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ON STAGE WITH 1244: TAX SHELTER IN THE THEATRE

JOHN HERBERT TOVEY*

THE PRIMARY OBJECTIVE OF THE AUTHOR is to demonstrate the application of the Small Business Corporation, as defined in the 1954 Code,1 to the financial and tax problems of the performing arts2 and to indicate how it may be used to generate theatrical capital under most favorable tax conditions. The fulcrum of analysis is the medium of grand opera,3 which appears to offer the maximum possibilities for attractive tax consequences, although the principles are equally applicable to commercial productions of symphony, ballet, concert, recital, drama, operetta, and musical comedy. Consideration is limited to ventures designed to produce gain from successful operation.4

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2 The expression “performing arts” is used to mean all live stage productions with the exception of vaudeville type entertainment. It necessarily excludes motion picture and television productions.

3 The accumulated earnings tax of § 531 is a hurdle to be overcome in any use of the corporate form to avoid or delay the imposition of income tax on shareholders. Analysis of § 531 later in this writing indicates that grand opera offers the most avenues for its solution.

4 One cannot deduct losses on transactions not entered into for profit as § 162 or § 165 items. They are properly restricted to § 170 if they amount to charitable contributions, but they are subject to the limitation imposed by that section. Lucia Chase Ewing, a wealthy, retired ballerina, made several loans to the Ballet Theatre. There were no provisions for interest, no agreements for the distribution of profits, and none of the usual indicia of business arrangement. She was denied a bad debt deduction when the loans became worthless. Lucia Chase Ewing, 20 T.C. 216 (1953), aff’d, 213 F.2d 438 (2d Cir. 1954).
For some years, investment in the classical theatre has been regarded as a speculation for the wealthy, if indeed it was regarded as investment rather than a form of philanthropy. Broadway musicals and drama, despite numerous failures, have produced great profit. Grand opera and its related fields, on the other hand, have generally been regarded as unprofitable activities, reserved for the area of public and private subsidy. The result has been to limit the availability of live stage productions to large cities, except for summer stock and the annual tours.

The major source of funds for classical music productions has been contributions, which are necessarily limited by the ceiling on charitable deductions at 20% of an individual's adjusted gross income. Competition for the charitable dollar within this limitation has been severe, and has tended to discourage the institution or expansion of operatic performances throughout the United States.

When investors have entered the theatre—almost always the drama and musical comedy—they followed the course charted by tax counsel and adopted the limited partnership or the joint venture, to obtain maximum centralized control without sacrifice of the ordinary loss deduction in the event the effort was unsuccessful. Although non-corporate operation offered excellent protection in the event of losses, it had little to commend itself in the event of gains since the partners or joint-venturers remained taxable at § 1 rates on distributive shares whether or not funds were actually paid to the investors. Even worse, the managers, usually the general partners, were denied fringe benefits since they had no status

6 1954 Code, §§ 170(b)(1)(B) and 170(b)(1)(C).
8 Under § 162(a) a joint venturer may deduct losses on any transaction entered into for profit.
9 A joint venture is not subject to tax unless classified as an association. 1954 Code, § 701. The venturers are taxable on their distributive shares. Id., §§ 702, 704.
as employees. Liability remained unlimited as to the general partners and transfer of interests necessitated cumbersome dissolution and reorganization with the necessarily high expenses. Despite these disadvantages, the limited partnership became the vehicle preferred for these productions by both the tax bar and the Service.\textsuperscript{10}

The addition of § 1244 to the 1954 Code offers distinct advantages both to the theatre and to taxpayers desiring to minimize tax rates on income from securities. Incorporation of theatrical ventures and qualification as Small Business Companies can preserve substantial deductibility of losses without the sacrifice of limited liability or free transferability of interests. In addition, it offers the interesting opportunity to shield dividend income until such time as it may be taken at capital gains rates. Of great importance is the facility with which a § 1244 corporation can attract investment capital under circumstances which combine patronage of the arts and profit, with a substantial reduction of risk to capital. Application of these principles will be considered in light of an opera company which holds a substantial portfolio of liberal dividend securities from the standpoints of (1) Organization; (2) Operation; (3) Dissolution and Liquidation; and (4) Problems of (a) Accumulated Earnings Tax, (b) Multiple Corporations, (c) Personal Holding Company Tax and (d) Collapsible Corporations.

\textbf{Organization}

Since the creation of § 1244 Stock depends upon qualification of the issuing corporation as a small business corporation, it is important that corporate organization comply strictly with the requirements of the Statute. It should be noted that corporate qualification at the time 1244 Stock is issued is not revocable by reason of prohibited transactions by the shareholders, who will receive protection as long as they hold qualified stock issued to them by the corporation.\textsuperscript{11}

\textsuperscript{10} See Taubman, \textit{op. cit.}, supra, n. 7, for an analysis of Treasury policy subsequent to the decision in Junior Miss, 14 T.C. 1, 3 (1950).

\textsuperscript{11} 1954 Code, § 1244(a) limits favorable loss treatment to individuals and partner-
A small business corporation contains two important restrictions on its capitalization, the first being a limit on the proceeds received for qualified stock, and the second being an overall limitation on total equity capital. Under § 1244(c)(2)(A) the aggregate amount, which may be offered under a qualified plan, plus the aggregate amount of money and other property received by the corporation after June 30, 1958 for the stock, both as a contribution to capital and as paid-in surplus, must not exceed $500,000.12 In addition, § 1244(c)(2)(B) limits the aggregate amount of the stock offering plus the total equity capital to $1,000,000.13

Although both of these requirements must exist at the time § 1244 stock is issued, there is no compulsion that they exist or continue to exist throughout corporate life. There is no reason to suppose, for instance, that subsequent to the issuance of qualified § 1244 stock a corporation could not issue additional stock which would increase its equity capital beyond the prohibition of § 1244(c)(2)(B), nor is there any reason to assume that such action would disqualify stock previously issued. Of course, the excess stock would not qualify for § 1244 treatment.

In addition to being a small business corporation when the plan to offer the stock was adopted, the corporation is further limited14 in that for the five taxable years, immediately preceding the year of the loss, or for a shorter period if corporate existence is less than five years, more than 50% of aggregate gross receipts must have been from sources other than royalties, rents, dividends,

12 "Other property" is taken at its adjusted basis for determining gain as of the time it is received, reduced by liabilities assumed or to which the property is subject. Costumes which cost $10,000 but had been depreciated to $5,000 and were transferred with a mortgage of $3,000 would be taken at a value of $2,000, regardless of whether the mortgage was assumed by the corporation as a personal indebtedness.

13 Equity capital is the aggregate of assets, at adjusted basis, less the indebtedness of persons other than shareholders.

14 § 1244(c)(1)(E).
interests, annuities, and sales or exchanges of stock or securities. Since gross receipts embrace virtually the total receipts of a corporation in a given taxable year without reduction for normal accounting practice, it seems that an amount of proceeds from ticket sales, program advertising, and miscellaneous income, which exceed 50% of the corporate total, would act to preserve § 1244 protection even though the bulk of corporate profit was realized from dividends or any of the other prescribed sources of income. In fact, it is contended that theatrical production expenses might well equal theatrical production income without loss of § 1244 status.

It is important to remember that only common stock in a domestic corporation may qualify for ordinary loss treatment under § 1244(c)(1). Although § 7701(a)(4) defines a domestic corporation, there is no definition of the term “common stock” in § 1244, nor is it generally defined in the Code. Significantly, although the Statute requires that § 1244 stock be common stock, there is no prohibition against the issuance of other types of stock prior, concurrently, or subsequent to the issuance of § 1244 stock, provided the capitalization restrictions are observed. If, for instance, an opera company was organized with a capitalization of $500,000, being represented by $100,000 of common and $400,000 of 5% preferred, the common would be § 1244 stock since the capitalization restriction of § 1244(c)(2)(A) was not violated. The preferred would be limited to capital loss treatment in the event of worthlessness, but it would be suitable for subsequent redemption without termination of a shareholder's complete interest. Of vital concern in a theatrical organization is voting

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15 Treas. Reg. § 1.1244(c)-1(g)(1)(i)(a) (1960) provides that the gross receipts requirement of § 1244(c)(1)(E) is not synonymous with gross income, but includes the total amounts received without diminution for returns, deductions, allowances or costs. It does not include amounts received in non-taxable transactions, other than those governed by § 337, except to the extent gain is recognized, nor does it include the proceeds of loans, repayment of loans, contributions to capital, or the proceeds of treasury stock.

16 A domestic corporation is a corporation “created or organized in the United States or under the law of the United States or of any state or territory.”

17 § 306(e) does provide that common stock cannot be stock which is convertible into other than common stock, but there is serious question as to the force of this rule throughout the Code.

18 Such a redemption would fall within the § 306(c)(2) exception since the stock was
control. Common stock remains common stock even though it is non-voting and qualifies for § 1244 classification.\textsuperscript{19}

The Code also requires that stock qualified for § 1244 treatment must be issued pursuant to a plan adopted after June 30, 1958 to offer the stock for a period ending not later than two years after the date such plan was adopted.\textsuperscript{20} The term "plan" is not defined but careful note should be taken of the requirement that the offering must take place within two years after adoption of the plan and not after the initial offering of the stock. In large publicly held corporations normal underwriting procedures through brokerage houses can be expected to dispose of an offering in a relatively short period of time. Since a theatrical corporation is not likely to attract widespread interest, careful planning for the disposition of the shares should be completed prior to the adoption of the corporate plan.

The plan should probably take the form of a resolution of the board of directors, or of the stockholders if this action is required, which should be set forth in detail in the minute book. It might be advisable to register a copy or extract of the minute book covering the plan in the local county clerk's office on the day of adoption since the Service might raise some question concerning that date. The resolution should state in dollars the maximum amount of consideration for which the stock will be transferred, the exact date and time limitations of the offering, and whether or not consideration other than cash will be received in exchange for the stock.\textsuperscript{21}

If property other than cash is to be accepted,\textsuperscript{22} it is important

\textsuperscript{19} Treas. Reg. § 1.1244(c)-1(b) (1960). But note that common stock qualified for § 1244, according to the Regulations, does not include convertibles.

\textsuperscript{20} § 1244(c)(1)(A).

\textsuperscript{21} Treas. Reg. § 1.1244(c)-1(C) (1960).

\textsuperscript{22} Since it is likely that costumes, scenery, properties, and similar items might be transferred by the organizers, note should be taken of § 1244(c)(D) which denies protection if stock is issued in exchange for other stock. Thus, it would be unwise to take the stock of a costume house in the exchange. A reorganization or a liquidation should be effected.
to fix the value of that property on the date it is transferred to the corporation.\textsuperscript{23} Counsel should consider the advisability of having an independent appraisal made of the value of the property by some person disinterested in the corporation and its shareholders.

