

# THE TAX TREATMENT OF COLLAPSIBLE CORPORATIONS

BORIS I. BITTKER\*

*Introductory.*—Section 331(a)(1) of the Internal Revenue Code provides that a complete liquidation of a corporation is to be treated by the shareholder as a sale of his stock, which will ordinarily produce capital gain or loss, and section 334(a) provides that the shareholders' basis for property acquired on the liquidation is its fair market value at the time of distribution.<sup>1</sup>

These rules, which are of long standing, led to the tax avoidance device known as the "collapsible corporation," which in its turn led, in 1950, to the enactment of what is now section 341. As will be seen, section 341 reaches a good many corporations besides those at which it was aimed; and its application is not limited either to "temporary" corporations or to corporate liquidations.<sup>2</sup> Although section 341 has thus come to encompass a wide range of corporations and transactions, it can be understood best after the "collapsible corporation" itself is examined.

The collapsible corporation first attracted attention in the motion picture industry. A producer, director and leading actors would organize a corporation for the production of a single motion picture. They would invest small amounts of cash and agree to work for modest salaries, and the corporation would finance the production with borrowed funds. When the motion picture was completed, but before it was released for public exhibition, the corporation would be liquidated. The stockholders would report the difference between the

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\* Southmayd Professor of Law, Yale University.

1. INT. REV. CODE OF 1954, §§ 331(a)(1), 1221. Taken literally, the collapsible corporation provisions of the Code would refer to all corporations, foreign and domestic, Western Hemisphere Trade Corporations, and United States Possessions corporations. Although no mention of this is made by the Code or the Regulations, it has been suggested by Gibbons that these provisions may be applicable to a foreign corporation which does not have any property in the United States. See, GIBBONS, TAX FACTORS OF BASING INTERNATIONAL BUSINESS ABROAD 30 (1957).

2. See *Burge v. Commissioner*, 253 F.2d 765, 1 AFTR 2d 1214 (4th Cir. 1958); The word "collapsible" considered apart from its context would be somewhat misleading; but there can be no question, we think, as to what Congress meant by a "collapsible corporation" as used in the statute. That term was used to describe a corporation which is made use of to give the appearance of a long term investment to what is in reality a mere venture or project in manufacture, production or construction of property, with the view of making the gains from the venture or project taxable, not as ordinary income, as they should be taxed, but as long term capital gains. Because the basic type of transaction which gave rise to the legislation involved the use of temporary corporations which were dissolved and their proceeds distributed after tax avoidance had been accomplished, the term "collapsible corporation" was employed to describe the corporations used for this form of tax avoidance; but the statute was drawn in broad general terms to reach the abuse which had arisen, whatever form it might take. 253 F.2d at 767.

cost of their stock and the value of their proportionate shares in the completed film (established on the basis of previews) as long-term capital gain under 331(a) (1). For example, if their investment in the stock was \$10,000 and the value of the film (subject to a liability of \$100,000) was \$510,000, the shareholders' profit would be \$400,000, on which the capital gains tax would be \$100,000. Under section 334(a), the basis of the film in the hands of the shareholders would be \$510,000; and if the net rentals thereafter received equalled that amount, they would have no further gain or loss since the fair market value of the film could be amortized against the rentals.<sup>3</sup> In effect, the exhibition profit, which would have been taxed as ordinary income to the corporation had it not been liquidated (or to the producers if they had operated in noncorporate form from the outset) was converted into capital gain. Moreover, instead of two taxes (a corporate tax on the exhibition income and an individual tax at the capital gain rate on the liquidation), there would be only one.

The collapsible corporation was also used by builders and investors for the construction of homes in residential subdivisions. A corporation would be created to construct the houses, but it would be liquidated before the houses were sold. The stockholders would report as long-term capital gain the difference between the cost of their stock and the value of the completed houses. The houses, which thus acquired a "stepped-up" basis under section 334(a) equal to their fair market value at the time of distribution, would then be sold, ordinarily with no further gain or loss to be accounted for. Here again, only one tax would be paid instead of two, and that one would be computed at the capital gain rate.

*Nonstatutory weapons against the collapsible corporations.*—Even without specific statutory authority, the Treasury was not entirely helpless in the face of the collapsible corporation. If the promoters receive inadequate salaries, something could be said for treating the stock of the corporation as additional compensation, taxable as ordinary income. Another possibility would be to treat the whole transaction as an ineffective anticipatory assignment of income, relying on the principle of *Lucas v. Earl*,<sup>4</sup> that the tax cannot "be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. . . ." Another argument open to the Treasury was that the collapsible corporation lacks substance and

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3. If the proceeds exceeded, or fell short of, the estimated fair market value, the shareholders would have additional income or deductible loss. In *O'Brien v. Commissioner*, 25 T.C. 376 (1955), it was held that income in excess of the film's basis was taxable as ordinary income. But see *Brodsky & King, Tax Savings Through Distributions in Liquidation of Corporate Contracts*, 27 TAXES 806 (1949).

4. 281 U.S. 111, 115, 8 AFTR 10,287 (1930).

that the arrangement should be taxed as a joint venture of the alleged stockholders.<sup>5</sup>

So far, however, the Treasury has been unsuccessful in two efforts to attack the collapsible corporation with these nonstatutory weapons. One of these cases was not an entirely fair test of the cogency of the nonstatutory arguments since the liquidation of the corporation there involved was not prearranged but resulted from a change in plans after one film had been completed.<sup>6</sup> But when the Tax Court came to pass on a collapsible corporation whose liquidation was apparently contemplated at its inception, it described *Herbert v. Riddell* as "almost identical," and similarly held for the taxpayers.<sup>7</sup> While these initial setbacks would not have entirely foreclosed the development of a nonstatutory weapon against the collapsible corporation, the Treasury quite naturally shifted in 1950 to its newly enacted statutory weapon and evidently gave up on pre-1950 transactions after its losses in the *Herbert* and *O'Brien* cases.<sup>8</sup>

*The framework of 341.*—Although the details of section 341 are quite intricate, its basic principle is simple: a shareholder who disposes of his stock in a collapsible corporation in a transaction that would ordinarily produce long-term capital gain must instead report the gain as ordinary income. As applied to the Hollywood collapsible corporation described above, section 341 (a) would compel the shareholders to report their \$400,000 gain on the corporation's complete liquidation as ordinary income, a result which may well be more costly than allowing the corporation to remain alive to realize the income from the film with a view to ultimate liquidation. If section 341 (a) were applicable only to complete liquidations, however, the shareholders would be able to escape by means of one of the following devices:

1. A corporate distribution of the property without a surrender of stock, since under 301(c) (1) (A) the excess of the value of the property over the shareholders' basis for their stock would ordinarily be taxed as long-term capital gain.
2. A sale or exchange of the stock.<sup>9</sup>

5. See Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 439-48 (1950).

6. *Herbert v. Riddell*, 103 F. Supp. 369, 41 AFTR 961 (S.D. Cal. 1952).

