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CITY GAINS FOR BUILDERS OF RESIDENTIAL SUBDIVISIONS

By THEODORE R. GROOM*

Ambitious and Backward are both builders of residential subdivisions. Their non-tax problems are characteristic of the building industry. Financially, building is a risky business. The items which must be purchased—land, steel, general building materials—fluctuate greatly in price. The supply, if not the price, of labor is uncertain, and the quality undependable. Most important, the purchasing public is a fickle group; their taste varies, and their ability and desire to purchase is unpredictable. Moreover, even a subdivision of moderate size requires investment of substantial risk capital and the borrowing of large sums at high interest rates. At the same time, the building industry does not readily lend itself to public, broad-based financing. This is partly because of the risk involved, but primarily due to the dependency of the

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The author's area of familiarity with the building industry is in the metropolitan Washington, D.C., area, primarily in Northern Virginia. Much of the discussion of the building industry is based upon the author's own experience in the real estate business and upon interviews with builders in this area.

Ability to purchase has always been affected by general and local economic conditions. However, today the matter of government financing is of utmost concern. One in the real estate industry is aware of every proposed change in FHA and VA terms. This awareness is often converted into anticipatory action. The author knows of many instances in which contracts of sale were based upon more favorable terms which were to be enacted several months after the date of the contract.

An example of the multitude of things which may affect the purchaser's desire to buy follows. In Arlington, Virginia, in 1958, enthusiasm for buying was dampened by the fear that as a result of the court's order to integrate the schools and Virginia's "Massive Resistance" policy, schools would not be opened. Thus many who would have bought a home in Virginia instead purchased in Washington or its Maryland suburbs.

For example, assuming an average profit of 10% of cost and loans of 75% of selling price, a builder of 100 houses in the $20,000 price range will invest $200,000 to $300,000 and borrow up to $1,500,000. These figures vary, of course, with local banking practice and with the number of houses built under the same loan at the same time.
enterprise on one or a few personalities for its success, and the necessary localization and comparative smallness of operation. This brief discussion suggests at least two propositions. First, the closed nature of the enterprise requires that investors be able to contribute large sums, and this in turn usually means that the investors will be high-bracket taxpayers. Second, the risk involved will not be worth the taking if the high-bracket taxpayer must report his gain at ordinary rates. However, with proper tax planning most of the builder's gain will be taxed at long-term capital gain rates, with an overall net tax rate somewhere between the 30 and 40 per cent range.

In order to understand the significance of proper planning, let us return to our two heroes, Ambitious (A) and Backward (B). Assume that each builder builds about 100 houses a year on which his gain is $2000 a house, or $200,000 in all. B is an unincorporated taxpayer, or is an incorporated taxpayer electing to be taxed under Subchapter S. If he files separately and has deductions and exclusions of $30,000, his tax on his net income of $170,000 is about $130,000, and he has about $40,000 left after taxes. A utilizes the corporate form. Ideally, his objective is accomplished in the following manner:

1. A corporation is formed, and the houses are built by it.

2. The corporation is liquidated before it earns any income from the sale of the houses.

3. The houses, and other proceeds if any, are distributed to A.

4. A pays a long-term capital gains tax on the difference between the basis of his stock and the appreciated value of the houses.

5. The houses are sold by A, as an individual. He realizes little or no gain because of his "stepped-up" basis.

Omitting personal deductions and exclusions, A's tax would then be $50,000 and he would have a net gain after taxes of

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6 1954 I.R.C., Subchapter S, §§ 1371-1377, added by § 64, Technical Amendments Acts of 1958, 72 STAT. 1650 (1958). All references hereafter made to the Code and to statutory sections refer to the Internal Revenue Code of 1954 or sections thereof, unless otherwise indicated.

7 § 334 (a).
$150,000. Although A's mode of operating was probably capable of literal attainment prior to 1950, the amazing thing is that by weaving a disciplined path through the present statutory labyrinth, he can still approach the attainment of this goal. The primary legal obstacle to the accomplishment of the builder's objective is that the property received in liquidation may be tainted by the corporation's "collapsible" status, and thus taxed at ordinary rates.

The purpose of this article is to ascertain the extent to which the collapsible corporations provision, Section 341, is applicable to the builder of residential subdivisions, and if so, how its effect may be avoided or minimized. In view of the extensive treatment already accorded the collapsible corporation,10 the author's justification for further dis-

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1961] CAPITAL GAINS FOR BUILDERS 101

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*1950 is the date of enactment of § 117(m) (now § 341). 1939 I.R.C. § 117(m), added by 64 STAT. 934 (1950).

*While concentrating on § 341, the tax planner must also direct his attention to two secondary problems: (1) Since use of the collapsible plan encompasses an accumulation of earnings, it is conceivable that the corporation may be subject to the accumulated earnings tax imposed by § 531. Note particularly the problems presented by such cases as United Business Corporation v. Commissioner, 62 F. 2d 754, 755 (2nd Cir. 1933); Wellman Operating Corp., 83 T.C. 192 (1959); and Pelton Steel Casting Co., 28 T.C. 153 (1957), aff'd 251 F. 2d 278 (7th Cir. 1958), cert. den. 356 U.S. 958 (1958). Generally the builder is not subject to the § 531 tax because (a) an accumulation to reduce indebtedness is considered a reasonable need, Gazette Telegraph Co., 19 T.C. 692 (1953), and (b) for all practical purposes, the tax does not apply in the year of liquidation. See §§ 535(a) and 562(b). (2) After the liquidation contemplated by the collapsible approach, the builder will desire to reincorporate and go through the same cycle again. Such a reincorporation may result in an assertion by the Commissioner that the new corporation is in reality a continuation of the old, that a reorganization resulted, and that the boot ancillary thereto is taxable at ordinary income rates. See Lewis v. Commissioner, 176 F. 2d 646, 648 (1st Cir. 1949); Love v. Commissioner, 113 F. 2d 236 (6th Cir. 1940); William M. Liddon, 22 T.C. 1220 (1954), rev'd on other grounds 230 F. 2d 304 (6th Cir. 1956). Since the builder, unlike the taxpayers in the above cases, does not use the same tangible assets in successive enterprises, it is unlikely that this argument will apply to him. Of course there are many other related problems, particularly those posed by §§ 1551, 269, 482, 541-47, and 337. To minimize or eliminate the corporate surtax, the planner's imagination is most challenged by the multiple corporation problem. For an example of one who failed to meet that challenge, see Alden Homes, Inc., 33 T.C. 582 (1959). See also James Realty Co. v. United States, 250 F. 2d 394 (8th Cir. 1960), aff'd 176 F. Supp. 306 (Minn. 1959); and Note, Problems of Multiple Corporations, 20 La. L. Rev. 761 (1960).

