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Taxation-Federal Income Tax-Corporation Held Not Collapsible Where View to Sell Arose After Construction Completed

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TAXATION—FEDERAL INCOME TAX—CORPORATION HELD NOT COLLAPSIBLE WHERE VIEW TO SELL AROSE AFTER CONSTRUCTION COMPLETED—Petitioners had formed a corporation for the purpose of building and operating a housing project. After the construction was completed and most of the apartments rented, small cracks were discovered in the buildings. Without soliciting engineering or other technical opinion, petitioners sold their stock in the corporation. The Tax Court[1] upheld respondent-commissioner's taxing the profit from the sale of stock as ordinary income rather than capital gain, on the theory that the corporation was "collapsible" under section 117 (m) of the Internal Revenue Code of 1939.[2] On appeal, *held,* reversed. Since the view to the sale of stock did not exist before construction was completed, the corporation was not within the contemplation of section 117 (m). *Jacobson v. Comm'r,* 281 F.2d 703 (3d Cir. 1960).

Section 117 (m), now section 341 of the 1954 Code, provides that gains from the sale of stock of a collapsible corporation be taxed as ordinary income. It defines a collapsible corporation as one *"formed or availed of* principally for the manufacture, construction, or production of property . . . *with a view to . . . the sale of stock* by its shareholders . . . prior to a realization by the corporation . . . of a substantial part of the net income to be derived from such property. . . ."[3] The cases and Treasury regulations

1 Lewis S. Jacobson, 32 T.C. 893 (1959).

2 Int. Rev. Code of 1939, § 117 (m), added by ch. 994, § 212, 64 Stat. 934 (1950) (now INT. REV. CODE OF 1954, § 341).

3 (Emphasis added.) *Ibid.* See also Int. Rev. Code of 1939, § 117 (m) (3) (C) (now essentially INT. REV. CODE OF 1954, § 341 (d) (3)): "this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production."

construing the section 117 (m) "view" requirement agree that a corporation can be collapsible even though the view to the sale of stock was not the sole or principal reason for which the corporation was "formed or availed of,"[4] and have been concerned primarily with the time when the view to sell must have arisen or existed. It must initially be recognized that in fact there must necessarily exist, if only immediately prior to the actual sale, a view to sell in every case where stock has been sold. The question would then be whether application of section 117 (m) requires more than such a belated "view."[5]

In the principal case, the Court of Appeals for the Third Circuit held that section 117 (m) requires for collapsibility the temporal conjunction of construction, which is one of the named corporate purposes of section 117 (m), and the view to the sale of stock. The Court looked primarily to the language of section 117 (m) and reasoned that the view with which the property was constructed must necessarily be a view held at the time of the construction. This interpretation appears to be reasonable in light of the statutory language and finds support in the Treasury regulations, which say that a corporation should not be deemed collapsible if the sale of stock is attributable solely to circumstances not reasonably foreseeable before construction was completed.[6] On the other hand, the Courts of Appeals for the Second and Fourth Circuits, in *Glickman v. Comm'r*[7] and *Burge v. Comm'r*,[8] respectively, use what is essentially an objective test.[9] They have held that a corporation can be classified as collapsible if the view to the sale of stock existed at any time during the life of the corporation.[10] This result is achieved by the somewhat strained reasoning that a corpora-

[4] See Weil v. Comm'r, 252 F.2d 805 (2d Cir. 1958); Burge v. Comm'r, 253 F.2d 765 (4th Cir. 1958) (dictum); Glickman v. Comm'r, 256 F.2d 108 (2d Cir. 1958) (dictum); R. A. Bryan, 32 T.C. 104 (1959) (dictum); Treas. Reg. 111, § 29.117-11 (b) (1953). It has also been argued that had Congress intended that the view to sell be a principal objective, it would have used the phrase with *"the"* view rather than with *"a"* view. MacLean, *Collapsible Corporations*, 67 HARV. L. REV. 55, 58-60 (1953).

[5] "Section 341 [of INT. REV. CODE OF 1954—which was formerly § 117 (m) of Int. Rev. Code of 1939] is a patchwork of interlaced problems of interpretation. For recurring obscurities of meaning it is hard to surpass. Neither well conceived nor well drafted, it is replete with vague concepts and obscure or faulty phraseology." DeWind & Anthoine, *Collapsible Corporations*, 56 COLUM. L. REV. 475, 534 (1956).

[6] Treas. Reg. 111, § 29.117-11 (b) (1953). Emphasis must be placed on "solely" for the Treasury regulations observe that the view can exist during construction if there was then recognized even a conditional possibility of sale. This has been criticized as giving the "view" an unreasonably weak meaning. See MacLean, *supra* note 4, at 60.

[7] 256 F.2d 108 (2d Cir. 1958).

[8] 253 F.2d 765 (4th Cir. 1958).

[9] The objective test is whether when the stock was sold, the corporation held recently constructed property. This reasoning ignores the subjective criterion which distinguishes between bona fide short-lived corporations and sham corporations.

