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Income Tax--Conversion of Capital Gains Into Ordinary Income in Collapsible Corporations

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Income Taxation—Conversion of Capital Gains Into Ordinary Income in Collapsible Corporations

Taxpayers, in 1948, formed two corporations and constructed two apartment houses financed by the Federal Housing Authority. In 1950, taxpayers sold their stock in the two corporations and reported the profit as capital gain. Tax Court held that the two corporations were collapsible and the shareholders realized ordinary income on the sale of stock and distributions from the corporations. *Held* affirmed. Under the Int. Rev. Code of 1954, § 341, gain from the distributions and sale of stock was ordinary income when more than seventy per cent of the gain was attributable to the constructed property, even though sale of corporate assets would have produced capital gain had no corporation existed. *Braunstein v. Commissioner,* 305 F.2d 949 (2d Cir. 1962).

The problem presented in this case is whether gain realized through a collapsible corporation should be ordinary income if such gain realized by an individual would be capital gain. The solution to the problem lies in the intent of Congress in its enactment of INT. REV. CODE of 1954, § 341. In essence, this section was enacted to prevent the conversion of ordinary income into capital gain through the vehicle of incorporation. Axelrad, *Recent Developments in Collapsible Corporations,* 36 TAXES 893, 894 (1958). The principal case is an example of how a broad interpretation of the statute has been used to convert capital gain into ordinary income.

Basically, the statute provides that if a corporation is formed or availed of for the manufacture, construction, production, or purchase of property with a view to the sale or exchange of stock by the shareholders or a distribution by partial or complete liquidation of the property before the realization of a substantial part of the income to be derived from such property, the shareholder's gain will be treated as gain from a non-capital asset. The statute attacks the gain on the shareholder level and not the corporate level and, therefore, all the gain is converted into ordinary income. Axelrad, *Tax Advantages and Pitfalls in Collapsible Corporations,* 34 TAXES 841 (1956).

Even though the collapsible definition is met, section 341 does not apply: (1) to the shareholder who does not own more than five per cent of the stock; or (2) if not more than seventy per cent of the gain realized in the taxable year is attributable to the collopsible property; or (3) if the gain is realized three years or more after completion of the property or its purchase. INT. REV. CODE of 1954, § 341(d) (1), (2), (3).

In 1958, Congress amended the statute and placed another limitation on it. INT. REV. CODE of 1954, § 341(e). Subsection (e) was enacted to provide relief from the collapsible rules in a few situations where it was felt that the statute might operate to convert bona fide capital gains into ordinary income. The cases prior to the 1958 amendment of subsection (e) generally hold that despite legislative history, it is irrelevant that the shareholder would have enjoyed capital gain rather than ordinary income had the corporate vehicle not been employed. *Glickman v. Commissioner,* 253 F.2d 108 (2d Cir. 1958); *Burge v. Commissioner,* 253 F.2d 765 (4th Cir. 1958); Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment,* 58 COLUM. L. REV. 1146, 1180 (1958).

A proposed revision for subsection (e) would "fragment" the shareholder's gain, on liquidation of the corporation or the sale of its stock, into ordinary income and capital gain components according to the ratio of the appreciation inherent in the ordinary assets and the capital assets held by the corporation. SURREY & WARREN, FEDERAL INCOME TAXATION 1384 (1960 ed. 1962).

In contrast to that approach, the present subsection (e) uses an "all or nothing" approach. Speaking generally, the subsection provides that if more than fifteen per cent of the appreciation in relation to the net worth of the corporation would be ordinary income, then the subsection does not apply, and the gain is taxable as ordinary income. However, if less than fifteen per cent of the appreciation in relation to the net worth of the corporation would be ordinary income, then the subsection does apply, and the gain is given capital gain treatment. See SURRY & WARREN, FEDERAL INCOME TAXATION 1383 (1960 ed. 1962); Axelrad, *Recent Developments in Collapsible Corporations,* 36 TAXES 893, 911 (1958). It should be observed that the determination of a subsection (e) asset depends upon its status in the hands of either the corporation or the shareholder of more than twenty per cent. Axelrad, *Recent Developments in Collapsible Corporations,* 36 TAXES 893, 912 (1958).