7. *O'Brien v. Commissioner*, *supra* note 3. See also *Gross v. Commissioner*, 236 F.2d 612, 618, 50 AFTR 68 (2d Cir. 1956), upholding the Tax Court's refusal to "impute" a salary to corporate officers who preferred to take their profits on a venture in the form of distributions on their stock.

8. But see *Jacobs v. Commissioner*, 224 F.2d 412, 47 AFTR 1445 (9th Cir. 1955).

9. The new shareholders would of course be concerned about the corporation's low basis for its assets, but they could liquidate the corporation without tax cost (since the value of the liquidating distribution would presumably be equal to the price paid for the stock). The property would thereupon take on a new basis equal to its value, either under § 334(a), or, if the buyer

3. A partial liquidation of the corporation, if the criteria of section 346 could be satisfied.

In recognition of the fact that the above arrangements might be used as a substitute for a complete liquidation, section 341(a) provides that gain so realized shall, to the extent that it would otherwise be long-term capital gain, be considered as gain from the sale or exchange of a noncapital asset.<sup>10</sup>

Section 341(a) is applicable only if the shareholder's gain would otherwise be long-term capital gain. The omission of short-term capital gain from section 341(a) is surprising since it permits the collapsible corporation to retain its old advantages for the shareholder who has capital losses that can be offset against any short-term capital gain realized on the liquidation or sale. Section 341(a) is also inapplicable to losses. Finally, section 341(a) applies to gain that otherwise "would be considered" as long-term capital gain, but it does not of its own force make gain taxable, with the result that it will have no effect upon a tax-free exchange, *e.g.*, under section 351 or section 1036.

Aside from the basic rules of section 341(a), the statute consists of (a) a definition of the term "collapsible corporation"; (b) a statutory presumption in aid of the definition; and (c) two sets of limitations that moderate the rules of section 341(a) in certain circumstances. These aspects of section 341 will be examined in the remaining sections of this chapter.

Two other limitations on the collapsible corporation are:

1. Section 337 (nonrecognition of corporate gain or loss on certain sales in conjunction with a complete liquidation) is not applicable to a

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was a corporation, under § 334(b)(2) the statutory "Kimbell-Diamond" rule, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951).

10. There is a curious omission from this pattern: a distribution in redemption of stock that is treated as long-term capital gain under § 302(a). The omission, which probably stems from carrying forward the pre-1954 reference to "partial liquidations" without noting that this term in the 1954 Code no longer includes stock redemptions, Rev. Rul. 57-387, 1957-2 Cum. BULL. 225, may be neutralized by the fact that most distributions by collapsible corporations will reflect a "corporate contraction" so as to constitute partial liquidations, which are covered by § 341(a)(2). In an effort to bring distributions by collapsible corporations within § 341(a)(2), the government may have to construe the term "partial liquidation" expansively, contrary to its usual position.

It is also possible that a § 302(a) redemption could be brought within § 341(a)(1), as a "sale or exchange" of stock, though this theory would be open to the objection that the Regulations require an "actual" sale or exchange, Treas. Reg. § 1.341-1 (1955); moreover, it would render the inclusion of partial liquidations in § 341(a)(2) redundant, since if a § 302(a) redemption is covered by § 341(a)(1), so would be a § 346 redemption. Note, however, that the term "sale or exchange" is used in § 341(c) to include partial and complete liquidations—or at least so the Regulations assume. Treas. Reg. § 1.341-3(a) (1955).

collapsible corporation "as defined in section 341(b)."<sup>11</sup> This limitation was partly relaxed in 1958.

2. Section 333 (nonrecognition of shareholder gain on elective one-month liquidations) is not applicable to "a collapsible corporation to which section 341(a) applies."<sup>12</sup> In 1958, a limited group of collapsible corporations became eligible for the benefits of section 333.<sup>13</sup>

*The definition of "collapsible corporation."*—The term "collapsible corporation" is defined by section 341(b) to mean a corporation that was formed or availed of:

1. Principally for the manufacture of property (or for certain other activities to be discussed below);
2. With a view to (a) a sale, liquidation, or distribution before it has realized a substantial part of the taxable income to be derived from the property, and (b) a realization by the shareholders of the gain attributable to the property.<sup>14</sup>

If we take the extreme case of a corporation that is organized solely to manufacture one motion picture and that, by agreement among the shareholders at the time of its creation, is to be liquidated as soon as the film is completed and before any income is received by the corporation, the applicability of section 341(b) is indisputable. Moreover, the use of an existing corporation for these purposes will not escape section 341(b), which deliberately employs the phrase "formed or availed of."

Since many—perhaps most—ordinary business corporations are "formed or availed of principally for the manufacture, construction or

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11. If § 337 were applicable to collapsible corporations, the punitive provisions of § 341 would be nullified. For the corporation would then be able to sell its assets, avoiding the recognition of gain under § 337, while the shareholders would escape § 341(a), because the corporation would have realized (though without recognizing) its gain, and hence would not be a collapsible corporation within the meaning of § 341(b). To protect § 341, therefore, § 337 is made inapplicable to collapsible corporations by § 337(c)-(1)(A). This limitation was partially relaxed in 1958; see § 341(e)(4).

12. Rev. Rul. 57-491, 1927-2 CUM. BULL. 232 holds that this restriction does not apply if the shareholders of the collapsible corporation can escape § 341(a) by bringing themselves within § 341(d)(3).

13. For analyses of § 341 as amended by the 1954 Code, see DeWind & Anthoine, *Collapsible Corporations*, 56 COLUM. L. REV. 475 (1956); *A Re-Examination of Collapsible Corporations "With a View To" Coexisting with Section 341*, 1956 So. CAL. TAX INST. 549; Weyher & Bolton, *Collapsible Corporations as Affected by the 1954 Code—Inventory and Unrealized Receivables*, 13th N.Y.U. INST. ON FED. TAXATION 657 (1955). Earlier discussions are MacLean, *Collapsible Corporations—The Statute and Regulations*, 67 HARV. L. REV. 55 (1953); Boland, *Practical Problems of the Collapsible Corporation*, 10th N.Y.U. INST. ON FED. TAXATION 657 (1955); Greenfield, *Effect of Collapsible Corporation Provisions on Real Property Holding*, *id.* at 91.