10E.g., Axelrad, Recent Developments in Collapsible Corporations, 36 Taxes 593 (1958); Axelrad, Tax Advantages and Pitfalls in Collapsible Corporations and Partnerships, 94 Taxes 841 (1956); DeWind & Anthoine, Collapsible Corporations, 56 Col. L. Rev. 475 (1956); Donaldson, Does the "Two-Shot" Corporation Escape Collapsible Treatment under Section 341, 8 J. Taxation 338 (1958); Donaldson, Collapsible Corporations, 36 Taxes 777 (1958); McLean, Collapsible Corporations - The Statute and Regulations, 67 Harv. L. Rev. 55 (1953); Modrall, Collapsible Corporations and Subsection (e), 37 Taxes 895 (1959); Salem, Collapsible Corporations: An
Discussion is two-fold. Although many articles and cases dealing with Section 341 have discussed some aspect of the building industry, few if any have considered Section 341 in the context of the builder of residential subdivisions. Moreover, little investigation has been directed to the problem of determining whether the asserted loopholes in Section 341 are in fact "plugged" by the economic infeasibility of utilizing them.

It has already been noted that A would like to have the corporation build the houses, liquidate before any sales are made, and distribute the houses to the shareholders at capital gain rates, thus paying a net tax of 25 per cent. Section 117(m), now Section 341, was enacted in 1950 with the ostensible purpose of preventing the achievement of this low tax rate. In ascertaining whether 341 has accomplished its apparent purpose, two limitations must be noted. First, no cases have been decided under the 1954 Code. Thus we must rely upon our own speculation and that of others as to the effect of any changes in the 1954 Code. The cases under the 1939 Code are neither numerous, due to the section's late date of enactment, nor illuminating, since the cases quite naturally reflect the confusion of the statute. Moreover, many of the cases arose in a special context, now otherwise provided for in the 1954 Code, and their value as precedents may be thereby diminished. Second, Section 341 has been called "a classical example of a 'bad' tax statute," with the result that reliance upon its literal provisions may be misplaced.


11 1939 I.R.C. § 117(m), added by 64 STAT. 934 (1950), as amended, 65 STAT. 497 (1951).

The latest addition is § 341(e), added by the Technical Amendments Act of 1958, § 20(a), 72 STAT. 1615 (1958). It covers four pages of the Code and excepts from the operation of § 341 certain situations where there is presumably no collapsible intent. Since the builder is one of the objects of § 341, and since no tax saving is worth the effort required of counsel in an attempt to understand this subsection, its provisions will be ignored during the remainder of this article. However, one hearty soul has made the attempt to understand subsection (e). See the article by Modrall, supra, n. 10.

13 These cases dealt with distributions by construction corporations which had received government insured loans in excess of the cost of construction. This problem is now specifically covered by § 312(j).

14 Axelrad, Tax Advantages and Pitfalls in Collapsible Corporations and Partnerships, 34 Taxes 841, 847 (1956). The same thought was phrased more picturesquely by Donaldson, supra, n. 10, 777:

"In the area of tax avoidance the collapsible corporation is a classic; imagination, simplicity in form, and beauty in achieved result mark it as such. The Treasury's legislative answer is grotesque."
THE STATUTORY SCHEME

With these limitations in mind, let us proceed to examine the statutory scheme of Section 341 insofar as it is relevant to the builder's problems. Section 341(a) provides that gain from the sale or exchange of stock or from a distribution in complete or partial liquidation of a collapsible corporation will be treated as ordinary income to the extent that it would normally be treated as long term capital gain. Section 341(b) defines a collapsible corporation as follows:

"[T]he term 'collapsible corporation' means a corporation formed or availed of principally for the... construction... 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... constructing... 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." 15

Section 341(c) establishes a presumption that corporations holding certain types of assets, which may be generally categorized as appreciated "inventory" assets, are collapsible corporations. Little need be said about this subsection since there is no doubt that the building corporation is usually within it, and it is otherwise clear that the building corporation is collapsible. 16

Section 341(d) provides three situations in which gain realized by a shareholder from a collapsible corporation will not be taxed under 341(a), although the corporation remains collapsible. Thus 341(a) is inoperative:

1. When the shareholder and his attributees own 5 per cent or less of the stock, 17 or

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15 Emphasis added to indicate words and phrases which have been the focal point of contention in litigation.
16 Lewis S. Jacobson, 32 T.C. 893, rev'd. on other grounds, 281 F. 2d 703 (3rd Cir. 1960) ("Ordinarily a corporation will be considered collapsible when its activity is principally construction and the construction is followed by the shareholder's sale of their stock before the corporation realizes a substantial part of the income to be derived from construction and the shareholders realize gain attributable to the constructed property. Carl B. Rechner, 30 T.C. 186 (1958)."). See also infra, n. 58.
17 This subsection eliminates most publicly owned corporations from the operation of 341.
2. Unless more than 70 per cent of the gain recognized by the shareholder from distributions received from the corporation is attributable to the property "so constructed," or

3. If the "gain is realized after the expiration of 3 years following the completion of such ... construction..."

**THE "VIEW"

We have noted above that to come within the terms of Section 341(b), the corporation must be formed or used "with a view to" doing the collapsible act. Since we are assuming that our builder has the collapsible "view," brief mention only need be rendered the definition of that term.\(^\text{18}\)

Three questions are presented. First, to what extent must the collapsible motive be the causative force in adopting the action contemplated by the statute? Initially, there was a feeling that "principally" might be interpreted to modify "with a view to" instead of the phrase "for the construction."\(^\text{19}\) The provision of the Regulations on this matter is all-encompassing, providing as follows:

"The requirement is satisfied whether the [collapsing] action was contemplated unconditionally, conditionally, or as a recognized possibility."\(^\text{20}\)

Although the possible invalidity of the Treasury's definition might be properly urged in an appropriate litigation, the purpose of this article is not advanced by such a discussion.

The second question is whether the tax evoking "view" is present if it arises at any time, or whether it is present only if it arises prior to the completion of construction. Here the Regulations take a position favorable to the taxpayer,\(^\text{21}\) but some doubt as to the appropriateness of the Commissioner's interpretation has been suggested by the courts.\(^\text{22}\) In any event, the Commissioner's position is

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\(^{18}\) The Tax Court has recently demonstrated that it will give little weight to self-serving testimony or explanation by counsel of the non-tax objectives of the taxpayer. *E.g.*, Jesse Hartman, 34 T.C. No. 111 (1960); Aldon Homes Inc., 33 T.C. 582 (1959).

\(^{19}\) Glickman v. Commissioner, 256 F. 2d 108 (2nd Cir. 1958); Burge v. Commissioner, 253 F. 2d 765, 768 fn. 2 (4th Cir. 1958); Weil v. Commissioner, 252 F. 2d 805 (2nd Cir. 1958).

\(^{20}\) Reg. § 1.341-2(a) (2) (1955).

\(^{21}\) Reg. § 1.341-2(a) (3) (1955).