Another problem is whether the taxpayer holds the property primarily for sale to customers in the ordinary course of his business within the meaning of INT. REV. CODE of 1954, § 1231(b)(1)(B). If so, the taxpayer is dealer and is subject to ordinary income. On the other hand, if the taxpayer is an investor, he is not subject to ordinary income but can report the gain as capital gain. This controversy of "dealer" or "investor" is held by the courts to be a question of fact. Axelrad, *Recent Developments in Collapsible Corporation,* 36 TAXES 893, 912 (1958).

In *United States v. Ivey,* 294 F.2d 799 (5th Cir. 1961), a taxpayer purchased an unimproved lot for $42,500 in February 1954 and improved the lot at his expense of $2,000. The taxpayer later formed a corporation with two others, each receiving one third of the stock of the corporation. In October 1954, the corporation bought the taxpayer's lot in consideration of a $25,000 note and two hundred fifty shares of the corporation's stock with a value of $25,000. The corporation began building an apartment building on the lot and when it was seventy five per cent completed, in July 1955, the taxpayer sold his stock for $100,000. The court held that where the shareholder's gain would be taxable as a capital gain had he realized it directly rather than through the corporate vehicle, the gain should not receive collapsible treatment.

The principal case criticized the *Ivey case, supra,* for misinterpreting the statute and not recognizing or applying subsection (e). In *Commissioner v. Kelly,* 293 F.2d 904 (5th Cir. 1961), the court stated that in the field of tax legislation, dictionary-tested meanings and common usage must be used in interpreting statutes. In this respect, the greatest objection to the decision in the *Ivey case, supra,* is that it acts to invalidate subsection (e). In the *Ivey case, supra,* the court reached a subsection (e) result, but the case enlarges the protection afforded by the subsection. The case omits the refinements and strict requirements of the subsection and goes beyond the "all or nothing" approach of the subsection and permits the fragmentation approach. CCH 1962 STAND. FED. TAX REP. 1128. It should also be noted that subsection (e) was not applicable to the *Ivey case, supra,* since the operative facts of the case had taken place before its enactment. The principal case asserts that either the *Ivey case, supra,* is correct and subsection (e) is unnecessary, or subsection (e) should be held as overruling the *Ivey* decision. For this reason, the court held against the *Ivey* decision and in favor of a strict interpretation of subsection (e).

The greatest objection to section 341 and subsection (e) is the complexity that prevails throughout the entire section. The section attempts to regulate by the use of specific percentages and in doing so, sets up complex standards which are difficult to apply. A simpler approach to this problem might be the fragmentation of gain. At any rate, it would appear that Congressional revision or amendment will be necessary to alleviate the undue complication.

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Income Tax—Nonrecognition of Gain Realized upon Involuntary Conversion of Investment Property

Taxpayer, a corporation, realized gain upon the condemnation of a building owned by the taxpayer and leased to a manufacturing company. Taxpayer replaced the condemned property with another building which was reasonably similar to the original building. The replacement property was leased to a wholesale grocery business. The Tax Court sustained the commissioner's determination of an income tax deficiency based on taxpayer's failure to include in gross income the gain realized on the condemnation. *Held,* reversed. Uses of original property, which taxpayer leased to a tenant for manufacturing purposes, and replacement property, which was leased for warehousing purposes, were "similar or related in service or use" within the meaning of INT. REV. CODE of 1954, § 1033 (a) (3) (A), and taxpayer's gain on original property was exempt from taxation. LOCO REALTY CO. v. COMMISSIONER, 306 F.2d 207 (8th Cir. 1962).

The Internal Revenue Code of 1954 provides that if property is involuntarily converted as a result of its destruction, theft, or requisition or condemnation, gain on the conversion need not be recognized if the money subsequently obtained is used to purchase replacement property which is "similar or related in service or use." INT. REV. CODE of 1954, § 1033 (a) (3) (A). In determining whether the replacement property fulfills the requirements of the statute, the various courts of appeals have distinguished the cases which involve a taxpayer-lessor and those which involve a taxpayer-user. The situation in further complicated by the fact that the courts are not in agreement as to what tests should be applied in ascertaining whether the taxpayer-lessor is entitled to the nonrecognition of gain benefits. As a result of the holding in the principal case there are now five different tests with respect to the taxpayer-lessor situations.