14. In the interest of simplicity, the statutory definition has been paraphrased; some nuances have been sacrificed in order to concentrate on the major issues.

production of property," the major issue under section 341(b) is the existence of the requisite "view" to a sale, liquidation or distribution before the corporation has realized a substantial part of the income to be derived from the manufactured property. From section 341's enactment in 1950 until very recently, the commentators debated whether the word "principally" in section 341(b) refers only to "manufacture," or also modifies the phrase "with a view to," since the statute would be appreciably narrowed if the corporation had to be formed or availed of "principally" with a view to a sale, liquidation or distribution before realizing a substantial part of the income attributable to the property. The Regulations rejected this restriction from the outset,<sup>15</sup> and two appellate courts have now done the same.<sup>16</sup>

The "classic" collapsible corporation was one whose shareholders planned at the outset to liquidate it before corporate income was realized. The Regulations, however, say that section 341(b) embraces any corporation, if a sale, liquidation or distribution before it has realized a substantial part of the gain from the property "was contemplated, unconditionally, conditionally, or as a recognized possibility."<sup>17</sup> This seems to suggest that the requisite "view" exists whenever the controlling shareholders of a manufacturing corporation consciously realize that they may decide—if the price is "right"—to sell the corporation before it has realized the income from the manufactured property. Of course, the statutory definition requires that the "view" embrace not only a sale, liquidation or distribution before the corporation has realized a substantial part of the taxable income, but also the realization of gain attributable to the property by the shareholders;<sup>18</sup> but the latter requirement will be satisfied almost automatically if the property has appreciated in value. Nor will the shareholder find much solace in the requirement that the "view" exist during the manufacturing process,<sup>19</sup> especially since it is very uncertain when that process can be said to have terminated. Finally, the Regulations state that the persons whose "views" govern are "those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise."<sup>20</sup> This may be hard on

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

16. *Weill v. Commissioner*, 252 F.2d 805, 1 AFTR 2d 1096 (2d Cir. 1958) ("The corporation may be treated as collapsible if 'manufacture, construction, or production' was a principal corporate activity even if the 'view to' was not the principal corporate objective when the corporation was 'formed or availed of . . . .'"); *Burge v. Commissioner*, 253 F.2d 765, 1 AFTR 2d 1214 (4th Cir. 1958) (The argument that "principally" modifies "view" is "without support of any rule of law or of grammar with which we are familiar").

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

18. Section 341(b)(1)(B).

19. Treas. Regs. § 1.341-2(a)(3) (1955).

20. Treas. Regs. § 1.341-2(a)(2) (1955).

minority shareholders, but without such a rule section 341 could be too easily nullified by keeping one shareholder in the dark.

It must be concluded, therefore, that the Regulations appear to bring within section 341 any corporation that is formed or availed of principally for the manufacture of property,<sup>21</sup> if the persons in control recognize the possibility of selling their stock or liquidating the corporation at a profit before it has realized a substantial part of the income from the property. Moreover, the natural tendency of administrators and judges to assume that what did happen was intended will probably lead to an emphasis on the objective results as distinguished from the shareholders' intent. This shift in emphasis can be seen in the Regulations, which provide that a corporation will "ordinarily" be considered collapsible if a shareholder sells his stock or receives a liquidating or other nondividend distribution, provided (a) he realizes gain attributable to property manufactured by the corporation, (b) the manufacture of this property was a substantial corporate activity, and (c) the corporation has not realized a substantial part of the taxable income to be derived from the property.<sup>22</sup> It is of course possible that in time the courts will come to require proof that an early sale or liquidation of the corporation was more than a "recognized possibility" before finding that the requisite "view" existed, but until that occurs, the taxpayer will have to look elsewhere for refuge from section 341.

One mode of escape is suggested by the Regulations which provide that the corporation will ordinarily not be a collapsible corporation if the sale, liquidation or distribution "is attributable solely to circumstances which arose after the manufacture . . . other than circumstances which reasonably could be anticipated at the time of such manufacture . . ." <sup>23</sup> This limit on section 341 is less useful than it might appear to be at first glance, because of the difficulty of proving that the cause of the sale, distribution or liquidation could not have been anticipated during manufacture,<sup>24</sup> as well as because the manufacturing process may include, under section 341, activity long after the process is regarded as complete for other purposes.<sup>25</sup>

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21. Treas. Regs. § 1.341-5(b) (1955).

22. Treas. Regs. § 1.341-2(a)(3) (1955).

23. For an example, see Rev. Rul. 57-575, 1957-2 CUM. BULL. 236 (sale of property to United States under a statute whose enactment was not anticipated).

24. *Rechner v. Commissioner*, 30 T.C. 186 (1958).

25. See *Glickman v. Commissioner*, 256 F.2d 108, 1 AFTR 2d 1883 (2d Cir. 1958), holding that the construction of an apartment project was not complete when the municipal authorities issued a final certificate of occupancy, since the landscaping was not then complete and the F.H.A. inspector had not yet made his final inspection. See also the Tax Court opinion in the same case, 57,124 P-H Memo TC, suggesting that the term "construction" included the obtaining of tenants for the project. In the appellate opinion, moreover, the portion of the Regulations quoted above was found to be too liberal to

A more promising escape is afforded by section 341(b)(1)(A), providing that the "view" must embrace a sale, liquidation or distribution "before the realization by the corporation manufacturing . . . the property of a substantial part of the taxable income to be derived from such property." Evidently "the taxable income to be derived" from the property means the taxable income that would be realized if the property were sold at the time the shareholder's gain arises.<sup>26</sup> If a substantial part of this amount has in fact been realized, the corporation is not "collapsible."<sup>27</sup> It is reported that at one time the Internal Revenue Service would rule that fifty percent was "substantial," so that upon realizing that portion of the total income to be derived from the property, the corporation would be free of section 341.<sup>28</sup> While ordinarily one might safely assume that as little as fifteen or twenty percent of a given amount is "substantial," the purpose of section 341 would be undermined if absolute were granted at such a low price.<sup>29</sup> The result in this case, where only ten percent of the profit was realized before liquidation, can be easily defended; but it is difficult to find support in the statute for its theory that a substantial amount of *unrealized* income is fatal.<sup>30</sup> The statute is clearly defective in this respect, since the realization by the corporation of a substantial part of the taxable income—even if it is fifty percent or more—may leave plenty of life in the collapsible corporation device; and the *Abbott* case may represent a judicial effort to give section 341 an application more in keeping with its purpose.<sup>31</sup> In addition to the problem of determining how much income is "substantial," section 341(b)(1)(A) poses difficult questions for the corporation that engages in more than one

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the taxpayers on the ground that the requisite "views" suffices if it exists at any time during the corporation's life, although the decision does not rest on this ground.

26. *Levensen v. United States*, 157 F. Supp. 244, 1 AFTR 2d 446 (N.D. Ala. 1957); see also *Sidney v. Commissioner*, 30 T.C. 1155 (1958).