\(^{22}\) "Since the corporation may at anytime during its corporate life be 'availed of' for the proscribed purpose ... , it seems surprising that the regulations have adopted a narrower view of the statute ... We are
limited to circumstances which could not be reasonably anticipated during construction, and may be hedged through the use of his niggardly interpretation of when construction is "completed."

A third problem concerning the necessary "view" will be discussed in the next section of this article.

**SUBSTANTIAL REALIZATION**

The most important limitation within Section 341(b) is that the collapsible action take place "before the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property." This disarmingly simple definition raises several questions. What is the relation between "substantial" and "view"? Does "substantial" refer to the income realized, or to that left unrealized, prior to the collapse of the corporation? What percentage is "substantial"? And, how is the total taxable income to be computed?

1. **The Relation Between "Substantial" and "View".**

A literal construction of the statute would mean that "substantial part" would modify "with a view to," with the result that Section 341(a) would be operative whenever there was an intent to collapse the corporation before a substantial part of the taxable income was realized, regardless of whether or not a substantial part of the income actually was realized. The issue has received little attention in the cases. Even if a literal interpretation were accepted by the courts, it would be of small consequence since, as one author suggested, "because of the difficulty disposed to disagree with so narrow an interpretation [of the statute]." Glickman v. Commissioner, 256 F. 2d 108, 111 (2nd Cir. 1958) *(dictum).* Accord, Spangler v. Commissioner, 273 F. 2d 665 (4th Cir. 1960); Sidney v. Commissioner, 273 F. 2d 928 (2nd Cir. 1960); Burge v. Commissioner, 253 F. 2d 765 (4th Cir. 1958) *(dictum).* See also Jesse Hartman, 34 T.C. No. 111 (1960); E. J. Sterner, 32 T.C. 1114 (1959); Carl B. Rechner, 30 T.C. 156 (1958). *Contra,* Jacobson v. Commissioner, 281 F. 2d 703 (3rd Cir. 1960), rev'd 32 T.C. 583. A comment on the latter case is Wilkes, *Post Construction Decision to Sell Avoids Collapsibility,* 13 J. Taxation 244 (1960). The Tax Court recently followed the Regulations, noting that the question of their validity was not raised. Charles v. Riley, 35 T.C. No. 35 (Feb. 28, 1961); Maxwell Temkin, 35 T.C. No. 101 (March 13, 1961). *Rev. Rul. 56-137,* 1956-1 Cum. Bull. 178, indicates that construction will not be considered as completed for purposes of the three year limitation until every "integral constructing" act is completed, such as zoning. This same reasoning may also be applied to the determination of whether the post construction motive is really post. See Max Mintz, 32 T.C. 723 (1959), *aff'd* 284 F. 2d 554 (2nd Cir. 1960).
of proof of state of mind, actual occurrences are likely to be the practical basis for the application of the section.\textsuperscript{24}

2. "Substantial" or "Insubstantial"?

A more significant problem is posed by Abbott v. Commissioner:\textsuperscript{25}

"The real question posed by the statute, however, is not whether a substantial part of the total profit was realized prior to the dissolution, but rather whether that part of the total profit realized 'after' dissolution was substantial."\textsuperscript{26}

Apparently, this is an acceptance of the Commissioner's argument that the limitation is satisfied only if "the amount of the unrealized taxable income from such property is not substantial in relation to the taxable income realized."\textsuperscript{27}

The argument of the Third Circuit is based upon a belief that the statutory purpose would be frustrated by a literal interpretation since such would result in a net tax approaching the long-term capital gain rate. The Tax Court\textsuperscript{28} and a District Court\textsuperscript{29} take a different view of the statute, reading it more literally. Thus they say that the statute is satisfied if a substantial part of the income is realized prior to dissolution. The same result would follow from the application of either test if, for example, 60 per cent. were determined to be substantial. If, however, substantial is some percentage lower than 50 per cent., the view which prevails may be outcome-determinative.

3. What Percentage is Substantial?

In other contexts, "substantial" has been held to range from 2 per cent. to 50 per cent.\textsuperscript{30} Considering the purpose

\textsuperscript{24} MacLean, Collapsible Corporations — The Statute and Regulations, 67 Harv. L. Rev. 55, 67 (1953). But see Spangler v. Commissioner, 278 F. 2d 665 (4th Cir. 1960); Payne v. Commissioner, 268 F. 2d 617, 622 (5th Cir. 1959).

\textsuperscript{25} Abbott v. Commissioner, 258 F. 2d 537 (3rd Cir. 1958).

\textsuperscript{26} Id., 542. It should be noted, however, that the amount realized here was only 10%, a figure which would not be "substantial" under either test.

\textsuperscript{27} Reg. § 1.341-5(c) (2) (1955).

\textsuperscript{28} James B. Kelly, 32 T.C. 135 (1959), on appeal to 5th Circuit. The Tax Court, with its customary disrespect for its multiheaded master, rebuked the Third Circuit for misinterpreting its own decision in Abbott. The Second Circuit has reserved decision on the point. Sidney v. Commissioner, 273 F. 2d 928 (2nd Cir. 1960).

\textsuperscript{29} Levenson v. United States, 157 F. Supp. 244 (N.D. Ala. 1957).

\textsuperscript{30} See cases cited, MacLean, supra, n. 24, 68, fn. 20.
of Congress in enacting Section 341, the figure will probably tend toward the latter percentage. One author states that until recently informal letter rulings were readily available, designating 50 per cent. as substantial, but that because of friction within the Internal Revenue Service, these rulings are no longer available. Several of the commentators think 50 per cent. to be a reasonable figure, and the Levenson case so held:

"Giving to the word 'substantial' its ordinarily accepted meaning, it is inconceivable to this court that the realization of more than 50% of the net income from the property should not be regarded as substantial."

No contrary authority exists. The Abbott case only said 10.84 per cent. was not enough. The Tax Court in James B. Kelly, which involved the collapse of a corporation that bought and subdivided real estate, held that 33\(\frac{1}{3}\) per cent. was substantial, and in G. A. Heft held that 17.07 per cent. was insubstantial. It is worth noting that even the dissenters in the Kelly case did not disagree with the Levenson result. Thus, for the present, it appears that the taxpayer can rely upon 50 per cent. being considered substantial.

One word of caution should be added. Even if one receives a firm ruling from the Treasury that, for example, 45 per cent. is acceptable in his particular case, the ruling is not binding upon questions of valuation. The Commissioner's valuation may be different, or values may change at a crucial time. The latter may be illustrated by the following example. Assume that one hundred houses are built and that a profit of $2000 per house is anticipated. After selling fifty houses upon which the profit is that predicted, the corporation liquidates. Thereafter, a steel strike or a Korean War causes values to wobble upward, so that the profit on the last fifty houses is actually $3,000 a house. Since the percentage realized before liquidation is only 40 per cent., the taxpayer would not have satisfied the substantial limitation. Thus the taxpayer may be well advised to hedge with some percentage greater than fifty.

