversion, the amount realized, or
>
> (B) in the case of any other disposition, the fair market value of such asset,
>
> exceeds the adjusted basis of such asset shall be treated as gain from the sale or exchange of such asset. Such gain shall be recognized notwithstanding any other provision of this subtitle, but only to the extent such gain is not recognized under any other provision of this subtitle.

corporation files a consent and the stockholder sells his stock within the following six months, the sale of stock receives the benefit of the amendment and is not subject to section 341(a)(1).[19]

The tax treatment attaching to the corporation is that any gain realized by a consenting corporation on the disposition of "subsection (f) assets" will be recognized to the corporation, notwithstanding other non-recognition provisions of Subtitle A of the Code.[20] Loss will continue to be non-recognized under these non-recognition provisions of the Code. "Subsection (f) assets" are non-capital assets owned by or, subject to an option to acquire, held by the consenting corporation at the time of the sale of stock. Land and unrealized receivables or fees are specifically made assets under the subsection.[21] If any manufacturing, construction, or production has commenced at the time of the sale of stock, the resulting product will be considered a "subsection (f) asset."[22] With respect to unimproved land, if any construction begins within two years after the sale of stock, the improvements will also be considered part of the "subsection (f) assets."[23]

If the corporation continues in business the appreciated value of the "subsection (f) assets" will be realized by the corporation in its normal business dealings (sale, rental, or exchange), and taxed to the corporation under the applicable provisions of the Code. If the corporation, contrary to expectations, fails to continue in business, then at this point the tax treatment attaching to its consent will operate to the corporation's disadvantage. The non-recognition provisions applicable to corporate distributions in liquidation will no longer be available. The corporation will be taxed on the unrealized appreciated value of the "subsection (f) assets" before any distribution to the shareholders if it sells such property, or upon distribution to the shareholders if it distributes the property in kind.

If the consenting corporation avoids "collapsible" corporation treatment upon liquidation, either because it no longer fits the definition, or because it has qualified for any of the exceptions to section 341, it still remains subject to the special tax treatment. This treatment will only be a disadvantage if the corporation has not had a very substantial realization of income from the "subsection (f) assets." The longer the corporation holds the assets the less likely this is to happen.

If the liquidation should take place while the corporation is still capable of being declared "collapsible," the fact that it has consented to the special tax treatment does not in any way affect the determination as to whether it is "collapsible" or not.[24] As a result there is a possibility

[19] Int. Rev. Code of 1954, § 341(f)(1):

> Subsection (a)(1) shall not apply to a sale of stock of a corporation . . . if such corporation . . . consents . . . to have the provisions of paragraph (2) apply. Such consent shall apply with respect to each sale of stock of such corporation made within the 6-month period beginning with the date on which such consent is filed.

[20] Int. Rev. Code of 1954, § 341(f)(2).

[21] Int. Rev. Code of 1954, § 341(f)(4)(A).

[22] Int. Rev. Code of 1954, § 341(f)(4)(B).

[23] Int. Rev. Code of 1954, § 341(f)(4)(C).

[24] S. Rep. No. 1241, 88th Cong., 2d Sess. 5 (1964).

of the corporation being taxed because of the loss of the non-recognition provisions, and then the shareholders being taxed at ordinary income rates on any gain realized in the distribution. The possibility is diminished when one considers that the remaining shareholders of the corporation, who have not sold their stock, would not have allowed the corporation to consent if there was even a remote chance of a subsequent collapse. If the sale of stock involves the entire stock issue there is no problem of a double taxation since the basis of the stock in the purchaser's hands will be the cost to him, which will presumably be equal to the appreciated value of the asset distributed. In this situation there will be little or no gain realized by the shareholder on the exchange of stock for the corporate assets.

The Senate Finance Committee indicated that the seller of the stock of a "collapsible" corporation will not derive any benefit from the amendment if the buyer intends to collapse the corporation for the value of its assets since the buyer's awareness of the impending tax liability will be reflected in the price to the selling shareholder.[25] The shareholders, in this situation, would not receive a price which would make it profitable for them to have the corporation consent.