If at the time the plan is adopted there is any part of a prior offering of stock outstanding, all stock issued pursuant to the offering is disqualified from § 1244 treatment.\textsuperscript{24} A prior offering includes any unissued portion of a prior offering of stock. The Regulation provides that a prior offer is outstanding until it is withdrawn by affirmative action prior to the date the plan is adopted.\textsuperscript{25} It also holds that stock rights, stock warrants, stock options, or securities convertible into stock, which are outstanding at the time the plan is adopted, are deemed to be prior offerings. However, the same regulation holds that authorization in the corporate charter to issue stock different from or in excess of the stock issued under the plan does not constitute a prior offering.

This latter exception has most attractive possibilities in the organization of a theatrical corporation. If a corporate charter authorized the issuance of voting and non-voting common and preferred stocks, it would be possible to attract capital with various degrees of risk protection. A substantial investor, for instance, might be attracted by the possibility that liquidation of his preferred at capital gains rates, which would consume a substantial portion of the corporate assets, might well be followed by a partial or complete ordinary loss deduction on his common. There is nothing in the Code to prevent such action by the directors.

The 2-year limitation on the offering may not be modified by the corporation if the effect of the modification is to extend the total period to one in excess of two years.

\textsuperscript{23} § 1244(d) provides special rules in the event contributed property has a basis in excess of fair market value at the time of contribution. Under § 1244(d)(1)(A)(iii), loss computation must be made by a reduction of basis to an amount equal to the excess of the adjusted basis over fair market value.

\textsuperscript{24} § 1244(e)(1)(C).

\textsuperscript{25} Treas. Reg. § 1.1244(e)-1(c) (1960).
In addition to the adoption of a plan, the corporation is required to issue the stock pursuant to a plan in order to qualify for favorable treatment. The corporation should be careful not to issue treasury stock since a mere increase in the basis of outstanding stock, resulting from contribution to capital, is held not to be an "issuance."\(^2\) The question of the status of treasury stock was considered in *Firestone Tire & Rubber Company*,\(^2\) wherein it was held that a disposition of treasury stock was not an issuance within § 113(a)(7) of the 1939 Code from which § 362(b) of the 1954 Code was taken. Although the Court was considering the definition of "issue" prior to the § 1032 provision that a corporation does not recognize gain or loss on the transfer of treasury stock, it did not clarify whether it was holding that treasury stock could never be issued or whether it was disqualified from an "issuance" in cases wherein the transaction might result in imposition of the tax on the corporation. At any rate, it would seem wise not to use treasury stock in a § 1244 situation. Fortunately, the nature of a theatrical enterprise is such that the problem usually will not arise since there is a limited amount of § 1244 stock available and this will normally be at a premium in the start of any speculative enterprise. As a securities portfolio is acquired by the corporation and securities dividends are received, the importance of § 1244 protection decreases since it would be unlikely that a substantial securities portfolio would become completely worthless to justify the §1244 loss deduction. The issuance of preferred, subsequent to the issuance of the § 1244 stock, would not destroy the attractiveness of a § 1244 deduction.

§ 1.1244(c)-1(c)(2) provides that stock subscribed for prior to the adoption of the plan, including stock subscribed to prior to the date of incorporation, may qualify for § 1244 treatment if the stock is not actually issued before the plan is adopted. This is convenient in that it permits the usual pattern of stock subscription prior to incorporation. The actual date of issuance

\(^2\) Treas. Reg. § 1.1244(c)-1(c)(1) (1960).
\(^2\) 2 T.C. 827 (1943).
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depends upon local law, some of which holds that the subscription constitutes issuance, while others indicate that payment is required.\textsuperscript{28}

**Operations**

Once the company has been incorporated and has completed the issuance of its § 1244 stock and any other securities that may be authorized,\textsuperscript{29} very careful financial planning is required from both a business and tax standpoint. The advice of the general artistic director, the investment advisor, and tax counsel are imperative in all matters that involve income or expenditure. Of prime importance is the immediate preparation of an adequate production budget which necessarily should precede the preparation of the securities investment plan.

**A. THE PRODUCTION BUDGET**

The production budget must be thoroughly within the grasp of both tax and investment counsel since flexibility here can produce protection from personal holding company status and possible violation of § 1244(c)(E) at a less loss of after-tax profit than can be obtained from the securities portfolio. Intelligent evaluation can obviate any risk that artistic integrity might be distorted for reasons of finance or tax saving.

Since most employees in the operatic field are members of some labor organization,\textsuperscript{30} the matter of union contracts must be

\begin{footnotesize}
\textsuperscript{28} Local law would usually bind the Commissioner on this point. See Fletcher, *Cyclopedia of the Law of Private Corporations*, §§ 1375, 1376, 1406, 1427, and 1428 (1930).

\textsuperscript{29} The discussion of what types of securities or instruments of indebtedness to be used would be governed by the demands of available capital. Generally, bonds are unsatisfactory.

\textsuperscript{30} The following unions represent most individuals in the field:

American Guild of Musical Artists (AGMA)
All vocalists, dancers, stage directors, stage managers, and assistants to the latter two individuals.

Actors Equity Association (EQUITY)
All dramatic artists and concurrent jurisdiction with AGMA in musical comedy and operetta.

American Federation of Musicians (AFM)
Conductors and musicians.

International Alliance of Theatrical Stage Employees (IATSE)
Stage hands, electricians, wardrobe personnel, and make-up personnel.
\end{footnotesize}
considered prior to the preparation of any cost estimate. Depending upon the location and activities of the corporation, involvement with many of these organizations may be avoided. In general, one is certain to encounter AGMA or Equity and AFM. Naturally, one's bargaining position with labor organizations in this field is materially strengthened if negotiations are undertaken prior to any corporate commitment to produce particular performances because there is then no compulsion on the corporation to do anything by any definite time. The corporate counsel should be thoroughly familiar with the usual contract demands and practices of the assorted labor organizations if he is to secure the most advantageous agreement for the corporation.\textsuperscript{31} Note should be taken, for instance, of the fact that one may produce operetta under the jurisdiction of other AGMA or of Equity.\textsuperscript{32} Although the prevailing wage scale under Equity is generally lower than under AGMA, the Equity contract contains provisions which might be disadvantageous in particular situations.\textsuperscript{33}

The selection of the repertoire, or works to be performed, should be made with the full participation of both tax and investment counsel; it should never be regarded as a matter of

\footnotesize{\textsuperscript{31} United Scenic Artists (USE) Scenery and costume designers. International Brotherhood of Teamsters (TEAMSTERS) Vehicle drivers and helpers.}

\footnotesize{\textsuperscript{32} In no field of labor relations is good faith more important, nor is there one in which it is usually more lacking. An elementary survey of the theatre is sufficient to demonstrate the great union concern that performers actually receive wages. Defaulting managements have unfortunately been milestones in the history of the stage, the reason why union bonding requirements have become so rigid. Once a management can establish that it will meet its commitments, these are usually relaxed by most of the unions. AGMA, in particular, has shown itself willing to cooperate with management once it can be shown that reasonable working conditions are assured. Whether a § 1244 corporation would want a decrease in bonding requirements is another question which might be determined by the need for an umbrella from the accumulated earnings tax.}

\footnotesize{\textsuperscript{33} Equity does not assert jurisdiction over concert soloists.}

\footnotesize{\textsuperscript{32} Under the Equity Rule Book, 1961 Ed., all performers are divided into principals and chorus, with a separate wage requirement for each. The AGMA Basic Agreement, 1960-1961 Ed., divides roles in a work according to the number of bars of music to be sung, and assigns wages accordingly. AGMA is much more realistic in the classical area since its contract considers depreciation of the voice, a factor ignored by Equity. Although the wage scales are minimum, they are not represented to be a fair wage for the particular work by the unions involved. In practice, it is impossible to secure leading talent of accomplishment at union scale.}
artistic concern alone.\textsuperscript{34} The repetoire will dictate the number of artists, the composition of the orchestra, the requirements for costumes and scenery and, most important from the standpoint of § 1244(c)(E), the likelihood of audience attendance which will determine gross income. An opera producing organization which has substantial losses loses its § 1244 benefits if 50% of the gross receipts are from prohibited sources, even if the expenses consume the entire income and capital so as to make the stock worthless. This should be remembered when proposals are made to offer the public works which it has shown it will not readily accept.

The engagement of artists and their terms of employment deserve the most careful consideration. Although it has become customary to engage through established managers or agents, management should not discard the savings that can result from the use of open auditions to discover talent. Wage demands are frequently lower with younger artists who, though highly qualified, have not secured prominence in the field.

The use of fringe benefits can materially reduce company operating costs, since an employer can offer tax free economic benefit to the artists without loss of his deduction.\textsuperscript{35} An artist who required $650.00 for personal expenses and desired the protection of group hospitalization, at a $50.00 premium, must demand a fee of $1,000 if he is in the 30\% bracket. If the employer offers $650.00 plus coverage for hospitalization, the artist receives what he bargained for and the company has a saving of $300.00, which is minimum after tax benefit of $210.00.\textsuperscript{36}

\textsuperscript{34} A production of The Merry Widow and La Traviata in the same season would reduce the cost of chorus costumes since one set could be used in both works. If Aida and I Pagliacci were being performed, a double set would be required.

\textsuperscript{35} The § 106 exclusion of employer contributions to health and accident plans from the gross income of the artist is a case in point. The employee who purchases his own insurance must do so after payment of the tax on his earnings, and consequently demands higher wages. Note that Rev. Rul. 61-146, 1961-32 IRB, p. 8, distinguishing, Rev. Rul. 57-33, 1957-1 CB, p. 303, provides that the § 106 exclusion remains effective in instances wherein the employer reimburses the employee for amounts expended to secure health insurance if it does so under a plan covering all employees and if it requires the employees to account for the expenditures which are the basis of reimbursement. Amounts paid by the employer remain deductible under § 1.162-10.

\textsuperscript{36} Assuming that the corporation has $25,000 or less taxable income. 1954 Code, § 11(b)(l).
If a company does considerable work in a year, it should likewise consider the use of a pension plan for the same effect.\textsuperscript{37} Consideration should also be given to furnishing appropriate meals to artists in a place designated as the premises of the employer. Although meals consumed when an artist is away from home would be deductible as a part of travel expense,\textsuperscript{38} no such deduction applies in the event the artist is attending rehearsals or performances in the city of his residence. To enable an artist to take advantage of the exclusion of § 119, meals must be served on the premises of the employer for the employer's convenience. Of course, as a practical matter, the availability of § 119 exclusion has the effect of increasing the economic wealth available to the artist for consumption and can be used to a great advantage in negotiations for a contract price.