27. In theory, the amount *actually* realized is irrelevant, and the amount which the shareholders *intended* the corporation to realize is controlling. But this would make the corporation collapsible even if all the income had in fact been realized by it, provided the shareholders had earlier entertained the "view" that the income should not be realized by the corporation. The Regulations, perhaps treating the events as they occur as the best evidence of what was intended, clearly imply that actual—rather than intended—realization is controlling. Treas. Reg. §§ 1.341-2(a)(4), 1.341-5(c)(2) (1955).

28. See *Levenson v. United States*, *supra* note 26 (51% held to be "substantial"; "it is inconceivable to this court that the realization of more than 50% . . . should not be regarded as substantial").

29. See also *Abbott v. Commissioner*, 258 F.2d 537, 542, 2 AFTR 2d 5479 (3d Cir. 1958), stating that "The real question posed by the statute . . . is not whether a substantial part of the total profit was realized prior to dissolution, but rather whether that part of the total profit realized [by the shareholders] after dissolution was substantial . . ."

30. For a similar approach, see Treas. Reg. § 1.341-5(c)(2) (1955), which, however, does not purport to be an exhaustive interpretation of § 341(b)(1)(A).

31. See *supra* note 29.



activity. If the corporation constructs two office buildings, for example, has it realized a "substantial" part of the taxable income if it sells one building outright at a profit of \$50,000 but takes no steps to realize any part of its potential profit (\$12,000) on the second? The Regulations take the position that the realization of all the income from the first building does not excuse the failure to realize a substantial part of the income from the second.<sup>32</sup>

The foregoing exposition has concerned itself with corporations formed or availed of principally for the "manufacture" of property. In point of fact, the statute uses the phrase "manufacture, construction, or production" of property, which may bring into the collapsible category a somewhat wider range of transactions.<sup>33</sup> Although at first blush the phrase "manufacture, construction, or production" seems to imply the process of altering the physical characteristics of property, it is possible that it will be construed to embrace promotional activity resulting in good will or consumer demand for a product or, conceivably, for services.

Even if the corporation does not engage in the "manufacture, construction, or production of property," it may fall within section 341 by engaging in the "purchase" of so-called "section 341 assets," provided this is done with a "view" to a sale, liquidation or distribution before it has realized a substantial part of the taxable income to be derived from such property. This portion of the definition (which was enacted in 1951 and expanded in 1954) is primarily aimed at the use of collapsible corporations to convert the profit on inventory property and stock in trade into capital gain:

The procedure used was to transfer a commodity to a new or dormant corporation, the stock of which would then be sold to the prospective purchaser of the commodity who would thereupon liquidate the corporation. In this manner the accretion in the value of the commodity, which in most of the actual cases was whisky, would be converted into a gain realized on the sale of stock of a corporation, thus opening the possibility

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32. Treas. Reg. § 1.341-5(d), Example (2), (1955). But see Treas. Reg. § 1.341-2(a)(4) (1955), treating "an integrated project involving several properties" as a single unit in determining whether a substantial part of the income has ever been realized; and note also Examples (3) and (4) of Treas. Regs. § 1.341-5(d) (1955).

33. For the scope of the term "manufacture, construction, or production," of property, see the *Glickman* case, *supra* note 25; *Abbott v. Commissioner*, *supra* note 29; *Weil v. Commissioner*, 28 T.C. 809 (1957), *aff'd per curiam*, 252 F.2d 805, 1 AFTR 2d 1096 (2d Cir. 1958) (Partial completion, near completion, or even substantial completion are thus not effective substitutes for full completion of the construction; Treas. Reg. § 1.341-4(c)(3) (1955), stating that gain on unimproved property is within § 341 if attributable to improvements made by the corporation on adjacent property; Rev. Rul. 57-346, 1957-2 CUM. BULL. 236, ruling that § 341 reaches appreciation in the value of unproved oil leases because their value had been enhanced by wells drilled by the corporation on other leases; Rev. Rul. 56-137, 1956-1 CUM. BULL. 178 (rezoning property preparatory to building thereon constitutes "construction").

that it would be taxed as a long-term capital gain. H. R. Rep. No. 586, 82d Cong., 1st Sess. (1951). (Reprinted in 1951-2 Cum. Bull. 357, 375.) If the transaction described by this committee report were sufficiently blatant, the corporation might be treated as a sham so that the owner would be regarded as selling the assets themselves,<sup>34</sup> or the repeated use of the device might lead to the conclusion that the corporate stock was held for sale in the ordinary course of business, which would make the capital gain provisions inapplicable. It was evidently thought, however, that a statutory tool would be preferable to the "single transaction" doctrine employed in the *Jacobs* case.<sup>35</sup> Under section 341 as amended, every corporation holding appreciated inventory or stock in trade would be a potential target for section 341, and its fate would depend on whether the elusive "view" were present; but the Regulations cut down the scope of the statute by conferring immunity on the corporation if its inventory property—more precisely, the property described in section 341(b)(3)(A) and (B)—is normal in amount and if it has a substantial prior business history involving the use of such property.<sup>36</sup> It will be noted that appreciated inventory property will get a stepped-up basis at the long-term capital gain rate if distributed in a liquidation to which section 341(a) does not apply.

The 1951 amendment brought into section 341 inventory property, stock in trade, and property held primarily for sale to customers in the ordinary course of trade or business—the categories now found in section 341(b)(3)(A) and (B). In 1954, section 341 was expanded to reach a purchase of "unrealized receivables or fees" and certain property described in section 1231(b) by section 341(b)(3)(C) and (D). At the same time, the generic label "section 341 assets" was created for the property reached by both the 1951 and the 1954 legislation.

Although the Senate Report on the 1954 Code does not explain the extension of section 341 to cover a purchase of "unrealized receivables or fees,"<sup>37</sup> presumably Congress sought thereby to prevent tax avoid-

34. *Jacobs v. Commissioner*, 224 F.2d 412, 47 AFTR 1445 (9th Cir. 1955).

35. The language employed by § 341(b) to reach the device described in the text is somewhat awkward: it might be argued that the corporation was not formed or availed of for the purchase of stock in trade, inventory property or property held for sale to customers—as required by § 341(b)(3)(A) and (B)—since the whisky in question was not to be sold by the corporation. The Regulations, in accord with the obvious legislative intent, state that the status of the property is to be determined without regard to the collapsibility of the corporation, i.e., if the whisky would be inventory in the hands of a "normal" corporation, it will have the same status in the hands of the collapsible corporation.

36. Treas. Reg. § 1.341-5(c)(1) (1955). See also Rev. Rul. 56-244, 1956-1 CUM. BULL. 176 (inventory, though appreciated in value, was normal in amount for volume of sales and not in excess of average inventory over preceding several years; corporation held not collapsible).