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Note: The text contains citations to legal cases and articles, such as:

- See supra, n. 26.
- 32 T.C. 135 (1959), on appeal to 5th Circuit.
- 34 T.C. 86 (1960).
4. What Constitutes the “Income To Be Derived From Such Property”?

We have determined that 50 per cent. is probably substantial realization, but 50 per cent. of what? The statute says, “a substantial part of the taxable income to be derived from such property.” It is simple enough to compute the realized portion of the gain, but the question is, how do you compute the unrealized portion? Until recently, the formula was assumed to be that proposed by Levenson.

“The only feasible test is to add to the taxable income already realized the additional taxable income that would be realized by the corporation if it sold the collapsible property [upon the date of collapse].”

However, at least two commentators and several courts have suggested a “projection” theory. The theory is well stated by Axelrad:

“The Statute suggests that the comparison is between what the property has already realized with what it would realize had it not been liquidated. This would in turn require a projection, during the life of the assets, of overhead and other costs . . . .”

The Tax Court first suggested acceptance of the projection theory in Rose Sidney. Here, distributions to shareholders, neither in liquidation nor redemption, but in excess of earnings and profits, were taxed under Section 341 when the distribution was attributable to the excess of FHA loans over the cost of constructing apartment buildings. The court held that since the useful life of the buildings was thirty years, rent income for only two years could not be a “substantial part” of the income to be derived from the property. Payne v. Commissioner, was another FHA case in which a distribution in redemption was taxed under Section 341. Although the corporation had rented its apartments for seven years, the court in a dictum said that “a substantial part of the income of the corporations remained to be realized over the thirty-five remaining years of their

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27 § 341(b) (1) (A). Emphasis added.
29 See supra, n. 31, 861. A similar formulation is given by Donaldson, supra, n. 10, 782.
30 30 T.C. 1155 (1958), aff’d 273 F. 2d 928 (2nd Cir. 1960).
31 238 F. 2d 617 (5th Cir. 1959), aff’g 30 T.C. 1037 (1958).
CAPITAL GAINS FOR BUILDERS

expected life."\(^4^2\) The most recent case, \textit{R. A. Byran},\(^4^3\) gives further support:

"The net income which would normally be anticipated in the instant situation would consist of rental income over the life of the property or of the lease. The lease . . . was for a term of 75 years . . . . At the times of the redemptions herein (after 1½ years of rent) the corporations would not have realized substantial parts of the total net income to be derived from the properties over their useful lives."\(^4^4\)

Despite these stalwart authorities, the author believes that the builder of a subdivision will be unaffected by their logic. In all three cases the property continued to exist in the corporation after the collapsible action. Further, the shareholders taxed continued to retain an interest in the corporation, and thus indirectly in the property, after the collapse. Arguably, it is a quite different case when the corporation is liquidated and the property is sold to someone else. Aside from a feeling that privity of relationship no longer exists between the shareholders, the corporation and the property, the shareholders no longer have any control over the income producing capabilities of the property. Perhaps a more persuasive distinction can be made as to the type of property involved. In all three cases, the property was rent-income producing, and usually bought primarily for the purpose of receiving the income from it. However, the builder of residential housing builds property primarily for sale.\(^4^5\) It is difficult to say that rental income from the property should be projected over its life when the normal pattern is to derive gain from the sale of the property. Even if rent were to be projected, substantial realization may occur since the rental of single dwelling houses is usually not a profitable business.\(^4^6\) Thus it is the author's opinion that the \textit{Levenson} test is still valid when applied to builders of residential housing.

\(^{4^2}\) \textit{Id.}, 622.
\(^{4^3}\) 32 T.C. 104 (1959), aff'd 281 F. 2d 238 (4th Cir. 1960).
\(^{4^4}\) \textit{Id.}, 127.
\(^{4^5}\) Especially is this true as the cost and value of the house go up. For example, in Northern Virginia a $10,000 house may rent for $90 to $110 a month while a $30,000 house will only rent for about $200 a month.
\(^{4^6}\) It has been the experience of the property management department of The Groom Company, Inc., of Arlington, Virginia, that after the payment of taxes, insurance, mortgage amortization, interest, agent's commission (7% of rent), and repair and redecorating expenses, the owner of a moderate to high-priced house just about breaks even. Moreover, it is not uncommon for the house to remain vacant between tenants for a period of thirty to sixty days.
5. Some Practical Considerations.

Even if the builder's corporation(s) is (are) not collapsible when liquidated, some other practical problems exist. Some provision will have to be made for paying the capital gains tax on the houses received in liquidation. If the corporation has received a substantial part of the income, the cash distribution will be sufficient to take care of this. Aside from the valuation problem mentioned above, valuation presents one other difficulty. Assume that the builder receives houses which he values at $20,000 and pays a long-term capital gains tax based upon this valuation. He has now acquired a new basis in the houses of $20,000. If he should sell the houses for $21,000, he may have to pay an ordinary tax on the $1,000 difference, although it is not clear that this is so.47 If instead he sells the houses for $19,000 he may find that he is unable to use the entire loss.48

The practical consideration most commonly raised by builders interviewed48a was the difficulty of building a hundred houses while only being able to sell fifty. Many large builders in the Washington, D.C. area are presently able to sell their houses as each is completed.49 Delaying the sale of houses means that risk capital is static and that interest payments on outstanding construction loans will be larger than usual. Further, the sales problem is more difficult if the builder must withhold the sale of one-half of the constructed houses until liquidation since the purchasing public and sales agents will lose interest during the time gap.50 To be matched against these very real disadvantages are some distinct benefits which will result from a time lag. For example, the grass has an

47 Axelrad apparently believes that ordinary income would result. Tax Advantages and Pitfalls in Collapsible Corporations and Partnerships, 34 Taxes 841, 873 (1956). However, the trend of the cases seems to be in the opposite direction. Alabama Land Mineral Co. v. Commissioner, 250 F. 2d 870 (5th Cir. 1958); Curtis Co. v. Commissioner, 232 F. 2d 167 (3rd Cir. 1956); Greenspan v. Commissioner, 229 F. 2d 947 (8th Cir. 1966), and cases cited therein. But cf. Estate of Barios, 29 T.C. 378 (1957).

48 Here we will enjoy the prospect of the Commissioner arguing that the asset is capital, and thus a capital loss results which the taxpayer can't set off against other ordinary gains.

48a See supra, n. 1.

49 During periods of shortage, such as the Korean War, houses were sold before the roof was on. Even today a few builders whose products are in particular demand sell their houses several months in advance of completion.

50 This will in turn require more advertising expense since the time gap will entail the loss of advertising carryover.
opportunity to grow, and the subdivision may lose a little of the customary raw look. Some of the fifty purchasers who are pleased may be able to entice some of their friends to purchase in the new area.\textsuperscript{51} Naturally, it is impossible for the author to resolve this problem, and all that can be offered is that each builder will have to work out a flexible plan according to his own abilities and inclinations. The model outlined below approaches perfection, and it is sufficient to add that the “build and liquidate” plan is still advantageous to the high-bracket builder if only a few houses are distributed in kind in the liquidating dividend.