The supply of costumes, scenery, properties and vehicles for transportation should be determined only after careful consideration of the tax consequences. In smaller organizations, these items are usually leased which, in a commercial organization, would provide a deduction for the amount paid for use of the property.\textsuperscript{39} When these items are purchased, they constitute capital assets and must be depreciated over their useful lives unless it can be shown that they have a useful life of one year or less.\textsuperscript{40} If scenery and costumes are to be constructed rather than rented, the amount of the ultimate after-tax cost should be carefully compared with the allowable rent deduction that may be taken

\textsuperscript{37} A chief problem in the theatre is the inability of the artist to spread the proceeds of his high income years over a sufficient period to enable him to accumulate surplus for retirement. The deferred compensation plans, qualified under Subchapter D, should be utilized to reduce cost to both artist and employer. Counsel should consider that an individual in the 50% bracket would find a contribution of $750 to a qualified pension plan under § 401 of more economic gain than an increased $1,000 in salary, since the latter would be subject to a tax of $500. A corporate gross saving of $250 in wages would, in the lowest tax bracket, realize a net saving of $175.

\textsuperscript{38} Out of town, an artist's entire traveling expenses, including meals, lodging, and incidentals, are fully deductible. Treas. Reg. § 1.162-2(a) (1958); Coburn v. Commissioner, 138 F.2d 763 (2d Cir. 1943). An artist who performs in town must provide himself with meals after payment of the tax.

\textsuperscript{39} 1954 Code, § 162(3) allows a specific deduction for rental payments to secure the use of business property providing the taxpayer is not purchasing the property with the payments.

\textsuperscript{40} 1954 Code, § 167(a)(1).
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for each item. In many instances, it may be cheaper to construct items that will afford a complete deduction by reason of having a short useful life.

Most production organizations do not commit themselves to a presentation unless they have a guaranteed minimum amount of proceeds for a particular show. The proceeds of this guarantee are not includible in corporate gross income until there is an unqualified right on the part of the corporation to demand these funds. This can offer a variety of opportunities to the draftsmen to defer this unqualified right and hence, to defer inclusion. On the other hand, the failure to have proceeds includible in a particular taxable year would necessarily reduce corporate gross income from operations for that year and might expose the organization to personal holding company status under § 541(1) if the stock ownership requirement of § 541(2) was met. In addition, the failure of an item to be includible in gross income, within the meaning of § 61, would seem to necessarily exclude that item from the total corporate gross receipts and consequently, § 1244(a) treatment would be denied in the event the stock became worthless in that particular year. This would appear to apply even though in a subsequent year the corporation received deferred sponsorship proceeds, because an operating loss of consequence in one year might demand suspension of operation in a succeeding year with the consequence that prohibited income could exceed 50% of gross receipts in the latter year.

B. THE SECURITIES PORTFOLIO

Once the annual production budget has been determined, it is possible to estimate how much securities income may be received in the particular year without the loss of § 1244 ad-

41 Prior to a decision to buy or rent, it might be wise to obtain a ruling on the property's useful life. There is little authority in this area since most opera companies, being non-profit, are unconcerned with depreciation as a tax concept. In general, they rent rather than purchase because of the storage problem.
42 McGlue, 45 B.T.A. 761 (1942).
43 If the contract provides that the corporation shall receive an unqualified right to a fund on a day certain, the fund is not includible in gross income until that date. J. E. Oates, 18 T.C. 570 (1953), aff'd, 207 F.2d 711 (7th Cir. 1953).
vantages or the liability for penalty taxes. The budget furnishes a limiting point under which investment counsel must work. If § 1244 status is to be preserved, this point is naturally lower than if the shareholders are content with faster dividend accumulation. Actually, once the company has established itself and can depend on repeat bookings the value of § 1244 diminishes rapidly and it might well be that use of the personal holding company limitation of 80% securities income would be preferable. Regardless of what limitation is employed, it should be fixed, and revised only when absolutely necessary to avoid tax consequences.

The desired form of income from securities is clearly dividends, since they produce the 85% dividends received deduction in computation of the corporate income tax.44 This has the effect of limiting corporate income taxes paid on dividend income to 4.5%, in situations in which corporate taxable income is $25,000 or less, with a corresponding total tax effect on liquidation at a maximum rate of 28.3%.45 Interest enjoys no such advantage and has little to recommend itself in this situation. Growth securities which themselves produce capital gains are likewise of little appeal since they are subject to a compound capital gains tax producing an effective maximum impact on the shareholder of approximately 43% of earnings.46 The treatment of appreciated securities will be discussed later in this writing.

Since great importance must be attached to a regulated securities portfolio, equally great care should be used in the selection of investment counsel. At all events, advice should be

44 1954 Code, § 243(a) provides corporations, other than Small Business Investment Companies, with a deduction equal to 85% of the dividends received from domestic corporations. The preferred stock of public utilities is not entitled to this deduction, however.

45 $100 in domestic dividends received by a corporation is reduced by $4.50, assuming taxable income to be $25,000 or under. On complete liquidation, the maximum exaction under § 1201 or § 1202 is 25% of the balance of $95.50, or $23.88, making the maximum shrinkage $28.38. This provides a return of $71.62 after taxes, an excellent inducement. For taxpayers electing the § 1202 deduction, the shrinkage should be even less and the return higher.

46 On the other hand, $100 of long term capital gain, produced by corporate securities holdings, would face a flat 25% levy under § 1201. If the shareholder elected § 1201 treatment on liquidation, the total impact of taxes would reduce the $100 to $75.00.
obtained from seasoned professional sources with adequate fac-
cilities for research and security analysis.

If investment counsel decides to compose the portfolio of
listed securities, his choice will probably run to preferred stock
since that type of security offers the highest steady dividend
return with relatively little chance of capital gains distribution.
Certainty of the ceiling on income from all prohibited sources
is crucial, since a surprise distribution could well give corporate
counsel the choice of permitting the company to lose a favored
tax position or of disposing of the offending security prior to the
dividend date through a dividends distribution to the opera
company's own shareholders. The latter would generate ordinary
income for them to the extent the distribution exceeded the
$50.00 exclusion of § 116, but this would be preferable to reten-
tion of the security and becoming the recipient of income that
would invite punitive taxation. The company itself could not
sell the security since appreciation would likewise yield prohibit-
ed capital gains income.

On the other hand, more and more investment counsel have
come to realize that institutional investment in regulated invest-
ment companies, the so-called mutual funds, has much to com-
mend it from the combined standpoints of management and
economics. In the first place, the built-in management fees of the
funds are proportionally deductible at the fund level, reducing
any offending capital gain distribution which, at the least, would
be taxed to the opera company at the capital gains rate of 25%.
In the second place, protection of the investment is assured
through the wide distribution of fund investments in the secur-
ities of many corporations to provide a diversification that is im-
possible to achieve in small holdings. A decision to employ
mutual funds should be made after careful analysis of the
company problems. They may not be suitable to all situations.

47 The larger service organizations that specialize in mutual fund shares can be
most helpful. It must be remembered, of course, that they are primarily sales institutions
with a monetary interest in counsel's decision to suggest these securities as an investment
medium.
Dissolution and Termination

Since distributions by the corporation to its shareholders are dividends, if made out of either earnings and profits accumulated after February 28, 1913 or out of earnings and profit of the current year, and dividends are includible in a shareholder's gross income, the application of § 1 rates appears mandatory unless some means can be found by which gain may be withdrawn from the corporation under the classification of a sale or exchange of a capital asset. If it is assumed that the corporation has been operating at a profit and has earnings and profits within the meaning of § 316(a)(1) and (2), stock redemption or liquidation are the only means the corporation may use to return capital and profit to the shareholders at favorable tax rates.

(a) Complete Liquidation of the corporation would clearly be treated as a sale or exchange of the stock of each shareholder under the rule of § 331(a)(1) and enable him to compute gain by the difference between his adjusted basis for the shares and the value received in money or other property on liquidation. If the corporation avoids the collapsible category of § 341, the sale or exchange would be that of a capital asset and subject to the rates of § 1201 and 1202. The result would necessarily involve surrender of a profitable corporate business and, in this case, elimination of a cultural media which the shareholders might wish continued in the community. If the same shareholders immediately formed a new corporation to continue the business of the old, the liquidation might be disregarded, distributions treated as dividends, and the entire transaction telescoped into a continuing venture. Added to the tax disadvantages are the

48 1954 Code, § 301.
49 1954 Code, § 61(a)(7).
50 Note that § 334(a) provides that the basis of property received in an exchange on liquidation is the fair market value at the time, provided gain or loss was recognized on its receipt.
51 Collapsible Corporate problems in theatre are discussed, infra, under that heading.
52 The Service might treat the transaction as a reorganization involving a mere change in form, identity, or place of organization under § 368(a)(1)(F) with the result that the liquidation remains non-taxable and the old basis carries over. Assets retained by the shareholders would be treated as § 301, § 354, or § 356 distributions under Treas.
practical business risks that the elimination of an opera company in an area with a proven market for opera might well lead to the invasion of the area by another group which would render further operation unprofitable. The longer the time between discontinuance of the old venture and institution of the new, the greater the danger from the competitor; yet it is doubtful if a short interval would offer anything satisfactory from a tax standpoint. Complete liquidation should be reserved for discontinuance of the enterprise. Even at that time, it presents several problems.

Since avoidance of the accumulated earnings tax, without payment of dividends, depends on investment of corporate profits in excess of $100,000 in property which is reasonably within the needs of the business, continued corporate life will probably result in the accumulation of property which will be held by the corporation at dissolution. If the corporation liquidates its property before the dissolution, a capital gains tax will be compounded. To avoid this, liquidation in kind is highly desirable.

Under § 337, the corporation will not recognize gain or loss in liquidation if liquidation is according to a plan adopted on or after June 22, 1954, and there is a distribution of all assets.
less those required to meet outstanding obligations, within a 12 month period from the date the plan was adopted. Even if there is a subsequent sale of the assets, arranged by the corporation or its agents prior to the liquidation and distribution, gain is not imputed to the corporation by reason of the protection of § 337(a). The Regulations expressly permit the corporation to negotiate for the sale, but do distinguish between an executory contract to sell and an actual sales contract, the latter being outside the scope of § 337(a) and taxable to the corporation itself.\textsuperscript{57}

Normally, under a § 337 liquidation, the shareholders will be subjected to recognition treatment under § 331. This may be expensive, since a corporation with greatly appreciated property can, upon distribution, generate heavy § 1201(b) liability for the shareholders which may not fall at a time when it can be reduced by items of capital loss. If the property distributed is not susceptible of ready division and the receiving shareholder is not sufficiently liquid to pay the § 1201 or § 1202 tax, as the case may be, a forced sale could readily destroy the potential

\textsuperscript{57} Treas. Reg. § 1.337-2(a) (1955) provides: “The date on which a sale occurs depends primarily upon the intent of the parties to be gathered from the terms of the contract and the surrounding circumstances. In ascertaining whether a sale or exchange occurs on or after the date on which the plan of complete liquidation is adopted, the fact that negotiations for sale may have been commenced, either by the corporation or its shareholders, or both, shall be disregarded. Moreover, an executory contract to sell is to be distinguished from a contract of sale. Ordinarily, a sale has not occurred when a contract to sell has been entered into but title and possession of the property have not been transferred and the obligation of the seller to sell or the buyer to buy is conditional. At all events, the existence of a plan is a question of fact to be determined after consideration of all the circumstances.” Mountain Water Co. of La Crescenta v. Commissioner, 35 T.C. 418 (1960). Despite judicial determination to this effect, it is undoubtedly wiser to comply with § 6043 and file an information return within 30 days after the plan is adopted.
profit and with it much of the stimulus to investment in the arts.\footnote{58} Unfortunately, there is no satisfactory solution to this problem, the chief protection against forced liquidation of a potentially profitable corporate asset being the cash return from liquidation of the corporate securities portfolio in the majority of instances. In those cases, wherein a corporation in liquidation has no earnings and profits, or has earnings and profits of substantially less amount than the appreciated assets, some protection is available under the elective nonrecognition provisions of § 333. Because of the relief offered by this section, it should be given continual consideration by counsel from the time of incorporation so that any possible advantages may be planned well in advance.