37. Despite the definition of "unrealized receivables or fees" in § 341(b)(4)—or perhaps because of it—the term is most ambiguous, especially as con-

ance by an individual on a cash basis by means of a transfer to a corporation of his rights to collect fees or the sales price of goods (which would produce ordinary income on collection), to be followed by a sale of the stock or liquidation of the corporation at the capital gain rate. The inclusion of section 1231(b) property in the category of "section 341 assets" is less clear, since capital gain can ordinarily be realized on the sale of such property without resort to the use of a collapsible corporation. The change may have been intended to prevent dealers in apartment houses or other rental property from converting ordinary income into capital gain through the use of a separate corporation for each parcel of property (a device that might have been defeated without resort to section 341 by treating the corporate stock as held for sale and hence, under section 1221(1), as a non-capital asset); but the statute is written in broader terms.<sup>38</sup>

Another unexplained 1954 change is the limitation of the term "section 341 assets" to property held for a period of less than three years. Because of this limitation, if a commodity is held by the corporation for more than three years (including the holding period of certain predecessors) after manufacture, construction, production or purchase has been completed, the shareholders can sell their stock or liquidate the corporation without running afoul of section 341(a).<sup>39</sup>

To safeguard its statutory purpose, section 341 provides that a corporation "shall be deemed to have manufactured, constructed, produced, or purchased property" if any of the following conditions are satisfied:

1. If the corporation engages in manufacture, construction, or production of property "to any extent." Section 341(b)(2)(A). By virtue of this provision, the corporation need not have originated or completed the process of manufacture, construction or production; any step is sufficient.
2. If the corporation holds property having a basis determined by reference to the cost of such property in the hands of a person who manufactured, constructed, produced or purchased it. Section 341

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cerns the status of rights under long-term contracts. For some of the difficulties, see DeWind & Anthoine, *Collapsible Corporations*, 56 COLUM. L. REV. 475, 497-502 (1956). Note also that the "unrealized receivables or fees" must have been "purchased" by the corporation. This implies the acquisition of a chose in action from a third party, but it is essential to the statutory purpose to include accounts receivable resulting from the corporation's own sale of merchandise or performance of services.

38. The breadth of this part of § 341 seems to be responsible for a 1958 amendment, entirely excluding certain corporations from § 341, *infra* at p. 142.

39. If property is transferred to a corporation to be held for more than three years for the sole purpose of obtaining capital gain on the sale or liquidation of the corporation, the transaction might be attacked as a sham without resort to § 341. *Jacobs v. Commissioner*, *supra* note 34. Or, if the "aging" process enhanced the value of the property, it might constitute the "manufacture, construction, or production of property."

(b) (2) (B). This provision reaches such devices as the transfer of manufactured property or "section 341 assets" to a corporation by a tax-free exchange under section 351, or the use of a second corporation into which a collapsible corporation is merged. The statute does not state whether the successor corporation inherits not only the collapsible property, but also the requisite "view."

3. If the corporation holds property having a basis determined by reference to the cost of property manufactured, constructed, produced, or purchased by it. Section 341 (b) (2) (C). Because of this provision, it will be impossible to escape section 341 by causing a corporation to manufacture property and to transfer it by a tax-free exchange (e.g., under section 1031(a) or in a corporate reorganization), under a plan calling for the sale or liquidation of the corporation following the exchange and before realizing income from the newly-acquired property.

A further buttress to section 341 is the inclusion of holding companies in the term "collapsible corporation." If a corporation is employed to hold the stock of a manufacturing corporation, the parent corporation will be a "collapsible corporation" by virtue of section 341 (b) (1) if it is formed or availed of with a "view" to a sale, liquidation or distribution before the manufacturing corporation has realized a substantial part of the taxable income from the property. In Rev. Rul. 56-50, 1956-1 *Cumulative Bulletin* 174, it was held that the holding company becomes noncollapsible (so as to protect its shareholders) if it sells the stock of the subsidiary and is taxed under section 341 (a) on its gain, notwithstanding some difficulty in bringing this result within the literal terms of the statute.

*The rebuttable presumption of collapsibility: section 341(c).*—In 1954, section 341 was amended to add a rebuttable presumption of collapsibility if the fair market value of the corporation's "section 341 assets" is (a) fifty percent or more of the fair market value of its total assets and (b) percent or more of the adjusted basis of such "section 341 assets." The theory of the rebuttable presumption is that if the "section 341 assets" are substantial in amount and have risen significantly in value above their basis, it is reasonable to place the burden of proof disproving collapsibility on the taxpayer.<sup>40</sup> In order to prevent manipulation, section 341(c) (2) provides that cash, stock and certain securities are to be disregarded in determining the corporation's "total assets"; otherwise, the shareholders of a corpora-

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40. Even without the presumption of § 341(c), the taxpayer has the burden of overcoming the presumption of correctness that accompanies the Commissioner's action in assessing a deficiency. What, if any, weight § 341(b) adds to this nonstatutory presumption is doubtful. Perhaps it is only "a handkerchief thrown over something covered by a blanket," as Randolph Paul said of an analogous statutory presumption. PAUL, *FEDERAL ESTATE AND GIFT TAXATION* 92 (Supp. 1946).

tion whose "section 341 assets" have appreciated substantially in value might attempt to avoid the statutory presumption by contributing liquid assets to the corporation's capital to dilute the value of the "section 341 assets" to less than fifty percent of the total assets. Perhaps the "business purpose" doctrine could be used by the Commissioner as an alternative weapon against an attempt to drown the corporation's "section 341 assets" in a sea of other assets by contributions to capital having no nontax purpose.

In applying the presumption of section 341(c), the appreciation in "section 341 assets" is measured against their basis, not against the shareholders' investment. Thus, if the shareholders invest \$15,000 in a corporation, and it constructs "section 341 assets" as a cost of \$100,000 (represented by \$15,000 of equity investment and \$85,000 of borrowed funds), the presumption of section 341(c) will not be applicable if the assets increase in value to only \$115,000 (this being less than 120 percent of their basis), even though the appreciation represents a profit of 100 percent on the shareholders' investment. If the assets increased in value to \$120,000, however, section 341(c) would become applicable; and this would be true even if the shareholders had financed the entire cost of construction (\$100,000) with their own funds and had enjoyed a gain of only twenty percent on their investment.

Since the presumption of section 341(c) is rebuttable, it is open to the taxpayer to establish that the corporation is not "collapsible" because it was not formed or availed of principally for the purposes set out in section 341(b) or because the requisite "view" did not exist. Section 341(c) also provides that its inapplicability shall not give rise to a presumption that the corporation was not a collapsible corporation.

*The statutory limitations of section 341(d).*—Even though the corporation is "collapsible" under the foregoing principles, section 341(d) makes the punitive rules of section 341 inapplicable to a shareholder unless *all three* of these conditions are satisfied:

1. *More than 5 percent of stock.*—The shareholder is not subject to section 341 unless he owns (a) more than five percent in value of the outstanding stock, or (b) stock that is attributed to another shareholder who owns more than five percent of the stock.<sup>41</sup> The ownership of stock is to be determined under a set of constructive ownership rules, and the specified amount of stock will be fatal if owned when the manufacture, construction or production of property is begun, when "section 341 assets" are purchased, or at any time thereafter.