Builder A has successfully navigated the collapsible provision, using the “substantial” limitation. He has built a hundred houses upon which he has made a profit of $2,000 a house. He has utilized four corporations, thus keeping the corporate tax down to the minimum 30 per cent. rate. After building the houses and selling fifty of them, he has liquidated the corporation. How has he fared?

Gain by the corporations on the sale of 50 houses $100,000

Corporate tax $30,000

Tax upon $70,000 balance distributed in liquidation $17,500

Tax on distribution of houses in kind $25,000

Total Tax $72,500

Gain on appreciation of distributed houses $100,000

Total gain $200,000

Net tax rate $72,000 or 36.25% $200,000

The “70-30” rule.

The other major manner of hurdling the consequences of Section 341(a) is through the utilization of Section 341(d)(2) and the so-called “70-30” rule contained therein.\textsuperscript{52}

\textsuperscript{51} In West Grass Ridge, McLean, Virginia, at least 50% of the 75 purchasers were influenced in their decision to purchase by the fact that friends had purchased there.

\textsuperscript{52} Much of the comment herein is based upon an expansion of or disagreement with Donaldson, Does the “Two-Shot” Corporation Escape Collapsible Treatment under Section 341F, 8 J. Taxation 338 (1958).
Section 341(d), unlike Section 341(b), eliminates the collapsible consequences to the qualifying shareholder for the distribution in question, but does not eliminate the collapsible status of the corporation. Section 341(d) (2) provides that gain recognized by a shareholder during the taxable year with respect to his stock in a collapsible corporation, shall not be within the results attached by Section 341 unless more than 70 per cent. of the gain "is attributable to the property so . . . constructed."

The Regulations say that "property so . . . constructed" means the "property referred to in section 341(b) (1)." This property, hereinafter described as "collapsible," is on the "70" side of the equation, while other property, which will be described as "non-collapsible," is on the "30" side. Non-collapsible property may consist of that type of property generally not within the provisions of Section 341(b) (3), such as investments in other businesses. This may take the form of stock or the assets of another business, such as a hardware store. Possibly, completely unimproved land would come within this definition.

The other type of non-collapsible asset is property which would be collapsible but for the fact that a substantial

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Footnotes:
53 Reg. § 1.341-4 (c) (1) (1955).
54 This term may be slightly inaccurate, but is convenient. It is not to be confused with "section 341 assets" referred to in § 341(b) (3).
55 § 341(b) (1) refers to 341(b) (3).
56 Although § 341(c) (2) (C) eliminates stock from the 341(c) computation, the statute gives no indication that stock may not be used for the "70-30" computation.
57 Since much that the builder purchases must or may come from a hardware store, this is not an unusual side business.
58 Payne v. Commissioner, 268 F. 2d 617 (5th Cir. 1959); Glickman v. Commissioner, 256 F. 2d 108 (2nd Cir. 1958); W. H. Weaver, 32 T.C. 66 (1959); Elizabeth M. August, 30 T.C. 969 (1958), aff'd 267 F. 2d 829 (3rd Cir. 1959); Donaldson, Collapsible Corporations, 36 Taxes 777 (1958). However, it is also clear that if the appreciation in the raw land is caused by its relation to the constructed property, such as an undeveloped tract adjacent to or part of a developed tract, or the very property upon which the construction takes place, the raw land will be treated as a collapsible asset. Glickman v. Commissioner, 256 F. 2d 108 (2nd Cir. 1958); Erwin Gerber, 32 T.C. 1199 (1959); Max Mintz, 32 T.C. 723 (1959), aff'd 254 F. 2d 554 (2nd Cir. 1960); Reg. § 1.341-4 (c) (8) (1955). See also, Spangler v. Commissioner, 278 F. 2d 365 (4th Cir. 1960), cert applied for (construing "attributable" broadly). The Maryland builder may be able to argue that his land should not be tainted since he often retains the land in order to receive the ground rents and it is thus not an inventory type asset.
part of the income has been derived from the property. Within this category, there are two types of assets. Assume that the assets of A consist of three subdivisions of fifty houses each, each subdivision being located several miles from either of the others, and one apartment building. The apartment building is one asset, and according to the Regulations, each of the subdivisions is a separate asset. Thus, the Regulations specify:

"Where any such property is a unit of an integrated project involving several properties similar in kind, the determination shall be made . . . by reference to the aggregate of the properties constituting the single project."

Assuming the 50 per cent. test to be valid, if one-half of the houses in one subdivision are sold by the corporation, then substantial realization has occurred with regard to that "property." Now assume that each of the subdivisions has a total possible gain of $100,000 and that the apartment house has a projected gain of $100,000, so that the total gain will be $400,000. Assume further that two of the subdivisions have earned $60,000 each, the third $80,000, and that the apartment house has no earnings. If the corporation were now collapsed, the substantial limitation would not apply although 50 per cent. of the total income has been earned. As we shall see, the distribution would qualify under the "70-30" rule.

With the above distinctions in mind, how is the "70-30" computed? Let us use the same example with three added facts: (1) $150,000 in corporate and other taxes has been paid from the earnings of the three subdivisions; (2) $10,000 has been earned by investing the balance of the earnings of the three subdivisions; and (3) a dividend of $30,000 has been distributed. When substantial realization has occurred with respect to any one "property," the entire income, earned and to be earned, from that property is placed on the "30" side. Surplus attributable to that income is also placed on the same side. The computation may then be outlined as follows:

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\(^a\) The Regulations also provide that "reference shall be made to each property." *Ibid.* Thus it is apparently the view of the Regulations that to come within the substantial limitation, there must be substantial realization with respect to each asset.

\(^b\) See Reg. § 1.341-4(c) (4) (1955).
Portion of gain attributable to non-collapsible property:

1. House sales from 3 subdivisions $300,000
   Plus investment income.............. 10,000
   Total ................................................ $310,000

2. Less:
   Taxes ........................................ $150,000
   Dividends .................................... 30,000
   Total subtractions........................ $180,000

Portion of gain on "30" side......................... $130,000
Portion of gain attributable to appreciation of collapsible property.......................... $100,000

Total gain to shareholder........................ $230,000
Percentage of total gain attributable to collapsible property........ $100,000 or 43.3%

Since the percentage is not more than 70 per cent, the entire distribution is not within section 341. Note that taxes, surplus, and dividends affect the application of the "70-30" rule, whereas they do not affect the substantial limitation.\(^2\)

Several suggestions have been made as to the various means of utilizing the "70-30" rule. MacLean states one such method:

"An exchange of low-basis investment property for stock at the time of formation of the corporation in order that 30% of the gain on sale or liquidation will be attributable to that property has [some] promise of success."\(^3\)

Thus, if A happens to own 1000 shares of IBM worth $400 per share and with a basis of $100 per share, the corporation will take his basis in the shares\(^4\) and his basis in

\(^2\) See also the explanation in Donaldson, \textit{supra}, n. 52, 339.