The purpose of § 333 is to permit shareholders to elect to avoid recognition of gain in liquidation at the price of having a substituted basis for corporate property received in exchange for stock.\footnote{59} It was designed to permit shareholders of corporations, which had appreciated assets but no earnings and profits, to defer recognition until a sale or exchange by the shareholder subsequent to the termination of corporate existence.\footnote{60} If the corporation has earnings and profits, or distributes cash or securities acquired after December 31, 1953, recognition is mandatory in whole or in part.

It is important to note that § 333 applies only to the gain of a qualified electing shareholder.\footnote{61} It cannot be used to defer recognition of loss by anyone,\footnote{62} nor does it avoid recognition by a non-electing shareholder.\footnote{63}

\textbf{(b) Complete Termination} of a shareholder’s interest in the corporation by redemption of all of his stock, regardless of type,

\footnote{58} Assume the corporation held several parcels of appreciated realty in an area in which industrial development was causing land prices to move upward. A shareholder who could hold the land until prices advanced to optimum would realize substantial profit. A sale of part to pay taxes might destroy the unit value of the whole.

\footnote{59} See 1954 Code, § 334(c).


\footnote{61} 1954 Code, § 333(c).

\footnote{62} Treas. Reg. § 1.333-4(a) (1955).

\footnote{63} Note 61, supra.
is a convenient way to permit investors who have helped the establishment of the opera, recover their capital and profit for use elsewhere. The shares most likely to be used for this kind of investor are preferred or non-voting common, since the investor in this instance is not concerned with the loss of voting power in the corporation. Capital gains treatment is guaranteed in most instances.  

Complete termination is effective to obtain § 302(b)(3) treatment however, only if the shareholder whose interest is being terminated does not fall within the constructive ownership rules of § 318 and is thus held to have a continuing interest in the corporation. In general, the shareholder will be considered owning shares owned by his family, by partnerships of which he is a member, by estates or trusts of which he is a beneficiary, and by corporations in which he has a 50% or more stock interest. Options to acquire stock, whether owned by the stockholder or by persons within the classification of family, are considered to be the same as stock itself. The tendency for interest in the arts to run to

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65 1954 Code, § 302(c)(1).
66 1954 Code, § 318(a)(1)(A) defines one's family as his spouse, unless legally separated under a decree of divorce or separate maintenance, children, parents, and grandchildren. Legally adopted children are considered children by § 318(a)(1)(B). Of interest is the failure of § 318(a)(1)(A) to embrace brothers, sisters, and in-laws.
67 Under § 318(a)(2)(A) stock owned by or for a partner is considered as being owned by the partnership, and stock owned directly or indirectly by or for a partnership is considered proportionately owned by the partners according to their distributive shares.
68 As in the case of a partnership, § 318(a)(2)(A) provides that stock owned by or for the beneficiary of an estate shall be considered as being owned by the estate, and stock owned directly or indirectly by or for an estate is considered owned proportionately by the beneficiaries. One ceases to be a beneficiary of an estate within the meaning of this section when all the property to which he is entitled has been received by him and when he has no further claim against the estate as a beneficiary. Treas. Reg. § 1.318-3(a) (1960).
69 Under § 318(a)(2)(C) ownership of 50% or more of the stock of a corporation by or for any person causes that person to be considered to proportionately own the shares owned by or for the corporation and causes the corporation to be held to own all the shares owned by or for that person. This rule can be troublesome in the event a prospective backer intends to maximize his § 1244 protection by taking $50,000 worth of shares in his own name and additional blocks of not more than $25,000 in the name of his closely held corporation. Although optimum deductability of losses would be maintained, he might lose § 302 protection unless the shares held by the corporation were liquidated at the same time he surrendered his own stock.
70 1954 Code, § 318(a)(5).
various members of the same family, combined with the tax advantage of obtaining maximum § 1244 protection by spreading large stockholdings throughout a family unit, can make the attribution rules troublesome. This is particularly true in the event a patron of the opera died and, although the estate wished to redeem the stock, the other family members did not wish to surrender their shares.

The retirement of one member of a family from the corporation without termination of the interests of remaining family members can be accomplished without loss of § 302(b)(3) protection if the retiring shareholder has no interest in the corporation other than as a creditor immediately after the redemption, does not acquire such interest, except through bequest or inheritance, and agrees to notify the Treasury in the event any interest is reacquired. If the shareholder meets these conditions, he will comply with § 302(c)(2), be freed from the family attribution rules, and be assured of capital gains treatment.

Note should be taken that although § 302(c)(2) can relieve an individual from the family attribution rules of § 318, its provisions do not extend to afford relief in the event ownership is attributed to an individual by reason of beneficial interest in any partnership, estate, trust, or corporation. Consequently, if A and B, a father and son, held shares, A could liquidate despite B’s continued holding since § 302(c)(2) offers protection to A from § 318. On the other hand, if B was a corporation and A owned 50% or more of B’s stock, A would not fall within the saving provisions of § 302, regardless of how many shares of the third corporation were held by B.

71 The maximum amount of a § 1244(b) deduction is $25,000 per person or $50,000 in the event of a husband and wife filing a joint return. No aggregate restriction is placed on a family unit.

72 Treas. Reg. § 1.302-4(a) (1955) specifies the content of the statement, which is briefly, that the distributee has acquired no interest, as described by § 302(c)(2)(A)(i), in the distributor since the distribution, and that, in the event he does acquire an interest within ten years from the date of the distribution, he will notify the Commissioner of such fact within thirty days of the reacquisition.
For these reasons, counsel should consider the desirability of buy and sell agreements to compel the estate of a deceased shareholder to offer the decedent's stock to the corporation under the terms specified in the agreement. In addition to preventing undesirable persons from becoming shareholders, the buy and sell agreement would insure that an executor could not retain shares in an estate to obtain leverage against a beneficiary who wished to redeem his stock. The agreements could also determine the circumstances under which stock held by a partnership, trust, or corporation in which an individual shareholder was interested, would be redeemed. The latter provisions would guard against attempts to eliminate a shareholder by a forced redemption of the stock of his partnership, trust, or other interest, under circumstances which would generate ordinary income to him if he did not sell the shares he owned in his individual name.

(c) Partial Termination of a shareholder's equity interest in a corporation is frequently desirable to permit return of capital and profit for other uses without either liquidation of the corporation or of the entire holdings of the individual. In opera production, where the risk is high, it is necessary to permit investors to secure profits as soon as possible in order to attract future capital to this type of venture. It is equally compelling to permit this return without causing the managers who operate the corporation to lose voting control of the company.

Stock redemption has always presented problems when the distributee did not terminate his entire interest in the company. Long ago, the Treasury posed an obstacle to distribution of preferred stock dividends on common shares, with a sale to a third party and subsequent redemption, by refusing to rule them to be tax free. Then the Chamberlin case, decided before the


1954 Code, established the principle that the bail-out of earnings through redemption of preferred shares did not generate ordinary income, even though an early sale of the preferred was contemplated. The ready escape valve, provided from § 115(g) of the 1939 Code by this decision, was partially closed by the enactment of § 306 in 1954 which removed some of the latitude offered by Chamberlin and created new avenues of escape in the process.

The basic effect of § 306 is to create a type of stock known as Section 306 stock, and to treat it, on most dispositions, as a non-capital asset to the extent of corporate earnings and profits at the time of the disposition, in the event of gain. The result, of course, is ordinary income rates on gain without any reduction of corporate earnings and profits, the dividend credit, or the dividend exclusion applicable on dividend distributions. The majority of technical problems in the application of § 306 are not considered here because the nature of theatrical production does not lend itself to continued bail-outs over a long period of time. The brief observations regarding these provisions are directed toward limited bail-outs which can suffice to avoid the accumulated earnings tax, if necessary, without requiring dividend distributions or liquidation.

To be § 306 stock, the shares must have been issued in such a way as to bring them within the provisions of § 306(c)(2) which demands, among other things, that the corporation have earnings at profits at the time of issuance. If earnings and profits are present in any amount, the ordinary income treatment reaches the entire earnings and profits at disposition.

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76 1954 Code, § 306(a)(1).
77 “Bail-outs” are a form of alternative relief when an activity is such that one corporation with a continuing life must be the business form. Theatre, fortunately, can operate through incorporation of individual seasons or productions just as the Limited Theatrical Partnership is usually formed for the run of a particular play rather than for production in general. Business reasons exist for the ready creation and destruction of corporate structures which serve to protect the transactions from destructive tax treatment.
78 1954 Code, § 306(c)(2).
79 Treas. Reg. § 1.306-3(a) (1955). It would seem that $1.00 of earnings and profits at the distribution would be sufficient to generate crushing tax liability in future years.
No apportionment is required by statute or by the regulations. Conversely, the absence of earnings and profits at issuance is an absolute bar to § 306 treatment. The proper time to issue callable shares is at incorporation, after the § 1244 issue has been completed, but before any earnings and profits have been accumulated. In fact, the best course would seem to indicate that preferred be issued prior to the receipt of any income by the corporation to minimize accounting problems. Since § 1244(c) limitations apply to capitalization at the time of incorporation and not to the forms of the ownership, there is no reason why the ordinary loss protection would be forfeited by this action.

Even if the shareholders avoid § 306(a) by reason of § 306(c)(2), a direct redemption of the stock by the corporation would probably be termed a dividend within the scope of § 302 unless, of course, the shareholder came within the exceptions of § 302(b). The appropriate course would seem to be sale to a third party with any redemption to be made by that party under the protection of the Chamberlin rule. The transferee could be either an independent, disinterested investor or an individual with some interest in civic music. If the Chamberlin facts were met, the taxpayer could resist the Commissioner in any relitigation of that case on the ground that Congress had Chamberlin before it when the 1954 Code was being drafted and it enacted the Code without disturbing the Sixth Circuit’s position. Although little is certain in tax law, the ground would seem to be solid here, particularly if the


81 Particularly of interest here are § 302(b)(2) involving a substantially disproportionate redemption and § 302(3), the termination section. Neither of these escape routes are attractive, in most instances involving the managing group.