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41. See *Butler v. Patterson*, 148 F. Supp. 197, 50 AFTR 1504 (N.D. Ala. 1957).

2. *Seventy percent of gain attributable to collapsible property.*—Section 341 is not applicable to the shareholder's gain during a taxable year unless more than seventy percent is attributable to the manufactured, constructed, produced, or purchased property. By virtue of this limitation, section 341(a) becomes inapplicable if thirty percent or more of a shareholder's gain in a particular taxable year is attributable to noncollapsible property.<sup>42</sup>

3. *Gain after expiration of three years.*—Finally, section 341 is inapplicable to gain realized by a shareholder after the expiration of three years following the completion of manufacture, construction, production or purchase of the collapsible property. This is a treacherous exception, since the breadth of the term "manufacture, construction or production" makes it very difficult to say when the process has been "completed."<sup>43</sup>

*The amnesty of section 341(e).*—Section 341(e), enacted in 1958, ameliorates the rigors of the collapsible corporation provisions in four respects:

1. *Sale or exchange of stock.*—If certain conditions are satisfied, a shareholder's gain on the sale or exchange of the stock of an otherwise collapsible corporation is exempted from section 341(a)(1), and hence will be taxed as long-term capital gain.

2. *Complete liquidation.*—In certain circumstances, a shareholder's gain on the complete liquidation of an otherwise collapsible corporation is exempted from section 341(a)(2), and hence will be taxed as long-term capital gain.

3. *Eligibility for section 333.*—Certain otherwise collapsible corporations are made eligible for the benefits of section 333 (elective nonrecognition of shareholder gain on one-month liquidations<sup>44</sup>).

4. *Eligibility for section 337.*—Certain otherwise collapsible corporations are made subject to section 337 (nonrecognition of corporate gain or loss on sales within 12 month period following adoption of plan of complete liquidation<sup>45</sup>).

The exemptions described in categories one and two above are granted shareholder-by-shareholder so that some shareholders of a corporation may qualify while others do not. The exemptions of categories three and four, however, are granted to the corporation itself, so that all shareholders of the corporation will benefit if the specified

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42. Treas. Reg. § 1.341-4(c)(4) (1955). See also Glickman v. Commissioner, *supra* note 25.

43. *Supra* at note 25. In Rev. Rul. 57-491, 1957-2 CUM. BULL. 232, it was held that the three-year period of § 341(d)(3) includes the holding period of certain predecessors.

44. See p. 133 *supra*.

45. See p. 132 *supra*.

conditions are met. Section 341(e), it will be noted, does not apply to gain realized on a partial liquidation or on a distribution in excess of the basis of stock; these transactions remain subject to the unabated vigor of section 341(a) (2) and (3).

Section 341(e) is intended solely as a relief measure: it establishes a zone of safety, and any shareholder who can bring himself within this zone is protected against the collapsible corporation provisions, regardless of the nature of the corporation. Section 341(e) also provides that the failure to meet its requirements shall not be taken into account in determining whether a corporation is a collapsible corporation under the statutory definition of section 341(b), and that this determination shall be made as if section 341(e) had not been enacted.<sup>46</sup>

The provisions of section 341(e) stem largely, though not entirely, from the 1954 changes in section 341<sup>47</sup> under which a corporation formed to purchase section 1231(b) property (e.g., an apartment house) may be a collapsible corporation by virtue of section 341(b) (3) (d), although the shareholders could in the alternative have acquired the property as individuals and reported their gain on a sale as long-term capital gain unless they were dealers in such property. It is perilous to summarize the fearfully intricate conditions of section 341(e), but its underlying theory is that the collapsible corporation provisions should not be applicable if the net unrealized appreciation in the corporation's "subsection (e) assets" (roughly speaking, property held by the corporation which would produce ordinary income if sold either by the corporation itself or by its shareholders) amounts to less than fifteen percent of the corporation's net worth.<sup>48</sup> This theory is applied with important variations to each of the four events listed above.

Before turning to these conditions and variations, we must first examine the term "subsection (e) assets," a new phrase which is employed throughout section 341(e). This term is defined by section 341(e) (5) (A) to include the following categories of property held by the corporation:

1. *Property not used in the trade or business.* Any such property is a "subsection (e) asset" if the corporation's gain on a sale

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46. See § 341(e) (11).

47. *Supra* at p. 133 note 13, p. 138.

48. The terms "net unrealized appreciation" and "net worth" are defined by § 341(e) (6) and (7). In computing the corporation's "net worth," § 341(e) (7) provides for the exclusion of increases in net worth during the preceding one-year period resulting from transfers for stock or as contributions to capital or paid-in surplus, "if it appears that there was not a bona fide business purpose for the transaction in respect of which such amount was received." Compare the handling of a similar problem under § 341(c) (2), *supra* at p. 140.

would be taxed as ordinary income—*i.e.*, if the property is neither a capital asset nor §1231(b) property. Moreover—and this is §341(e)'s unique innovation—property held by the corporation *if in the hands of any shareholder owning (directly or constructively)*<sup>49</sup> *more than twenty percent in value of the corporation's stock* it would not be a capital asset or §1231(b) property. Thus, property held by the corporation constitutes a "subsection (e) asset" if it is stock in trade, inventory property, or property held for sale to customers in the ordinary course of trade or business in the hands of the corporation, or *if it would have this status were it held by any shareholder owning more than twenty percent of the corporation's stock*. If any more-than-twenty-percent shareholder is a dealer, in other words, his status taints the corporation's property.

2. *Property used in the trade or business—net unrealized depreciation.* If there is a net unrealized depreciation on assets used in the trade or business, they constitute "subsection (e) assets."<sup>50</sup>

3. *Property used in the trade or business—net unrealized appreciation.* If there is net unrealized appreciation in such assets, they constitute "subsection (e) assets" if they would be neither capital assets nor §1231(b) assets in the hands of a more-than-twenty-percent shareholder.<sup>51</sup> This provision is crucial to the purpose of §341(e). If a corporation's sole property is an apartment house or other rental property that has appreciated in value, the property will constitute a "subsection (e) asset" only if a more-than-twenty-percent shareholder is a dealer in such property.

4. *Copyrights and similar property.* A copyright, literary composition, or similar property is a "subsection (e) asset" if it was created in whole or in part by the personal efforts of an individual owning directly or constructively more than five percent of the corporation's stock. By virtue of this provision, a motion picture will be a "subsection (e) asset" if created partly by the personal efforts of a more-than-five-percent shareholder.

The function of the new category of "subsection (e) assets" is to

49. Throughout § 341(e), with a minor exception, the ownership of stock is determined by a set of constructive ownership rules. § 341(e)(10).