\(^3\) MacLean, \textit{supra}, n. 24, 80.

\(^4\) § 362.
the corporation's shares will be adjusted accordingly. Upon distribution of the shares in liquidation, he will then report the capital gain attributable to these shares, and if his total gain is $100,000 or more, the "70-30" rule will make the entire gain outside the operation of 341(a). One difficulty with this approach is that the courts may merely say that stock in another corporation is not the type of property referred to by Section 341(d)(2). A second difficulty is that such an approach may run afoul of the accumulated earnings tax provision since there is no reasonable need for the retention of the stock. A's situation in regard to the Section 531 tax might be improved slightly if the low basis assets were of the non-liquid type, such as the assets of a hardware business. Perhaps the earnings tax will be inapplicable for some other reason. If the low basis asset is raw land upon which the builder will someday build, the objections suggested above are minimized further, but A may be in trouble when he reincorporates. Although the difficulties are apparent, this approach may be worth considering if the builder's financial situation lends itself to this pattern and the safer alternative discussed below is unavailable.

The use of the "70-30" rule which has the most promise of success is through the "two-shot" corporation. As illustrated above, the two-shot is accomplished by building two or more separate and distinct housing developments, realizing a substantial part of the income with respect to one of them, and then liquidating at such a time that the gain to the shareholder from the collapsible subdivision does not exceed 70 per cent. of the total gain.

Although the "two-shot" corporation seems quite within the statutory language as implemented by the Regulations, several builders interviewed suggested some substantial

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[9] See supra, n. 9. It would seem that the accumulated earnings tax would not apply if the stocks were used as security for a more favorable construction loan. Also, § 543(a) (1) classifies income from stocks, and § 543(a) (2) income from the sale or exchange of stocks as personal holding company income. However, the amount of non-holding company income from the sale of houses ought to avoid any danger of a personal holding company tax. See also § 542(a) (2), which excludes from the operation of the provision corporations in which six or more shareholders own more than 50% of the stock.

[9] The presence of a tangible asset may help the Commissioner in his argument that a reorganization with taxable boot was effected. See supra, n. 9.

[9] When this general approach was suggested to one builder, he appropriately replied, "I don't happen to have 1000 shares of IBM with a basis of $100 a share."
practical difficulties. The primary criticism offered was that two distinct operations would entail extra expenditures. The principal economy effected by the subdivision operation results from the utilization of mass production methods within a small geographic area. As the operation becomes decentralized labor costs are increased since part of the labor time is spent between jobs. Needless to say, effective supervision of the construction process is also impeded when the work is decentralized. Advertising expense may be almost doubled when the two subdivisions are advertised during the same period since different outdoor signs must be used, and the two subdivisions may lend themselves to separate newspaper advertising. Contractual costs may also be increased if, for example, two fifty acre tracts are developed instead of one hundred acre tract. Thus, two sewer lines would have to be brought in for the former but only one for the latter. Similarly, street costs are usually greater when two tracts are involved. Building permits and other county costs may to some extent depend upon the number of houses within the same plat. Many other extra costs are possible. Of course, one answer to these arguments might be that the two subdivisions need not be built simultaneously. However, successive building raises other problems. If the houses from the first subdivision are sold, and the profits retained by the corporation while the second subdivision is built, chances that the accumulated earnings tax will be imposed are increased since, inter alia, the life span of the corporation is increased. The added cost of allowing houses to remain unsold has already received mention. Perhaps the short answer is that tax-saving devices do entail extra cost, and that the ultimate decision as to their utilization depends upon balancing the potential saving and the risk involved against the extra cost.

Another way suggested by Donaldson of utilizing the "two-shot" is to build houses on one portion of a plot of

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*Many builders pay for their own advertising expense, while others pay advertising expense only indirectly through the sales commissions. This does not depend upon whether or not the builder has his own sales organization, since it is often part of the agreement between builder and broker that the former will pay for advertising. The mode of advertising also varies with each builder. Some rely extensively upon newspaper advertising. Others feel that this very expensive form of advertising brings out only the "Sunday" and "professional" lookers, and instead rely almost solely upon outdoor directional signs, brochures to people moving into the area, and word of mouth. 

*Two different locations may lend themselves to two different types and price ranges of houses. This obviously will increase the architect's fee and labor costs.
land, sell the houses, and with the proceeds from their sale build a shopping center upon a remaining corner.\footnote{Donaldson, supra, n. 52, 340.} Then lease the various shops, and sell the stock or liquidate the corporation. Under the Regulation's definition of property,\footnote{See supra, n. 60.} the housing subdivision and the shopping center will be two separate assets. Since more than 30 per cent. of the gain to the shareholder will be attributable to the non-collapsible asset, i.e., the subdivision, the entire distribution will be taxed at capital rates. Since the situation in which a shopping center may be built upon the corner of a subdivision is comparatively unusual, the primary objection to this plan is its general lack of utility. If the subdivision is at all isolated from other housing, it will have to be rather large to sustain the shopping center. But regardless of its size, zoning restrictions or the fact that the area is already adequately served may mean that the shopping center variation cannot be used.\footnote{Donaldson, supra, n. 52, suggests two other variations of the "two-shot." The redemption part of the "Two-shot Corporation with Redemption Out" will be discussed infra. The fourth variation which he suggests is the "Parent-Subsidiary Two-shot Combination."}

The 5 Per Cent. and the Three Year Exceptions.

Two other exceptions to the general operation of Section 341 are provided in Section 341 (d). The first requires but brief mention. Section 341 (d) (1) provides for the inapplicability of the section to shareholders owning 5 per cent. or less of the shares. The definition of "shareholder" includes the attribution rules.\footnote{With certain additions, attribution rules are the same as those in § 544 (a). Under the 1939 Code the per cent was 10% rather than 5%. For a case involving this provision, see Butler v. Patterson, 148 F. Supp. 197 (Ala. 1957).} Due to the closed nature of the enterprise, most of the investors in the building corporation will usually own considerably more than 5 per cent. The section may be of use to the occasional investor or to the attorney or architect whose fee is paid in shares of stock.\footnote{Of course part of the payment of stock to the attorney will be compensation for services.}

Section 341 (d) (3) provides for the inapplicability of Section 341 "to gain realized after the expiration of 3 years following the completion of such . . . construction." Thus one possibility would be to rent all the houses in the subdivision for the required period. High rent would be obtained because of the new house condition. Accelerated
depreciation could be taken on the houses while held by the corporation. At the end of the three year period, the corporation would be liquidated and all of the houses distributed in liquidation. Not only would the profit from building the houses be taken in long-term capital gains, but the corporation could take an ordinary deduction for accelerated depreciation, and the difference would be "paid back" at capital rates.