82 In the Chamberlin case, there was not only a pre-arranged plan for the distributees to sell the shares on receipt, but the added attraction of a mandatory retirement of them in seven years. See n.75, supra.
redemption was not immediately subsequent to the distribution and transfer.

PROBLEMS

The use of corporate structures to shield individual taxpayers from the confiscatory rates of § 1 has been subjected to a series of statutory obstacles placed in the Code by way of attempting to maintain the exaction at a level approximating that intended by its draftsmen. The temptation to avoid the tax remains, however, and despite the suggestions of assorted commentators to the contrary, 83 it has received the blessing of the courts. 84 As long as the taxpayer conducts his affairs in a manner that circumvents the impact of the statute, as opposed to fraudulent or criminal activity, he is protected. 85

(a) The Accumulated Earnings Tax of §§ 531-537 was designed to discourage corporate accumulation of profits with a view to distribution to shareholders in subsequent years or on liquidation. The impact of the tax is a 27 1/2% levy on the first $100,000 of improperly accumulated surplus and 38 1/2% on all excess. 86 Since the corporation is permitted a credit of $100,000 in computing accumulated taxable income, 87 the effect is to limit the exaction to accumulations in excess of that amount, provided they are determined to be unreasonable. In a small opera company with an equity capitalization of $100,000, the credit alone would whet the appetite of the speculator since 75% profit on his investment could be returned

84 "The legal right of a taxpayer to decrease the amount of which otherwise would be his taxes, or altogether to avoid them by means which the law permits cannot be doubted." Gregory v. Helvering, 293 U.S. 465, 469 (1935).
85 "If (the taxpayer) really avoids the tax, if he actually conducts his operations outside the scope of its effectiveness, his device is said to be avoidance, and succeeds; if, on the contrary, he merely screens an operation by making it seem the thing it is not, then he fails and suffers the consequences of his failure." Appeal of W. C. Bradley, 1 B.T.A. 111, 118 (1924).
86 1954 Code, §§ 531(1); 531(2).
87 1954 Code, § 535(c)(2).
to him at a maximum tax rate of 28%. A capitalization of $500,000, the maximum that could be offered under the umbrella of § 1244, would permit substantial after tax profit under a plan of $450,000 invested in 5% yield securities on a liquidation date five years after organization.

The accumulated earnings tax is applicable to all corporations formed or availed of for the purpose of avoiding the imposition of income tax on shareholders, with certain limited exceptions. It is in addition to the regular corporate income taxes imposed by § 11. Although the Code states that an unreasonable accumulation of earnings and profits or the fact that a corporation is a mere holding or investment company shall place the burden of proving to the contrary by a preponderance of the evidence on the corporation, the Regulations hold that factors outside of those enumerated in the Code are to be considered in determining whether or not the corporation is used for the prohibited purpose. To defend itself, the opera company must either satisfy the Commissioner that the use of a securities portfolio and retention of its income is necessary to provide a capital basis for expansion or for security, or that is must expend the income on items reasonably within the needs of an organization that produces opera.

Assuming that corporate annual income was subjected to not more than a 30% tax.

For instance, $450,000 invested in 5% dividend securities would produce annual income of $22,500, which would be subject to a tax of $1,012.50 (30% of $3,375, the amount of dividend income taxable after consideration of the 85% dividends received deduction) and would produce a net of $21,397.50 per annum. If corporate life was limited to 5 years, which it need not be, the earnings and profits distribution of $106,987.50 would be subject to a maximum levy of $26,747.00 (25%) on liquidation, permitting the investor to realize after tax income of $80,241.00 or 72% of total securities income of $112,500. This assumes no attempt is made to further shield dividend income by property investments and also assumes the securities, being preferred stock, do not appreciate.

1954 Code, § 532(a).

1954 Code, § 532(b) excepts personal holding companies and foreign personal holding companies, although the former are subject to the § 541 tax and the latter to the § 551 provisions. It also exempts corporations exempt from tax under Subchapter F.

However, computation of accumulated taxable income permits a deduction for certain income and excess profits taxes under § 535(b)(1).

1954 Code, § 533.

Since all theatre is a cash business, liquidity is of great importance in any production. Credit is extended warily, and most artists and suppliers demand either advance payment or escrow deposit to insure payment after the goods or services are delivered. As the company develops an audience, the cash demand increases since the engagement of more expensive artists necessitates larger cash advances. In addition, the great hazards in the entertainment business, which a Court would doubtless notice as a matter of law, make retention of a substantial amount of earnings a sound business action. The Commissioner would be hard put to defeat a claim that this uncertainty did not exist unless the producer followed a course of advance sales prior to incurring production expenses, which had the effect of reducing corporate risk to zero. For this reason, it might be prudent to limit season sponsorships to total guarantees insufficient to cover production cost in the expectation that additional sales would be forthcoming.

Even if the Commissioner determines that the corporation is being used to avoid income tax on the shareholders, the § 531 tax applies only to accumulated taxable income as defined by § 535. Of great import is the accumulated earnings credit of § 535(c), which permits the corporation to deduct amounts determined to be retained for reasonable business needs, but not less than $100,000, from the amount on which the tax is computed.

The reasonable needs of an opera company extend to so many items it is difficult to list them in this discussion, but

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95 AGMA contracts provide for advance payment plus deposit of a bond for single performance engagements, thus necessitating the producer to allocate double the amount of artist's compensation to the budget. AGMA Basic Agreement 1961-1962. The AFM makes a similar demand as does Equity. Suppliers of materials invariably deal on a C.O.D. basis.


97 Producers attempt to avoid the uncertainty that bad weather or other attractions may have on a show by selling discounted blocks of tickets to sponsoring organizations which resell the tickets at a profit to themselves. Although this is an effective way of reducing risk, counsel should be careful to preserve some risk, at least as to profits. This could be done on a show or on an average season basis by insuring that total guaranteed receipts do not exceed guaranteed expenses.

98 1954 Code, § 535(c)(2).
tax purposes are best served by expenditures to obtain appreciable capital assets. The purchase of valuable real estate for construction of a warehouse and parking lot would doubtless qualify as reasonable if the warehouse was actually constructed and used for storage of costumes and scenery. A bit of imagination might indicate that the warehouse be constructed in such a manner as to make it readily convertible into a small apartment building on liquidation of the corporation. In addition, purchase of a motion picture theatre would qualify if the purchase was made to insure availability of a place to perform. The latter asset might well be secured through a controlled subsidiary in an attempt to secure an additional accumulated earnings credit.\footnote{The problem of multiple corporations will be discussed later in this article.}

Motion picture theatres, particularly if constructed twenty or more years ago, are frequently equipped with stage and dressing room facilities that lend themselves to operatic activities.\footnote{Most theatres built prior to 1930 were designed to house dramatic and vaudeville productions, as well as screen entertainment.} As a business matter, control of a good theatre is a decided advantage to an opera company since it can be used for motion pictures out of season to support itself and, at the same time, has guaranteed availability when its use is required for music.\footnote{Live stage presentations can take up slack periods in motion picture theatres that otherwise might be used for offerings of lower grade pictures to partly filled houses. The reduction in time that must be taken up with pictures creates greater selectivity in determining what pictures will be shown.} Of course, parking lot facilities seem reasonable for any theatre regardless of the use to which it is put. All of this yields a tax shelter in real estate which can become available at capital gains rates in the future.

Theatrical properties are legitimate items of investment since they are used in production of the product offered to the public. Particular attention should be given to antique firerams, swords, paintings, and furniture which are demanded by the score. These may be copies which are modest in price or may be expensive originals which, in addition to adding authenticity to the works, afford a business reason for purchasing property which will appreciate in value and would be readily marketable
by shareholders in the event of a distribution in kind on liquidation. Costumes depreciate in real value too rapidly to be used for this purpose, although there may be other reasons to purchase rather than rent them. Jewelry would probably be challenged as an inordinary expense since costume or paste products can produce a stage effect equal to genuine articles. Furniture and fixtures, including works of art, are legitimate business expenditures for lobby decoration of an opera house.

The primary rule in items of this kind is that they must be the sort that would have merit without tax incentive. If they would not, the likelihood increases that a court would find them not to be usual business expenses. Equipping soldiers with real French muskets of the Napoleonic era would be reasonable since they would look better on stage. Equipping them with priceless weapons owned by distinguished persons of the period undoubtedly involves some risk.

The decision to purchase trucks and other vehicles in lieu of leasing them may be influenced by the accumulated earnings shelter that can be bought in a particular year at the price of the higher rental deduction that must be sacrificed in subsequent years.\textsuperscript{102} Unless the total cost factor must be determinative, contracts for the lease of these vehicles should expire in sufficient time in advance of the close of the corporate taxable year to permit removal of accumulations by purchase of automotive equipment if counsel feels it is advantageous. Needless to say, ownership of vehicles probably reduces operating expense and is abandoned in favor of leasing primarily for tax advantage. The loss of the higher annual rent deduction might be offset by business justification for the purchase of real estate for vehicular storage.

Musical scores, records, tapes, sound reproduction equipment, and photographic equipment generally do not have ap-

\textsuperscript{102} The total amount of rent paid is deductible each year under § 162(a)(3), whereas the cost of a capital asset must be deducted over its useful life under § 167. Invariably, the former is higher since amounts paid to a lessor include profit.
preciation value but, on the contrary, depreciate rapidly. They offer little consideration for investment although they operate to reduce accumulations.\(^{103}\)

It should be remembered that the accumulated earnings tax is not computed on a basis of annual depreciation deductions. If $10,000 is expended in a taxable year for an item which must be written off against income during a useful life of 10 years, the full amount of the investment is allowed as an accumulated earnings credit.\(^{104}\) Section 531 does not tax income as such; it reaches income which has been withheld from shareholders without good business reason.

Expenditures for purchase of stock in another corporation have been repeatedly held to have business purpose if control of or interest in the other corporation is necessary for the business of the purchasing corporation.\(^{105}\) Thus, since purchase of a motion picture theatre could be a necessary means of acquiring the use of that theatre, the purpose of stock in a corporation owning the theatre or in a chain owning several theatres might qualify if sufficient relation was shown between the opera company and the purchase.

**(b) Multiple Corporations** in a single business activity offer additional surtax exemptions and accumulated earnings credits. Since the intent of Congress in providing these benefits was to encourage the formation of small businesses,\(^{106}\) it was expected that the Code, the Courts, and the Commissioner would react strongly to attempts by taxpayers to divide businesses into multi-

\(^{103}\) 1954 Code, § 535(c)(1).

\(^{104}\) Treas. Reg. § 1.535-3(b).