[10] All of these cases involve essentially the same fact situation: taxpayers form a closely-held corporation, get an FHA loan, and build an apartment house, or housing project. After construction is completed, but before a "substantial part" of the rental moneys are received, taxpayers sell the stock, or liquidate the corporation, realizing a large profit on their original investments. Thus there does not appear to be any factual basis for reconciling the conflict among the circuits.

tion is collapsible if it is "availed of" for the proscribed sale of stock.[11] In effect these courts read into section 117 (m) the proscribed sale of stock as one of the purposes for which a corporation may be availed of under section 117 (m).[12] Thus they accept the most belated view possible as satisfying section 117 (m) and negate any significance which Congress might have intended to attach to the "view" requirement. The courts in *Burge* and *Glickman* were persuaded to this interpretation by considerations of the problems which led Congress to enact section 117 (m).[13] Subsection (m) was added to the Internal Revenue Code of 1939 in 1950[14] to prevent the formation or use of short-lived corporations in isolated ventures for the purpose of lessening tax liability by converting what was essentially ordinary income into long-term capital gain.[15] From these problems, the courts in *Burge* and *Glickman* have drawn their inference that Congress intended to preclude the enjoyment of capital treatment by means of any short-lived corporation which engaged in any of section 117 (m)'s enumerated activities.[16] In each of the pre-enactment cases confronting Congress, the taxpayers admittedly sought from the outset to avoid ordinary treatment; accordingly the competing inference could reasonably be drawn that Congress intended section 117 (m) to apply only to those whose formation or use of corporations was influenced by "a view to the sale of stock." Since this more restrictive interpretation of the pre-enactment materials is reasonable and is consonant with the language of the statute, reference to these pre-enactment materials does not dissolve the ambiguity found in the statute by the courts in *Burge* and *Glickman*.

The rule laid down by *Burge* and *Glickman* does have the effect of plugging what those courts would otherwise have considered a loophole.

11 *E.g.*, Glickman v. Comm'r, *supra* note 4, at 111: "Since the corporation may at any time during its corporate life be 'availed of' for the proscribed purpose, . . . it seems surprising that the Regulations have adopted a narrower interpretation of the statute, and require the requisite view to exist 'during the construction . . .' or to be 'attributable' to 'circumstances which reasonably could be anticipated by the time of such . . . construction.' We are disposed to disagree with so narrow an interpretation. . . ." There is little, if any, justification for omitting the words "manufacture, construction, or production" as modifiers of "formed or availed of." "How can one 'construct property with a view to a distribution' if the 'view' arose after the property was constructed? If the draftsmen truly intended to apply section 341 based on the taxpayer's intentions on the sale or liquidation date, they could easily have said so." Comment, 28 GEO. WASH. L. REV. 855, 865 (1960).

12 See, *e.g.*, Burge v. Comm'r, *supra* note 4, at 768.

13 Such ambiguity as there is in this part of the statute seems hardly great enough to warrant reference to pre-enactment materials.

14 Added by ch. 994, § 212, 64 Stat. 906 (1950).

15 In the movie and construction industries, the practice had arisen of forming a corporation to make a movie or build a building; the actors and directors, or the contractors, would take stock instead of salaries. When the production or construction was completed, the stock in the corporation would be sold before box office or rental moneys were received. The profit was thus taxable as capital gain rather than ordinary income. For further discussion, see STANLEY & KILCULLEN, THE FEDERAL INCOME TAX (Supp. 1950, at 24-25); DeWind & Anthoine, *supra* note 5.

16 See Burge v. Comm'r, *supra* note 4, at 769; Glickman v. Comm'r, *supra* note 4, at 110.

While the decision in the principal case closes only a smaller loophole, it is probably the one which Congress sought to close. In fathoming congressional intent, the whole difficulty stems from the question of whether to hinge capital treatment on the motive or on the consequences of the taxpayer's acts. The *Burge-Glickman* rule, while it does not thwart at least the original reason for limiting tax on capital gains,[17] does disregard what seems to be a congressional determination that the taxpayer's motive is an essential consideration in determining collapsibility. Therefore, although the *Burge-Glickman* rule is easier to administer, since it does not require judicial inquiry into the existence of a subjective factor, it is a less reasonable conclusion to draw. The rule in the principal case is the more justifiable interpretation, recognizing as it does the requirement of subjective intent which has been written into the statute. It is to be presumed that Congress did not require a "view" without intending some significance.

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[17] The limitation of taxation on income defined as capital gains was originally enacted, in part, because such income may have accrued over a period of several years and it would be "inequitable to tax [it] . . . at progressive rates in the particular year in which [it is] . . . realized." MAGILL, TAXABLE INCOME 115 (rev. ed. 1945). However, the possibility of this unfairness is much diminished in the case of a corporation collapsible by either interpretation of the statute, since the gains will probably have accrued in less than three years. See note 3 *supra*.