The primary legal difficulty with this scheme is the Commissioner's definition of "completed." Construction is not completed until every "integral step in the construction" is completed. Thus the Commissioner held that construction of a shopping center was "completed" when a zoning petition was issued after a two-year hiatus. The three-year period could then begin to run "if the corporation has no other construction activity with relation to the land subsequent to the date the rezoning became final." Since our entire subdivision will be regarded as one asset, and since some construction activity will remain until every house is built, presumably the three year period will not run on any of the houses until all are built. Thus, in a subdivision taking three years to build, the first house built would have to be rented for five to six years.

If the builder is willing to have his investment tied up for this period of time, the decision as to the use of this plan then turns upon his estimate of the economic considerations. Primary among these is the question of the price for which the houses will sell in six years. This in turn will depend upon two factors. The first is the national and local economic situation at that time. If there is a depression, or even a recession, the builder will be badly hurt. This should not be a substantial impediment since this is a risk which always faces a long-term investor. Of course, since the builder is normally a short-term investor, his risk is increased. But in view of the present, generally optimistic attitude toward the national economy, the builder may believe that the local economic situation presents the more serious risk. The main industry in a town may close, thereby depressing the real estate market. A factory, or an industrial development may be built nearby,
thus making the particular neighborhood less desirable. These and many other such factors will be considered by the builder in making his decision.

More terrifying to the builder is the effect which renting the houses may have upon their sales price three to six years hence. In Northern Virginia, realtors usually estimate that one who purchases a new house, and subsequently sells it in three to six years, will sell it for more than he paid. Discounting any improvements which the homeowner may make, the subdivision generally has a more settled appearance after several years. Trees, grass and shrubbery will grow. On the other hand, one leasing a house does not have the same incentive to improve the property, or even to maintain it in its present condition. Aside from the usual precautions which the landlord takes, such as the security deposit, the type of arrangement suggested calls for more ingenious planning. First, the lessor of a new house should have his choice of tenants, and this choice should be exercised with care. There are people who take pride in the manner in which their property is maintained regardless of any material advantages they may or may not reap thereby. Second, a way may be found by which the lessee may be motivated to give the property greater care. When the houses are initially rented, a rental agreement with an option to buy may be offered. Perhaps the imaginative builder could conceive a plan by which lessees are rewarded for maintenance or improvements which increase the value of the property. A third planning feature to be considered is the cost of redecorating at the termination of the lease. The houses may have to be repainted, and certain minor repairs made. Or, instead of waiting until the end of the lease, the builder may decide that in some respects it is wiser to have his own maintenance staff. This staff would be

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80 Although the manner in which the “sheep are separated from the goats” is something of a mystery. It is the experience of many realtors that not much can be told in this regard from personal appearance or position. If practical, the most reliable method is to check with previous landlords.

81 Query the result of exercising the option after the corporation is liquidated — will the income from the sale be considered the corporation’s or the transferee’s?

82 Or perhaps more realistically, by which the builder helps to defray the cost of such improvements. For example, he might contribute to the purchase of shrubbery, or share the cost of having a recreation room finished.

83 This expense will vary considerably with houses and geographic locations. Most builders in the Washington area would only have to consider interior painting since it is an area where the houses are predominantly brick. New England builders, would have the added expense of painting the exterior of the house.
primarily concerned with that type of maintenance which, if not undertaken immediately, would ultimately lead to more serious damage.

Another expenditure which renting entails is property management. The houses must be rented, rent collected and the expenses resulting from retained ownership paid. The builder may prefer to do this himself, or he may turn the whole project over to a realtor. Although the realtor in the Washington area usually charges individual homeowners 7 per cent. for this service, the fee would be considerably reduced if a large package deal were offered the realtor, especially if it also involved the agency for the eventual sale of the houses.

This plan, then, involves numerous risks and extra planning. It should be noted, that if successful, the reward is correspondingly increased. Unlike either the "substantial realization" plan or the "70-30" device, this method allows liquidation before the corporation earns income from the sale of any of the houses. Further, the low return upon the investment during the years of rental may be more than offset by the accelerated depreciation deduction allowed during that period.

Redemption.

One other possible method of avoiding the consequences of Section 341 mentioned by some commentators is through the utilization of a Section 302 redemption. There are numerous cases under the 1939 Code holding Section 117(m) applicable to redemptions. However, Section 341(a)(2) of the 1954 Code provides that ordinary income will result from:

"... a distribution in partial or complete liquidation of a collapsible corporation, which distribution is

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84 The commencement of an intrusion by termites is a ready example.
85 See § 543(a)(7). Although the personal holding company tax may be levied on rent income, it may only be applied if the rent income constitutes less than 50% of the corporation's gross income. Here, during the years of the corporate existence, rent income will be 100% of total income. See also § 543(a)(6).
86 DeWind & Anthoine, Collapsible Corporations, 56 Col. L. Rev. 475, 480 (1956); Donaldson, supra, n. 52.
87 E.g., Bryan v. Commissioner, 281 F. 2d 238 (4th Cir. 1960); Payne v. Commissioner, 268 F. 2d 617 (5th Cir. 1959); August v. Commissioner, 267 F. 2d 829 (3rd Cir. 1959); Burge v. Commissioner, 253 F. 2d 765 (4th Cir. 1958); W. H. Weaver, 32 T.C. 66 (1959). See also Jesse Hartman, 34 T.C. No. 111 (1960); and Arthur Pompanio, 33 T.C. 1072 (1960), on appeal to 4th Circuit.
treated under this part as in part of full payment in exchange for stock."

"[T]his part" is Part II, whereas Section 302 dealing with redemptions is in Part I of the chapter. Thus a strict interpretation of the section would exclude redemptions from its operation. Should the attitude manifested by Judge Magruder in *Granite Trust Co. v. United States* toward a strict construction of the Code be applied in this area, the taxpayer would have another sizable out. The author believes such a construction to be extremely unlikely. The exemption of redemptions from the operation of the section would go a long way toward defeating the purpose for which it was enacted. Although this argument does not always save a statute from destruction when the court feels that the legislature is participating in a masochistic exercise, the "redemption argument" seems to have at least one gaping technical hole. Section 302 provides for capital gain treatment for certain redemptions not "essentially equivalent to a dividend." Section 346, defines partial liquidations, and in conjunction with Section 318, provides for capital gain treatment for partial liquidations if:

"(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan, or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of part of the stock of a corporation pursuant to a plan. . . ."

Section 346(c) gives explicit recognition to the fact that the same fact situation may fall under both Sections 302 and 346. Thus, due to the blurred line between the two sections, it would seem that the utilization of a redemption to collapse the corporation could almost always be treated by the court or the commissioner as within the vague definition of a partial liquidation. It is recommended that no reliance be placed upon the redemption technique or argument.