\(^{105}\) Under § 537, reasonable needs include reasonably anticipated needs. Note should be taken of the warning of Treas. Reg. § 1.537-1(b) (1959) that a definite plan must exist for business use of the accumulation. The regulation states that the plan must be feasible. Purchase of a substantial block of shares in a local theatrical corporation which owned several theatres would have more chance of withstanding an IRS attack than would purchase of shares of a large, national theatrical chain, such as Loews, Inc.

ple parts to secure additional tax advantages. Although the problem of multiple incorporation has become increasingly thorny, there remains sufficient leeway for intelligent tax planning.

The enactment of § 1551 in the 1954 Code, a carryforward of § 15(c) from the 1939 Code, disallowed the surtax exemption and accumulated earnings credit in the event a corporation transferred property other than money to corporations either formed to receive such property or which were not actively engaged in business at the time the property was received. The taxpayer may retain his additional credits and exemptions only if he proves, by clear preponderance of the evidence, that obtaining such credit or exemption was not a major purpose of the transfer. Although § 1551 is limited in scope to corporations, as opposed to individuals, and further limited to exclude transfers of money by anyone, it must be considered in planning corporate activities. It is not necessary that the exemption or credit be the sole motive of a prohibited transfer to bring § 1551 into action; if it is a principal motive, the exemption or credit is lost. The language of the statute is broad enough to caution counsel against having the corporation purchase property in its own name if the possibility exists that transfer of the property to a controlled corporation would be indicated in the future. Real estate is the most likely prospect for this treatment, particularly if it is used for purposes other than that of opera production. The addition of some logical business reason for separate property holding, although unnecessary to avoid § 1551 if the purchase is made by the new corporation with cash contributed to it by the parent, is helpful in other areas which will be discussed hereafter. Vehicles would also fall into this category although, as was discussed earlier, counsel should weigh the

107 Treas. Reg. § 1.1551-1(a)(4) (1959). Under Treas. Reg. § 1.551-1(a)(5) (1959) the Commissioner has authority to allow the credit or exemption but it is unlikely that he will exercise this power frequently.

108 Treas. Reg. § 1.1551-1(e) (1959) holds that even showing of a valid business reason for the transfer is no protection unless it can also be shown that tax exemption or credit was not a major purpose as well. The difficulty of proof in this matter is self-evident.
advantage of being able to purchase them to avoid accumulated earnings tax on the parent against any advantage in additional surtax exemptions that might be gained on sale and leaseback.\textsuperscript{109}

Even if counsel avoids the impact of § 1551, the additional hurdles in the path of multiple exemptions and credits deserve serious consideration. It has long been held that corporations will be recognized in tax law only when they serve some business purpose in addition to reduction of tax liability.\textsuperscript{110} The taxpayer need not use the business entity that produces the greatest tax, but whatever form he does use must have some independent merit.\textsuperscript{111} Separate corporations should have separate books and records and, if possible, activities which do not coincide exactly one with another.\textsuperscript{112} As was noted earlier, there would seem to be little difficulty in operating a motion picture theatre, which offered both movies and opera, through a separate corporation. There would probably be great difficulty in forming a separate corporation to purchase or manufacture costumes for lease exclusively to the parent. If the costumes were available and actually were leased to other organizations or if union contracts became a factor, the division would have more chance of success. The courts have not been uniform in interpreting this problem. In \textit{Miles-Conley Company, Inc.},\textsuperscript{113} the use of a fruit corporation and a vegetable corporation in the same retail grocery store was held to be entirely proper, while \textit{Theatre Concessions, Inc.},\textsuperscript{114} rejected the argument that protection of a motion picture theatre corporation from tort claims for food poisoning and the ease of sale of

\textsuperscript{109} This decision should not be made on tax reasons alone. Leasing one’s vehicles from a separate corporation offers the added advantage of insulation from tort liability arising out of operation of the vehicles and can reduce the required coverage of liability insurance. The accumulation of corporate assets in the opera company would demand high coverage to protect the accumulation, and this demand would increase with the rise in the amount of accumulations.
\textsuperscript{110} Higgins v. Smith, 308 U.S. 473 (1940).
\textsuperscript{111} Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Friedlander Corporation v. Commissioner, 216 F.2d 757 (5th Cir. 1954); Commissioner v. Kolb, 100 F.2d 920 (9th Cir. 1958).
\textsuperscript{112} National Investors Corporation v. Hoey, 144 F.2d 466 (2d Cir. 1944).
\textsuperscript{113} 10 T.C. 754 (1948), aff'd, 173 F.2d 958 (4th Cir. 1949).
\textsuperscript{114} 29 T.C. 754 (1958).
the concessions were sound reasons for separate corporations. Most of the leading cases involved division of existing businesses rather than formation of distinct entities at the start of operations, and there is little to assist the taxpayer in determining what treatment will be afforded original organization of businesses in multiple units.

An old, reliable weapon of the Commissioner in assailing multiples has been § 61 which taxes income to the person or entity earning it. Under Lucas v. Earl, anticipatory assignments of income cannot operate to reduce the tax of the assignor. This was restated in Gregory v. Helvering, and has been accepted as an established principle of taxation for many years. A recent application of this principle to the law of multiple corporations was Alden Homes, decided in 1959 by the Tax Court, which involved a real estate corporation's organization of sixteen development corporations to which it transferred property in a subdivision in exchange for stock. The subsidiary corporations had separate officers, books, and bank accounts, but common employees and a common office. Advertising was conducted as a unit in the name of the parent without mention of the subsidiary. The Tax Court allocated all income to the parent and disallowed the surtax exemptions of the subsidiaries.

In its opinion, the Court stated that the alleged business purposes of the multiple structure were nothing more than an attorney's checklist of the possible business reasons for using several units of organization. The salient fact remained that there was no difference in the activities of the corporate shells and the only real purpose was to gain additional surtax exemptions. Application of the Alden Homes rule to the theatre is questionable since good business reason can be shown for limiting a corporation to the production of a single play, series of plays, or season of opera. The work presented and the artists engaged

115 Taylor, Problems in the Formation and Use of Multiple Organizations, 1954 Tulane Tax Inst. 175.
116 281 U.S. 111 (1930).
118 33 T.C. 582 (1959).
for particular activities will have marked effect on the enthusiasm of the investor since this will govern the amount of risk. An operatic season of popular works like La Boheme, Tosca, and Pagliacci has a greater chance of success, other things being equal, than one of Don Giovanni, Ernanni, or some other works which have proven themselves to have little popular appeal. Multiple corporations along these lines, of course, would have more appeal in the Tax Court if the stock holdings were distributed among different shareholders in varying amounts than if they were all owned outright by the same group in similar proportions.

Although the Alden Homes situation has been codified in favor of the Commissioner by § 1551, reallocation of the incomes of multiple corporations to the individuals who formed them does not seem to be likely since a person or group has traditionally been allowed the use of one corporation for business activities. There is, however, some danger that income from multiple corporations might be bunched and the entire group taxed as an association if caution is not used in the incorporation of business divisions.¹¹⁹

Although § 482 was enacted to prevent shifting of earnings between related persons and corporations,¹²⁰ its language is broad enough to reach improper attempts to obtain the benefit of any deduction, credit, or allowance the transferees would not have enjoyed except for the act of acquiring control of any corporation.¹²¹ The history of § 482 was confined, until recently, to cases involving profits and losses, or deductions in cases of related taxpayers.¹²² Since the 1952 decision in Advance Machinery Exchange v. Commissioner,¹²³ it has been extended to permit real-

¹¹⁹ 1954 Code, § 7701(a)(3).
¹²² G.U.R. Company v. Commissioner, 117 F.2d 187 (7th Cir. 1941); Asiatic Petroleum Company, Ltd., 31 B.T.A. 1152 (1935), aff'd, 79 F.2d 234 (2d Cir. 1935), cert. den., 296 U.S. 645 (1935); Hugh Smith, Inc., 8 T.C. 660 (1947), aff'd, 173 F.2d 224 (6th Cir. 1949); Birmingham Ice and Cold Storage Company v. Davis, 112 F.2d 453 (5th Cir. 1940); Central Cuba Sugar Company v. Commissioner, 198 F.2d 214 (2d Cir. 1952); cert. den., 344 U.S. 874 (1952); Glenmore Distilleries Company, Inc., 47 B.T.A. 213 (1942).
¹²³ 196 F.2d 1006 (2d Cir. 1952), cert. den., 344 U.S. 835 (1952).
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location of income to deny the surtax exemption. In that case, two of the three corporations were disregarded and the total income was attributed to the first which carried on the same business activities as the others with common employees and facilities. Although the Advance Machinery view of § 482 has not received universal acceptance, it is worthy of note and seems to be in the spirit of the statute.

The enactment of § 269 was primarily designed to counter the purchase of loss corporations by individuals desiring to take advantage of the deduction. Its scope was later applied to cases in which high depreciation bases were obtained through purchase, merger, or consolidation. Coastal Oil Storage Company v. Commissioner extended the reach of § 269 to the acquisition of surtax exemptions, and held that benefits would be denied to both the acquiring and the acquired corporations where tax avoidance was the principal purpose. This was ratified by British Motor Car Distributors, Ltd. and by James Realty Company v. United States in 1959. In James Realty, the Court held that acquiring control of a corporation, as used in § 129(a) of the 1939 Code, from which § 269 of the 1954 Code was taken, includes the organization of a new corporation subject to the control of the taxpayer. It went on to state that § 129(a) applied to both corporations since the word “benefit” precedes the word “which” in § 129(a)(2). The decision indicated that the Court was impressed with the fact that the sole business purpose of forming James Realty Company was to remove income and to obtain an additional surtax exemption. Although James Realty, like Alden Homes are real estate development cases, there is some question as to their application in other areas. Present indications are that a physical or geographical separation

127 242 F.2d 396 (4th Cir. 1957).
130 The language of § 269 and § 129 is substantially identical.
of activities offers protection. In *Turner-Moore No. 22 v. United States*, the taxpayer, one of 24 gasoline stations owned by a husband and wife, was determined to be entitled to the surtax exemption and a refund when the court found that the multiple structure was reasonable in view of principal purposes of limiting liability of the stockholders, insulation of the assets of each corporation from liabilities of the others, and protection of the businesses against losses in gasoline price wars.

Multiple corporation problems should cause little difficulty in opera production because the limited capitalization permitted under § 1244, the natural reluctance of the public to invest substantially in the theatre, and the shadow of §§ 531-537 will not indicate the need for more surtax exemptions than can be obtained through use of subsidiaries with legitimate business purpose.