50. The Senate Report on § 341(e), S. REP. No. 1983, 85th Cong., 2d Sess. (1958), 1958-3 CUM. BULL. 922, does not state why depreciated property used in the trade or business is included if there is net unrealized depreciation in such assets. Since such assets would ordinarily qualify for the hotchpot of § 1231(b) and give rise to ordinary losses if the net result of the hotchpot were a loss, it may have been thought appropriate to include them in the § 341(e) calculation in order to counterbalance appreciation in inventory and similar property.

51. *Supra* note 47.



permit a determination of whether there has been a significant increase in the value of the assets which would produce ordinary income upon sale by either the corporation or a more-than-twenty-percent shareholder,<sup>52</sup> since in the absence of such an increase in the value of the ordinary income assets, the corporation is to be relieved of the collapsible corporation restrictions. As stated earlier, however, this test is applied with variations to each of the four situations to which section 341(e) is applicable, and we now turn to these variations.

1. *Sale or exchange of stock.*—Section 341(e) (1) makes section 341(a) (1) inapplicable to a sale or exchange of stock if the net unrealized appreciation in the corporation's "subsection (e) assets" does not exceed fifteen percent of the corporation's net worth and if the shareholder does not own more than five percent of the corporation's stock.<sup>53</sup> If the shareholder owns between five and twenty percent of the stock, a similar calculation is made, but he must take into account not only the corporation's "subsection (e) assets" but also any corporate assets which would produce ordinary income if held by him by virtue of section 341(e) (1) (B). And if the shareholder owns more than twenty percent of the stock, *his* calculation must also take into account any corporate assets which would have produced ordinary income (a) if he owned them and (b) if he had held in his individual capacity the property of certain other corporations of which he owned more than twenty percent of the stock in the preceding three years under section 341(e) (1) (C). Thus, the corporate assets will not only be tainted—as to all shareholders, under the definition of "subsection (e) assets" in section 341(e) (5) (A) (i) and (ii)—by the dealer status of a more-than-twenty-percent shareholder, but also—as to him only, under section 341(e) (1) (C)—by the hypothetical dealer status that he would have attained had he engaged in business as an individual, rather than in corporate form, during the preceding three years.

The net result of these extraordinary statutory gyrations is that profit on the sale of stock of an otherwise collapsible corporation will qualify as long-term capital gain unless the assets of the corporation (and, hence, presumably the gain on the stock) reflect a significant amount of unrealized ordinary income—the corporate veil being pierced for the purpose of determining the amount of unrealized

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52. Five per cent in the case of a copyright, literary composition, or similar property.

53. Such a shareholder might find it simpler to take refuge in § 341(d) (1), which makes § 341(a) inapplicable to certain not-more-than-5% shareholders, but that sanctuary is closed to a shareholder who owned more than 5% of the stock *at any time* after manufacture, etc., commenced, as well as to a shareholder, *e.g.*, an estate or trust, whose shares are attributed to a more-than-5% shareholder. Section 341(e) (1) is not quite so exclusive.

ordinary income, in order to take account of assets that might have changed their character by the interposition of a corporation between the shareholder and the assets.

To illustrate the operation of section 341(e) (1), assume that a corporation has three stockholders, unrelated to each other, whose holdings by value are as follows:

A	5 percent
B	15 percent
C	80 percent

Assume also that the corporation's assets fall into four categories, as follows:

Class	Net unrealized appreciation	Nature of asset
W	\$10,000	Stock in trade in hands of corporation.
X	\$10,000	Capital asset to corporation; but would be stock in trade if held by C but not if held by A or B.
Y	\$10,000	Capital asset to corporation; but would be stock in trade if held by B, though not if held by A or C.
Z	\$20,000	Capital asset to corporation; but would be stock in trade if held by C <i>and</i> if sales by certain corporations in which C was interested during preceding 3 years were treated as sales by C <i>or</i> if sales by C of stock in such corporations were treated as sales by him of his share of assets.

Under section 341(e) (5) (A), the corporation's "subsection (e) assets" would include Classes W and X. Consequently, on a sale of stock by A the net unrealized appreciation of the corporation would be \$20,000, and if this does not exceed fifteen percent of the corporation's net worth, the corporation could not be collapsible as to A. On a sale of stock to B, however, the net unrealized appreciation would be \$30,000, since section 341(e) (1) (A) and (B) require him to take into account not only the corporation's "subsection (e) assets" (Classes W and X), but also any corporate assets which would be "subsection (e) assets" if he held more than twenty percent of the stock (Class Y). B, therefore, can take advantage of section 341(e) (1) only if \$30,000 does not exceed fifteen percent of the corporation's net worth. Finally, if C invokes section 341(e) (1), he must take into account Classes W, X, and Z (but not Class Y) in determining the net unrealized appreciation under section 341(e) (1) (A) and (C). For him, section 341(e) (1) will be applicable only if \$40,000 does not exceed fifteen percent of the corporation's net worth.

For another example, which is both similar and more typical of section 341(e)'s intended operation, assume a corporation (Smith-

Jones, Inc.) owned equally by Smith and Jones (who are unrelated), the sole asset of which is an appreciated apartment house. Assume also that neither Smith nor Jones is a dealer in such property, but that Jones has owned more than twenty percent of the stock of certain other real estate corporations during the preceding three years. In these circumstances Smith-Jones, Inc., owns no "subsection (e) assets," either in its own right or by attribution from Smith or Jones. As to Smith, the net unrealized appreciation under section 341 (e) (1) is zero, and a sale or exchange of his stock (except to the issuing corporation or to a "related person") is exempt from the operation of section 341(a) (1). As to Jones, it is necessary to determine whether more than seventy percent in value of the assets of any of the *other* corporations are similar or related in use or service to the property held by Smith-Jones, Inc. If so, Jones is to be treated (a) as though any sale or exchange by him of stock in such other corporation (while he owned more than twenty percent of its stock) had been a sale by him of his proportionate share of the corporation's assets, and (b) as though any sale or exchange by such other corporation (while he owned more than twenty percent of its stock) which was subject to section 337(a) had been a sale by Jones of his proportionate share of the property. If, taking into account these hypothetical sales or exchanges by Jones, he would have been a dealer in the type of property held by Smith-Jones, Inc.,<sup>54</sup> he can make use of section 341(e) (1) only if the net unrealized appreciation in the property of Smith-Jones, Inc. does not exceed fifteen percent of the corporation's net worth.

Section 341(e) (1) cannot be invoked if the stock is sold to the issuing corporation,<sup>55</sup> nor does it apply to a more-than-twenty-percent shareholder if the stock is sold to a "related person" as defined by section 341(e) (8).

