F. T. S. Associates, Inc. v. Commissioner, 58 T. C. 207 (1972)

A corporation is not collapsible under IRC Section 341 if the intent to liquidate arises after the cessation of business activity and not during the manufacture or production of the property.

Summary

F. T. S. Associates, Inc. developed a disposable toothbrush but failed to generate sales. Facing insolvency, it sold its assets and liquidated. The IRS argued F. T. S. was a collapsible corporation under IRC Section 341, subjecting its gains to tax. The Tax Court held that F. T. S. was not collapsible because the intent to liquidate arose after the business ceased operations, not during the product's development, allowing the corporation to exclude the gains under IRC Section 337.

Facts

F. T. S. Associates, Inc. was incorporated in 1962 to develop and market a disposable toothbrush named "Tush. " After unsuccessful marketing efforts in the Boston area in 1965, the company faced insolvency. In October 1965, F. T. S. sold all its assets to Oscar Alvareztorre for $205,000 and adopted a plan of liquidation. The company realized a gain of $145,968. 24 from the sale, which it elected to exclude from taxable income under IRC Section 337.

Procedural History

The IRS determined a deficiency in F. T. S. 's 1965 income tax, arguing that F. T. S. was a collapsible corporation under IRC Section 341, which would render the nonrecognition provisions of Section 337 inapplicable. F. T. S. petitioned the U. S. Tax Court, which ruled in favor of F. T. S. , holding that it was not a collapsible corporation.

Issue(s)

1. Whether F. T. S. Associates, Inc. is a "collapsible corporation" as defined in IRC Section 341(b)(1).

Holding

1. No, because the intent to liquidate and sell the assets arose after the cessation of business activity, not during the manufacture or production of the product.

Court's Reasoning

The court analyzed the definition of a collapsible corporation under IRC Section 341(b)(1), which requires that the corporation be formed or availed of principally for manufacturing property with a view to selling stock or distributing property before realizing taxable income from such property. The court emphasized that the intent to liquidate must exist during the time of manufacturing or production, not after business cessation. In this case, F. T. S. did not have the requisite intent during the development and initial marketing of Tush. The intent to liquidate arose only after the failure of the Boston campaign and the subsequent insolvency, which was after the cessation of business. The court accepted the IRS's regulation that the proscribed intent must exist during the manufacturing phase, not merely at the time of liquidation. Therefore, F. T. S. was not a collapsible corporation, and the gains from the asset sale were properly excluded under IRC Section 337.

Practical Implications

This decision clarifies that the timing of intent to liquidate is critical in determining whether a corporation is collapsible under IRC Section 341. For similar cases, attorneys should focus on when the intent to liquidate arose relative to the business operations. This ruling encourages careful planning of corporate liquidations to avoid unintended tax consequences. Businesses contemplating liquidation should document the timing and circumstances leading to the decision to liquidate, especially if they face financial difficulties after unsuccessful business ventures. Subsequent cases have followed this principle, reinforcing the importance of timing in the application of the collapsible corporation provisions.