The amendment provides an exception to the non-recognition provision of the special tax treatment incurred by a consenting corporation.[26] The non-recognition provisions of section 332 (complete liquidation of subsidiaries), section 351 (transfers to corporations controlled by transferor), section 361 (exchanges in reorganization), section 371(a) (transfers to another corporation in certain receivership and bankruptcy proceedings) and section 374(a) (transfers by a railroad corporation in receivership and bankruptcy) will be available to the transferor corporation despite its prior consent if the transferee corporation consents to the special tax treatment on its subsequent distribution of "subsection (f) assets." These exceptions are not available to the transferor if the transferee is a tax exempt organization.[27]

The amendment will go a long way to eliminate the unnecessary double taxation which prevailed in the tax treatment accorded shareholders of those corporations which intended to continue in business, but which could be classified as "collapsible" under the Code definition. The tax treatment imposed on consenting corporations will virtually insure that such corporations will continue operations and will not be prematurely collapsed.

There are certain problems raised by the special tax treatment, however. If the consenting corporation collapses during the period in which it could still be classified as "collapsible," not only will the corporation be taxed where it otherwise would not be, but the shareholders will be denied capital gain treatment on gain realized in the distribution of corporate assets. It would appear that the elimination of the non-recognition provisions at the corporate level, and the consequent tax treatment applied at that level, would assure that the unrealized appreciation in the value of "subsection (f) assets" would receive adequate tax treatment.[28] As indicated earlier,

[25] Id. at 3.

[26] Int. Rev. Code of 1954, § 341(f)(3).

[27] Int. Rev. Code of 1954, § 341(f)(3)(A).

[28] The Senate Finance Committee indicated that the tax treatment at the corporate

the purchaser of the stock sold under the consent will not feel the tax imposed on the shareholder level since the basis of his stock will normally equal the value of the distributed assets, and he will realize little or no gain as a result. Those shareholders, however, who have not sold their stock will be taxed at ordinary income rates on the gain realized computed on the original basis. This additional tax under section 341(a)(2) does not appear to have any reasonable relation to the problem to which the drafters of this amendment addressed themselves.

A further problem in the amended provision concerns the extensiveness of the elimination of the non-recognition provisions of the other Code sections. A literal reading of the "recognition of gain" provision indicates that any gain realized in the disposition of a "subsection (f) asset" will be recognized to the corporation "notwithstanding any other provision of this subtitle." It appears that the drafters of the amendment were primarily concerned with the non-recognition provisions relating to liquidations and partial distributions. The examples given in the Senate Report concerned recognition of gain in such liquidations and distributions.[29] There are other non-recognition provisions, however, which are seemingly unrelated to the intent and purpose of the amendment but which will not be available to the consenting corporation because of the all-inclusive language of the special tax treatment. The non-recognition provisions applying to exchanges of property held for productive use or investment,[30] or to involuntary conversions[31] are illustrative. For example, if a consenting corporation owned a truck used in its business at the time of the consent,[32] and later exchanged the truck for another, any gain realized in the transaction would be recognized to the corporation because of its consent to the special tax treatment. Normally, section 1031 could be utilized and there would be no gain recognized to the corporation in the transaction.[33] Again, there is no apparent relation between the tax treatment imposed in such a situation and the purpose and intent of the amendment.

The amendment presents possible pitfalls of which buyers of stock and corporations contemplating "consent" should be aware. Potential purchasers of stock in a corporation which has any indications of being of the "collapsible" type should determine whether a consent has been filed, and how

level would assure that there would be full recognition of unrealized appreciated value of "subsection (f) assets." S. Rep. No. 1241, 88th Cong., 2d Sess. 3 (1964).

[29] S. Rep. No. 1241, 88th Cong., 2d Sess. 6 (1964).

[30] Int. Rev. Code of 1954, § 1031.

[31] Int. Rev. Code of 1954, § 1033.

[32] The truck would normally fit the definition of a "subsection (f) asset," since it would be depreciable property and hence a non-capital asset. Int. Rev. Code of 1954, § 1221.

[33] It should be noted that if the truck could be treated as a "1231 asset" any gain recognized would be treated as capital gain. Int. Rev. Code of 1954, § 1231. While the special tax treatment would prohibit the use of the non-recognition provisions by the consenting corporation, the capital gain and loss treatment afforded certain non-capital assets by virtue of section 1231 would still be available. See S. Rep. No. 1241, 88th Cong., 2d Sess. 2 (Example 2) (1964). Nonetheless, the non-recognition provisions of sections 1031 and 1033 could not be availed of by the corporation to avoid tax altogether on the immediate transaction.

this consent will affect their investment, before they make the purchase. Corporations which are contemplating the filing of a consent under the amendment should carefully appraise their situation in light of the definition of a "collapsible" corporation, and the exceptions provided to the "collapsible" corporation treatment. It would be a needless and expensive consent which was not necessary because the corporation could qualify for any of the exceptions to the section 341 tax treatment.

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