2. *Complete liquidations.*—A shareholder's gain on a complete liquidation is exempted by section 341(e) (2) from section 341(a) (2)—and hence can enjoy long-term capital gain treatment—if two con-

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54. When § 341(e) (1) (C) is applicable, the shareholder is treated as though he had sold his proportionate share of property held by the other corporations during the preceding three-year period. The mere fact that these corporations were or were not dealers in the property in question is not relevant; the purpose of imputing sales to the shareholder is to determine his status, based on both these hypothetical sales and any actual sales by him of similar properties held in his individual capacity. The number and frequency of sales are usually only two of the factors determining whether the taxpayer is a dealer, however, and it is not clear whether § 341(e) (1) (C) attributes to the shareholder not only his proportionate share of the corporations' assets, but also his share of any corporate activity (use of agents, advertising, etc.) that might have resulted in the sales.

55. This restriction may reflect an excess of caution, since § 341(e) (1) is an exception to § 341(a) (1), which embraces sales and exchanges of stock, but not partial or complete liquidations. As to § 302(b) redemptions, however, see *supra* note 10.

ditions are met. The first is that the net unrealized appreciation in the corporation's assets must meet the same test as is imposed by section 341(e) (1), i.e., the appreciation in the corporation's "subsection (e) assets" plus, in the case of the shareholders owning more than five or twenty percent of the stock, the appreciation in certain other assets held by the corporation, may not exceed fifteen percent of the corporation's net worth. The second condition is that section 337(a) applies to the corporation by reason of section 341(e) (4). This condition, as will be seen<sup>56</sup> cannot be satisfied unless the corporation sells substantially all of its property before the liquidation; its purpose is to prevent a liquidation in kind of assets subject to depreciation or depletion, which if permitted would give the shareholders a stepped-up basis for such assets (which could thereafter be written off against ordinary income) at the capital gain rate.

3. *Elective one-month liquidations under section 333.*—Ordinarily, the shareholders of a collapsible corporation are excluded from section 333 (elective nonrecognition of shareholder gain on a complete liquidation within one calendar month). Section 341(e) (3) provides that a corporation shall not be considered collapsible for this purpose, however, if the unrealized appreciation in its "subsection (e) assets" does not exceed fifteen percent of the corporation's net worth. The term "subsection (e) assets" is modified in applying section 341(e) (3), so as to reduce from twenty percent to five percent the stock ownership that will impose the shareholder's status on the corporate assets. If the corporation can meet the test of section 341(e) (3), all shareholders may take advantage of section 333; otherwise, section 333(a) remains in full force and no shareholders may do so.

4. *Use of section 337 by a collapsible corporation.*—We have already seen that section 337 (nonrecognition of corporate gain or loss on certain sales within the one-year period following the adoption of a plan of complete liquidation) is not applicable to a collapsible corporation.<sup>57</sup> Section 341(e) (4) lifts this barrier to a limited extent. Under section 341(e) (4) an otherwise collapsible corporation becomes subject to section 337 if:

1. At all times following the adoption of the plan of complete liquidation, the net unrealized appreciation in its "subsection (3) assets" does not exceed 15 percent of its net worth;
2. It sells substantially all the property owned by it on the date the plan of liquidation was adopted within the twelve-month period following that date; and
3. Following the adoption of the plan, it does not distribute any depreciable or similar property.

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56. *Infra* at p. 148-49.

57. Section 337(c) (1) (A).

The first of the foregoing conditions (with variations noted above) is common to section 341(e) (1), (2), (3) and (4)—relief from the collapsible corporation provisions is granted only to corporations whose ordinary income assets have not appreciated significantly in value. Thus, the shareholders of a corporation holding substantially appreciated assets that in its hands are (or the hands of any more-than-twenty-percent shareholder would be) inventory property or stock in trade may not employ section 337 to obtain capital gain on a sale by having the corporation sell the property and distribute the proceeds in liquidation. The second and third conditions have a different purpose: even if the corporation's ordinary income assets have not appreciated substantially in value, the corporation is not permitted to distribute some of its assets in kind in order to give its shareholders a stepped-up basis for them at the lenient long-term capital gain rate. Thus, the second condition requires the corporation to sell substantially all of its assets if it wishes to come under section 337; it may not sell some, and transfer the rest by a liquidating distribution in kind to its shareholders. The third condition overlaps the second to a considerable degree: it forbids the distribution of corporate property that is depreciable (or subject to amortization or depletion) in the hands of either the corporation or the distributee. Since the second condition requires "substantially all of the properties" held by the corporation when the plan of liquidation is adopted to be sold within the twelve-month period thereafter, the third condition would be automatically satisfied as to such properties, but it has the additional effect of preventing the distribution of any depreciable, amortizable and depletable properties that may fall outside the "substantially all" clause or that were not held by the corporation when the plan of liquidation was adopted. If property is distributed before the plan is *formally* adopted in an effort to avoid the impact of these conditions, the plan may be "pre-dated."<sup>58</sup>

A final restriction in section 341(e) (4) makes it inapplicable to any sale to a more-than-twenty-percent shareholder, or to a person related to such a shareholder, if the property so sold is subject to depreciation, depletion or amortization in the hands of either the corporation or the buyer. By virtue of this restriction, section 341(e) (4) and hence section 337 may be applicable to some of the corporation's sales but not to others,<sup>59</sup> so that an otherwise collapsible corporation may employ section 337 to ward off gain on some sales, while avoiding section 337 on sales producing losses (by selling to a more-than-twenty-percent shareholder), an ironic result in view of the

58. See § 337(a); Rev. Rul. 57-140, 1957-1 CUM. BULL. 118.

59. See the Senate Report on the Technical Amendments Act of 1958. S. REP. No. 1983, 85th Cong., 2d Sess. 143 (1958), acknowledging the possibility of a selective application of § 337 by virtue of § 341(e) (4).

effort to prevent corporations from straddling section 337.<sup>60</sup> The irony will be heightened by the fact that the shareholder, not the government, will be seeking to establish that the corporation is collapsible.

Another problem in this final restriction on section 341(e) (4) is whether a "sale" of appreciated corporate property to shareholders pro rata (e.g., if two fifty percent shareholders each "purchase" a fifty per cent interest in depreciable assets) will be treated as a true sale. If so, the corporation will be subject to tax on the sale (probably under section 1231(a), at the capital gain rate), but the shareholders will obtain a stepped-up basis for the property; at the same time, the other sales by the corporation will be subject to section 337, and the liquidation will produce capital gain for the shareholders by virtue of section 341(e) (2). If, on the other hand, the transaction is treated as a distribution in kind of the property, rather than as a "sale" followed by a distribution of the proceeds of sale, section 341(e) (4) (B) and (C) will have been violated, with the result that section 337 will not apply to the corporation's sales of other property. This, in turn, will make section 341(e) (2) inapplicable at the shareholder level to the liquidation.

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60. See *supra* note 56.