(c) *The Personal Holding Company Tax* is a punitive exaction intended to prevent shareholders of closely held corporations from receiving investment income in the corporate name and accumulating it for eventual distribution on liquidation at capital gains rates. The passage of time and the ingenuity of tax counsel has done a great deal to insulate holding companies from this form of taxation, and consequently, has produced a partial frustration of the draftsmen's purpose. The tax has remained a part of the Code, however, and has been extended by the Service and by the courts to reach business activities which were clearly not the victims intended by Congress. The levy is considerable: 75% of the first $2,000 of undistributed personal holding company income, plus 85% of all additional undistribu-

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132 60-2 U.S. Tax Cas. # 9675 (D. Ct. Texas).
135 For instance, corporations in the process of liquidation. O'Sullivan Rubber Co. v. Commissioner, 120 F.2d 845 (2d Cir. 1941); 320 East 47th Street Corp. v. Commissioner, 243 F.2d 894 (2d Cir. 1957).
ted personal holding company income, in addition to the normal corporation tax.\textsuperscript{136} The danger of the tax is that good faith, a lack of intent to avoid the income tax on shareholders, or any other subjective factors are immaterial. If the corporation is a personal holding company within the meaning of § 542(a), the Commissioner may exact his due.

The serious consequences of becoming a personal holding company demands that counsel keep the applicable statutes in his mind, not only during organization but also throughout budget preparation and annual operations. If this is done, there is no reason to assume the tax will present serious difficulties. It must be borne in mind that although the personal holding company tax is objective and may be defeated by showing a literal failure to comply with the statute, as a general rule defenses of good faith and sound business purpose should be prepared in order that counsel does not inadvertently furnish the Service with a sound basis for imposition of the accumulated earnings tax or equally troublesome situations. If through some misfortune the corporation does fall into the pit, the exculpatory method of deficiency dividends must be weighed.\textsuperscript{137}

With certain limited exceptions,\textsuperscript{138} a personal holding company is any corporation\textsuperscript{139} which meets the standards of stock ownership\textsuperscript{140} and of gross income\textsuperscript{141} from proscribed sources as defined in the Code. Both the significant stock ownership and gross income requirements must coexist to create liability for the tax. If one exists without the other, the tax is avoided. Although an analysis of these factors indicates little chance of

\textsuperscript{136} 1954 Code, § 541.
\textsuperscript{137} 1954 Code, § 547, although operating to reduce liability for the tax does not relieve the corporation for interest or other penalties.
\textsuperscript{138} Primarily tax exempt corporations, life insurance companies, banks, surety companies, some finance companies, foreign personal holding companies, and certain other foreign corporations.
\textsuperscript{139} The term "corporation" is used in its usual tax sense, and includes any entity which may be an association and subject to taxation as a corporation. G.C.M. 19619, 1938-1 C.B., 225.
\textsuperscript{140} 1954 Code, § 542(a)(2).
\textsuperscript{141} 1954 Code, § 542(a)(1).
their coexisting in a theatrical corporation, prudent tax planning would dictate that every effort be made to eliminate both factors from corporate operations. In this way, counsel and shareholders will enjoy a greater degree of peace of mind.

Under the stock ownership requirements of § 542(a)(2), more than 50% in value of the outstanding stock must be owned by not more than five individuals.\textsuperscript{142} Obviously, the effect of this section is to limit personal holding company status to corporations owned by less than ten unrelated shareholders. The ownership prohibition applies to control of value, not voting power. There is no limitation on the concentration of voting power in the hands of management with a distribution of ownership by means of non-voting stock among many individuals.\textsuperscript{143} This problem of diversification is probably of assistance to the development of corporate production business since it encourages a wider distribution of financial interest in the corporation. Community leaders and others in a position to help develop audience appeal can be conveniently brought into the corporation without divesting management of its power.

The Regulations demand that § 532(a)(2) requirements be measured by a valuation of the shares which considers all factors likely to effect the value of stock in any closely held corporation.\textsuperscript{144} They expressly deny a maximum limitation of value by net assets. This presents two problems which, although not a source of litigation to date, can create difficulty in the future. In the first place, the issuance of bonds which create an unrealistic ratio of debt to equity capital can lead to a classification of bonds as stock and to a subsequent compliance with

\textsuperscript{142} 1954 Code, § 544 applies constructive ownership rules to the determination of the ownership of stock in any personal holding company. An individual is held to own stock owned by or for his spouse, ancestors, brothers, sisters, and lineal descendants or his partner. § 544(a)(2). Options are considered the same as direct ownership. § 544(a)(3). Stock owned by or for an estate, trust, corporation, or partnership is considered owned proportionately by shareholders, partners, or beneficiaries. § 544(a)(1). For an authoritative discussion of these rules, see Ringel, Surrey & Warren, Attribution of Stock Ownership in the Internal Revenue Code, 72 Harv. L. Rev. 209 (1958).

\textsuperscript{143} Treas. Reg. § 1.542-3(a) (1958).

\textsuperscript{144} Treas. Reg. § 1.542-3(c) (1958) provides that the value of shares shall be determined “in the light of all the circumstances.”
§ 542(a)(2). Several commentators have remarked on this possibility and indicate that it should be borne in mind. In point of fact, there would seem to be little reason for a § 1244 theatrical corporation to issue a substantial amount of bonds to any individual, nor would there be cause for the issuance of bonds at all to controlling shareholders. Another source of potential trouble is consideration of the respective values of voting and non-voting shares. Counsel must be prepared for a claim by the Service that the value of non-voting shares has been diluted by reason of the power vested in management or in the voting shareholders. Particular caution should be observed in requirements for recapitalizations or new issues which might decrease the market value of the non-voting stock. Sufficient safeguards should be given to this latter stock to insure that its approximate net asset value would be accepted by a court. Investment counsel should be consulted about the effect that any contemplated action of management might produce on the value of the non-voting shares. In this regard, the selection of investment counsel becomes of paramount importance. Several brokerage houses have developed highly skilled research personnel who are both willing and qualified to analyze the value of closely held stock from a standpoint of the over-the-counter market. At the time investment counsel is designated, there should be a discussion of this problem so that he may be prepared at any time to advise management on the effect of its actions.

145 See Greenfield, Personal Holding Company Status, 29 Taxes 795, 797 (1951). Klooster, writing in Tax Advantages and Hazards in Operating as a Personal Holding Company, 8 J. Taxation 101 (1958) concurs in this view and suggests that corporate accumulations in instances where there is more than one class of stock outstanding can generate similar problems of valuation.

146 Controlling shareholders would receive more benefit by accumulations for eventual liquidation than they would by interest received on bonds which, although deductible by the corporation, would be taxable at ordinary income rates to themselves. The same rule would apply to other individuals who wanted to offer capital to help the corporation get started but expected return of principal plus profit within a short period. Preferred, secured if necessary by a sinking fund, would solve the problem as well as bonds, but at capital gains rates. The high ratio of corporate capital invested in good securities would offer adequate protection to those who wished to be in the status of lenders rather than investors.

147 Needless to say, great care should be exercised in the selection of a qualified broker.
Even if the stock ownership requirements are met, punitive tax consequences do not flow unless 80% or more of corporate gross income in any taxable year is personal holding company income as defined by § 543. A consideration of the concept of gross income is, therefore, mandatory. The early Treasury position that gross income was not synonymous with gross receipts was accepted to a degree by the Courts.\textsuperscript{148} The concept evolved to mean that gross income does not necessarily mean gross receipts although under certain circumstances the two terms will have the same effect. In a mercantile, manufacturing, trading, or mining corporation, gross receipts must be reduced by a cost of goods sold to produce gross income.\textsuperscript{149} In a theatrical corporation in which no product as such is manufactured or sold, however, the IRS has ruled that the two terms are the same.\textsuperscript{150} This seems reasonable because income from an audience is essentially a series of payments for a limited license to view particular productions. No tangible product that can be reduced to possession and enjoyment is manufactured. The distinction between gross income and gross receipts is crucial. An opera company which received $100,000 from the sales of tickets and $100,000 in dividend income would have gross receipts of $200,000, only 50% of which would be from prohibited sources if gross income and gross receipts are the same. On the other hand, if the same corporation were required to deduct production costs of $95,000 from ticket receipts, clearly more than 80% of gross income would be from prohibited sources.

(d) \textit{The Collapsible Corporation}, a product of the inventive genius of the tax bar, has been properly described as a classic

\textsuperscript{148} Southern Pacific Co. v. Lowe, 247 U.S. 330 (1918); Woodside Acres, Inc., 46 B.T.A. 1124 (1942), aff'd, 134 F.2d 793 (2d Cir. 1943); Garrett Holding Co., 9 T.C. 1029 (1947).

\textsuperscript{149} Mim. 2915, 1922-1 C.B. 233 holds: "Gross income does not necessarily mean gross receipts. A merchant or a trader, for instance, in computing statutory gross income should deduct therefrom the cost of goods sold in accordance with Schedule B of Form 1040."

\textsuperscript{150} Greenfield, \textit{op. cit., supra}, note 145, at 801 states: "In a recent letter ruling holding that the entire revenue derived from the operation of a theatre constitutes 'gross income' the Bureau took the view that the Bechtel and Jergens cases stood for the proposition that gross income of a corporation other than manufacturing, merchandising, or mining companies consists of the total revenue . . . from the operation and management of the business and property of the corporation."
in tax avoidance devices whose simplicity in operation stands in marked contrast to the confusing statutory weapon enacted by Congress to combat it.\textsuperscript{151} The price of being "collapsible" is frightfully high since a sale or exchange of the stock in a corporation falling under that definition in most instances is treated as the sale or exchange of a non-capital asset.\textsuperscript{152} The tax consequences are, of course, ordinary income treatment to all gain realized. One of the greatest dangers of being "collapsible" is that there is no apparent way a corporation can relieve itself from that classification once it has been unfortunate enough to be so designated.\textsuperscript{153} While this construction of the statute is doubtless not within congressional intent, the lack of action to revise it by appropriate legislation would be a strong buttress for the Commissioner's position that Congress was content with the interpretation of the Second Circuit.\textsuperscript{154}

Although there are innumerable refinements in design, operation, and usage of collapsible corporations, the basic theory is that liquidation of a corporation after the completion of income-producing activity, but before receipt of the income, will enable the shareholders to receive at capital gains rates that which would have been taxable income to the corporation and eventually dividend or capital gain income to themselves.\textsuperscript{155} If a collapsible corporation can avoid the effects of § 341, the shareholders may convert ordinary income, otherwise receivable by them as receipts from the sale of stock in trade, into the preferred capital gains by the use of multiple corporations.\textsuperscript{156}

\textsuperscript{152} 1954 Code, § 341(a).
\textsuperscript{153} "The Statute contains no provisions relieving a corporation from its 'collapsible' status once an event has occurred which brings it within that definition." Arthur Glickman, 16 T.C.M. 434 (1958), aff'd, 256 F.2d 108 (2d Cir. 1958).
\textsuperscript{154} Arthur Glickman, \textit{supra}.
\textsuperscript{156} For instance, division of real estate lots into corporations and sale of each by
Examples are legion, with the two most prominent being the real estate subdivision corporations and the motion picture production organization.