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48 Emphasis added.
50 The section specifically provides that a determination that the distribution is "essentially equivalent to a dividend" does not necessarily make § 302(a) inoperative, but this may be an awkward trick for the courts to perform. See § 302(b) (5).
The Section 337 Hedge.

One last suggestion may be made to cautious counsel. The substantial realization test may be combined with Section 337 to provide a hedge in borderline cases. Assume that the corporation sells 50 per cent. of the houses, realizing 50 per cent. of the gain. A plan of liquidation pursuant to Section 337 is then adopted, and the remainder of the houses are sold by the corporation. If the Commissioner or the court determines that the corporation is not collapsible, the same result follows as if Section 337 had not been used and 50 per cent. of the houses had been distributed in liquidation. If the Commissioner determines that the corporation is collapsible, Section 337 is then inapplicable and the gain from the sale of the property is included in the taxable income of the corporation. "However, since the corporation has realized all of the taxable income from its property, the stockholders gain upon liquidation would not constitute ordinary income within the purview of section 341 of the code."\(^2\) The catch, as far as the builder is concerned, is that since the houses are inventory assets, the benefits of Section 337 are unavailable unless "substantially all" of the houses are sold to one person in one transaction.\(^3\) It would seem that even if a buyer could be found, the discount which he would require would be almost as great as the tax advantage to be gained.\(^4\)

\(^1\) § 337(c)(1)(A).
\(^3\) § 337(b).
\(^4\) The purchaser will determine his price by subtracting from the total proceeds to be received after the houses are sold and taxes are taken out, the sales commissions and a large percentage for the risk involved.
FEDERAL TAX LIENS AND FORECLOSURES

WILLIAM F. MOSNER*

In the ordinary course of events, an attorney who receives an adverse decision from the Court of Appeals based solely on statutory law — or the lack of it — knows well that the opinion will state, "If the recognized rule of law is to be changed, this is a matter for the Legislature, and not for this Court." Be the disappointed lawyer a crusading soul — or one with many friends in Annapolis — he may succeed in having a bill enacted to achieve the statutory change he feels desirable. However, the reverse of the picture is most unexpected — that the Courts, after the Legislature has considered a proposed amendment and rejected it, will construe existing law to achieve the result denied by the Legislature. And, once again, the Supreme Court of the United States has done the unexpected.

In its opinion of June 13, 1960, in United States v. Brosnan,† the Supreme Court has ruled that the foreclosure of a senior mortgage under State procedure will completely wipe out junior Federal tax liens, without prior notice to the Government, without joining the Government in the case, and without a one-year right of redemption attaching to the sale.

Perhaps a brief history of the matter would be enlightening. As was pointed out in an earlier article published in the Maryland Law Review,‡ there existed a considerable problem with respect to establishing clear title at a foreclosure sale when a Federal tax lien had been filed against the owner prior to sale. Even though the defaulted mortgage was senior to the tax lien, the practically unanimous holding of the cases reported at the time the prior article was written established the principle that a tax lien could only be discharged as provided by Federal statute..§ This meant by one of three ways: (1) applying

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† 363 U.S. 237 (1960).
to the Secretary of the Treasury for a discharge under Section 6325, Internal Revenue Code of 1954; (2) bringing suit to clear title in the Federal Court under the cumbersome provisions of Section 7424, Internal Revenue Code of 1954; (3) joining the United States as a party in the State foreclosure case under Title 28, U.S.C.A., Section 2410, which allows the Government one year from date of sale in which to redeem.

None of the three methods afforded a really practical remedy for the mortgagee, as the first two entail a great loss of time and the third results in a discounted price being bid at the foreclosure sale, since no buyer will pay top dollar with the year redemption right attaching to the property. The moneylender was, therefore, faced with a serious problem in protecting his investment even though the property was completely free of liens and the borrowers indebted in no way to the Government at the time the loan was made. The lender through no fault of his own was liable to incur financial loss through the facets of the tax laws which allowed the Government privileges never afforded to ordinary creditors.

The situation was sorely recognized by those affected, but every effort by the Bar Associations or Savings and Loan Leagues to effect remedial legislation in Washington was met with opposition from the Internal Revenue Service, and the tax laws were not amended to afford relief.

Enter the Supreme Court: The Third Circuit Court of Appeals, in a case involving a tract of land in Pennsylvania, had held that the Government's tax lien — junior to the mortgage — was effectively extinguished by foreclosure proceedings wherein the United States was not a party. The Ninth Circuit Court of Appeals, however, ruling on a California issue, decided that a foreclosure sale wherein the Government had no notice and was not a party, was ineffective to wipe out the junior lien as it could be divested “only with the consent of the United States and in the manner prescribed by Congress.” The conflict between Circuits brought the case to the Supreme Court, and it granted certiorari.

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1953); Integrity Trust Co. v. United States, 3 F. Supp. 577 (N.J. 1933); Oden v. United States, 33 F. 2d 533 (W.D. La. 1929); and cases collected in 174 A.L.R. 1373, 1403 (1948) and 105 A.L.R. 1244 (1936).

*United States v. Brosnan, 264 F. 2d 762 (3rd Cir. 1959).

*United States v. Bank of America National Trust & Savings Association, 265 F. 2d 862 (9th Cir. 1959).

The opinion of the majority (Justice Harlan) cut through the multitude of previously adjudicated Federal cases, declaring that uniformity throughout the States was a necessary objective to oil the machinery for the effective collection of Federal taxes. The Court recognized that different states had different procedures for foreclosure — some requiring a public sale, some not; some requiring notice to junior lienors, others not. But, rejecting the time-honored precept of uniformity, the Court declared, "We believe that, so far as this Court is concerned, the need for uniformity in this instance is outweighed by the severe dislocation to local property relationships which would result from our disregarding state procedures . . . ;" and the opinion continued, "We . . . believe it desirable to adopt as federal law state law governing divestiture of federal tax liens . . . ."8

Having thus stated its objective, the Supreme Court set about achieving it by declaring Sections 6325, 7424 and 24109 to be permissive only, and not mandatory directions as to the exclusive methods for disposing of tax liens, as had been held by the former decisions.' (One cannot but comment that these statutes — if not mandatory — will quickly become as archaic and unused as those on our books which authorized public whippings, for no sane attorney with a title problem will add to his woes by making the Government a party where the simpler, quicker and more readily available state procedure will suffice.) Justice Harlan declared that the legislative history of the cited sections gave no evidence that Congress believed that a suit to which the United States was a party was the only way in which a Federal lien could be extinguished, and he reasoned that those statutes were only enacted as optional methods which could be used in addition to existing state procedures. But it is respectfully submitted that this reasoning is difficult to follow. Consider, for instance, certain excerpts from the legislative debates preceding enactment of these statutes as set out in footnotes to the majority opinion:

"At the present time, in cases in which the lien prior in time to that of the United States equals or exceeds in amount the value of the property, there is

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1 Supra, n. 1, 242.
2 Id., 241.
3 Id., 246-250.
4 Supra, n. 3.