Treasury attack on the corporations was manifestly unsuccessful in the past. Confronted with a Second Circuit decision, affirming the Tax Court, that portions of capital gain could not be imputed to officers who served a corporation without compensation, and by other defeats, it resigned itself to § 117(m) in the 1939 Code and to the present § 341.159

To be collapsible, a corporation must be formed or availed of *principally* for the manufacture, construction, or production of property which (in the hands of the corporation) is a § 341 asset, or for holding of stock in a similar corporation, with a view to the sale or exchange of its stock, or a distribution to its shareholders, prior to corporate realization of a substantial part of the income to be derived from such property.

The principal activity of an opera company is the production of performances rather than the construction or purchase of property, so at first blush, the company would seem to be immune from the operation of § 341. The breadth and confusion of the statute, however, preclude its ready dismissal. Even though it has been held that the adverb *principally* modifies "for the . . . construction or purchase" of collapsible type assets,160 serious problems can arise from the word "purchase" as applied to § 1231(b) assets. Might the Commissioner, for instance, argue that the principal activity of the corporation was insulation of its shareholders from the income tax by conversion of corporate income into § 1231(b) property to avoid the accumulated earnings tax? He disposition of the stock. This would probably be held to be either a sham, with the corporate entity disregarded, or the shareholders would be considered dealers in the stock and taxed accordingly.

157 Commissioner v. Gross, 236 F.2d 612, 618 (2d Cir. 1956).
159 Added to the 1939 Code by § 212(a) of the Revenue Act of 1950.
160 In Weil v. Commissioner, 252 F.2d 805 (2d Cir. 1958), the Court held that the requisite principal intent need only be to manufacture, construct, or purchase the § 341 asset. Burge v. Commissioner, 253 F.2d 765 (4th Cir. 1958) is in accord.
might be sorely tempted to attack in this manner upon discovery of the high percentage of corporate capital invested in securities having no connection with the business of theatre. The temptation would be stronger if the corporation had issued a prospectus promising that a certain ratio of working capital would be maintained in relation to the investment portfolio. If the prospectus did not contain any promises, but the intent was established by other means, the Service might find the prospect equally inviting.

One defense would be that there was never an intent to liquidate or distribute corporate property before realization of any income to be derived from the property. This defense would seem valid since the Statute requires, by implication, that a corporation must not only have collapsible assets and a view to exchanging or distributing them, but that the property must be the kind which would produce taxable income in the normal course of events. Its comfort is short-lived, however, since the presumption of collapsibility created by § 341(c) would apply if the collapsible assets at liquidation, distribution, or sale of stock, equaled 50% of the fair market value of total assets and 120% of the adjusted basis of the collapsible property itself. Since total assets are computed without regard to cash or securities, it is likely that the collapsible assets would well exceed the 50% limitation. The 120% appreciation would probably be exceeded as well if the § 341 property included many items with a high rate of appreciation, such as some antiques or paintings, or a combination of both appreciation and adjustment of basis by depreciation allowances, such as a warehouse on certain property. This is cause for concern since

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161 This attack would not be directed against securities which were § 1231(b) assets such as stock in a corporation that owned a motion picture theatre.


163 But note that the failure to fall under § 341(c) does not create any presumption that the corporation was not collapsible.

164 If the securities were § 1231(b) assets, they would probably be taken into account as collapsible property under § 341(b)(3)(D).

165 The basis of § 1231(b) property is adjusted by depreciation allowances. Thus, property held for a period of years and depreciated by 75% would require only an appreciation of 45% to bring it within § 341(c)(1)(B) to make the value at liquidation 120% of the then adjusted basis, for example, property with a cost basis of 100 and a fair market value of 145 which had been depreciated to an adjusted basis of 25 at the time of liquidation.
these assets are swept into § 341(b)(3) by the requirement of § 341(b)(3)(D) which includes all § 1231(b) property in the former section.

This generates the problem that avoidance of the accumulated earnings tax depends on reinvestment in property which is defined by § 1231(b), yet appreciation of this business property will create a presumption of collapsibility. Even the saving feature excluding property held over three years from § 341 is weakened by the provision that completion of the manufacture, construction, production, or purchase is mandatory before the holding period begins to run.\textsuperscript{166} The Courts have held that the term "construction" requires the broadest possible application,\textsuperscript{167} so presumably a warehouse would not be absolved from classification as a § 341 asset if an addition or major repair were made to it within three years of liquidation.\textsuperscript{168}

The exculpatory provisions of § 341(e), while offering some security once they can be understood,\textsuperscript{169} are far from a satisfactory answer to the general problem. Since they do offer a guarantee of non-collapsibility within the scope of § 341, they must be given due consideration. The focal point of interest in § 341(e) for an opera company is § 341(e)(1) which excludes corporations from the effect of § 341 if their total subsection (e) assets are less than 15\% of the corporate net worth. Since § 341(e)(5)(A)(iii) limits subsection (e) assets to property which would produce gain in whole or in part from the sale or exchange of a non-capital asset in the hands of a shareholder who owns more than 20\% in value of the outstanding stock of the corporation, the effect is that corporate § 1231(b) assets which have appreciated greatly in value do not cause the collapsible status to attach unless someone holding 20\% or more of the outstanding value of the stock is a dealer who would realize ordinary income if he sold the asset himself.\textsuperscript{170}

\textsuperscript{166} 1954 Code, § 341(d)(3).
\textsuperscript{167} Abbott, 28 T.C. 795 (1957), aff'd, 258 F.2d 537 (3d Cir. 1958); Payne v. Commissioner, 268 F.2d 617 (5th Cir. 1959).
\textsuperscript{168} The statute is extremely complicated, perhaps needlessly so. § 341(e)(1) contains a sentence with over 800 words.
\textsuperscript{169} Note the constructive ownership rules of § 341(e)(8).
In the latter event, the corporation is collapsible only as to the particular shareholder.

Obviously, it becomes vital in the solicitation of investment capital to determine whether or not the corporation is collapsible as to each shareholder involved since much good will and sources of future capital can be lost through faulty interpretation of the tax consequences. If wide distribution of the stock is contemplated so that this determination cannot be made by the corporation, each prospective shareholder should be advised to consult counsel. It should be made clear that the directors will not limit their investment actions by the tax positions of any shareholders so that a real estate dealer who proposed to purchase over 20% in value of the stock would not expect that real estate investments be avoided for his benefit. On the other hand, an individual contemplating purchase of a substantial interest might demand contractual limitation of corporate investments in §1231(b) assets to preserve his own capital gains position on liquidation. Needless to say, corporate tax counsel should be careful not to limit avenues of escape from §531 by unworkable restrictions on §1231(b) investments.

**Conclusion**

Although the effect of §1244 on the American theatre has yet to be felt, it would seem that limitless possibilities have been created which may have a drastic effect on production of live stage performances. The result should be an increase in the number of offerings and in the amount of capital seeking to enter the field.

In the arena of drama and other Broadway type entertainment, §1244 has certainly made the limited partnership and joint venture between individuals obsolete. The ordinary loss protection of §1244 makes sacrifice of corporate advantages foolhardy except in some rare instances in which a few persons share all of the risk of the show. Even then, once the initial cost of a show has been recovered, incorporation would seem to be the wisest course of action. Dividend credit, dividend exclusion, and the
eventual capital gains treatment on liquidation are attractive to taxpayers of all brackets.

Classical music, so long committed to the status of a loss operation, can realize the greatest benefits. Whether the corporation exists for a long or a short period, it is bound to offer more than the present civic music association organization. The $25,000 or $50,000 § 1244 deduction enables devotees of opera to put more money into their favorite than is possible under the present 20% restrictions of § 170. The possibility of profit through a securities portfolio will encourage greater amounts of risk capital, since human experience would indicate that people take more risk when personal gain may crown success of the venture. Whether the shares of an opera company are held by individuals or by organizations, the effect is going to be attachment of a financial interest in the theatre among a wider group of persons. This should help generate greater popular interest in the stage.

The national touring companies, with the large overheads necessarily involved, offer more to the high bracket investor because of the extended shelter for securities and potential income at reduced tax rates. Since the larger the overhead, the larger the securities income that may be realized safely, adoption of § 1244 organization should encourage more and more tours with the resulting benefit to the public. Frequency of exposure to the classics should, in turn, create a greater popular demand.

The increase in number of performances, and the corresponding increase in employment opportunities will provide incentive to artists and to those talented persons who hesitate to enter a career in the arts because of the present uncertainty of one's economic future. In addition, the expansion of activity of repertory companies, encouraged by the desire to keep gross income high, will enable fringe benefits to become common in the arts and to spread the gain of high income years of artists with the corresponding personal security. The overall result should be an expanding core of American artists, available to offer the public the benefit of their work at frequent intervals.
The proponents of federal spending in every conceivable area will, of course, suffer since they will no longer be able to point to a need for government funds in this area. In addition to avoiding another bureaucratic temptation, the American people can rest assured that the arts will survive free of state control. Money for the arts will reach the stage without deduction of the federal brokerage fee. At the least, we will have our opera, symphony, and drama at less cost.

There remains to be considered the attitude of the Treasury toward application of statutes in this manner. At the present time, there is no reason to believe it will be a deterrent.

In the first place, the result will be a public good. There is evidence in the areas of oil depletion, charitable contributions of appreciated property, and similar matters that Congress is willing to permit tax avoidance if the overall result is to accomplish something that promotes the public interest. The use of the § 1244 corporation will assist the arts materially without risk of antagonizing the public by appropriating additional funds to offer subsidy. The present climate in the nation would seem to indicate that the President is going to have enough difficulty in securing passage of his regular budget. It is doubtful if he would welcome another issue in this area, even to help the arts.

In the second place, there is evidence that, aside from public interest matters, Congress does not want an airtight system of taxation. It would prefer to point to the 91% top rates on the highest incomes to salve the complaints of those in the lower brackets, without destroying incentive by actual enforcement of the high rates. As long as the revenue loss does not become too significant, an avenue of avoidance like the one under discussion has little to fear.

But would the revenue loss be considerable? Probably not. The gross income umbrella, necessary to protection of the securities income, is limited by the amount of this kind of entertainment the public is willing to pay for in a given year. Although this amount may be large, it is nevertheless restricted by national
income, other taxes and expenses, and popular taste. The normal saturation point of any luxury item will offer great protection to the public purse. A corollary protection is the probable failure of many investors to commit funds to anything connected with a speculative enterprise like theatre. Many people who could take advantage of the tax savings will doubtless refuse to do so, increasing the Commissioner's share of their income through lack of foresight.

The advantages of § 1244 are indeed artificial, in that they spring from an unnatural system of tax exaction in which incentive is rewarded by demands for a higher percentage of one's effort. Despite this root, the advantages do offer taxpayers the opportunity to consume more of what they earn with a corresponding benefit to the entire national community. They are worthy of the most detailed consideration.