

4-1-1955

## Income Taxation of Collapsible Corporations

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### Recommended Citation

Irwin E. Ginsberg, *Income Taxation of Collapsible Corporations*, 4 Buff. L. Rev. 325 (1955).

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## NOTES AND COMMENTS

Yet it may not be too presumptuous to conclude that no test truly superior to those already devised will be forthcoming until the various schools of psychiatry reach substantial agreement among themselves as to the meaning of their own terminology so that laws and decisions made in recognition thereof will become capable of practical and efficient administration.

*J. A. Guzzetta*

### INCOME TAXATION OF COLLAPSIBLE CORPORATIONS

#### INTRODUCTION

“Collapse” concerns the practice whereby the dissolution of a corporation or partnership is availed of as a means to the transformation of ordinary income into long term capital gain. The technique would be inconsequential but for the attractiveness of the capital gain provisions of the Internal Revenue Code. Desire to convert ordinary income into long term capital gain with resultant preferential tax treatment has been almost boundless.<sup>1</sup> Development of the concept of collapse was but the outgrowth of the discovery of defects in the tax structure of the 1939 Code which paved the way for such conversions. Subsequent additions and amendments to the 1939 Code served in some measure to plug the existing loopholes in the area of corporate taxation. The 1954 Code has to a degree strengthened the collapsible corporation provisions of the prior law, and in addition, has introduced loophole plugging provisions aimed at the prevention of the use of the collapsible partnership as a device to attain the same end.<sup>2</sup> Although the effectiveness of such provisions awaits judicial expression, interim analysis of the statute would not be inappropriate.

#### EARLY DEVELOPMENT OF COLLAPSE

Prior to the effective date of Section 117(m) of the 1939 Code, a corporation holding appreciated property, but which had not yet realized taxable gain, had available two procedures whereby it could benefit its stockholders at capital gain rates by the amount of the appreciation without incurring to itself adverse tax consequences. The corporation could distribute to its shareholders

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1. Murphy, *Sale of a Sole Proprietorship—An Irrationale in Three Parts*, 9 TAX L. REV. 309, 310 (1953).

2. S. REP. No. 1622, 83d Cong., 2d Sess. 98 (1954). Space limitations prevent consideration of the collapsible partnership; but note herein INT. REV. CODE OF 1954, §§ 741 and 751, in effect supplanting G. C. M. 26379, 1950-1 CUM. BULL. 58.

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the proceeds of a loan secured by the appreciated property,<sup>3</sup> or it could dissolve and distribute its property in kind as a liquidating dividend.<sup>4</sup> Such distribution could not be said to confer taxable gain upon the corporation.<sup>5</sup> The corporation which had not realized income on the distribution in kind of these appreciated assets would pay no tax on the amount of the appreciation.<sup>6</sup> The shareholder would pay capital gain tax on the liquidating dividend, which tax was applied to the excess of fair market value of the property so distributed over the cost basis of the stock. The appreciated assets taken in liquidation had a stepped-up cost basis, i. e., fair market value at the time of the distribution. Subsequent realization of proceeds from these assets resulted in little if any gain, assuming the sale price was equivalent to the fair market value.

Use of the collapsible corporation especially was suited to joint venture types of enterprise. Effective adaptation of the device was made in the building construction industry; later in the motion picture industry.<sup>7</sup> While the publicity given the use of the device in the latter area served in no small measure to hasten the enactment of the collapsible corporation statute,<sup>8</sup> it may well be that the more extensive use of the practice of collapse was made—and possibly unwittingly still is being made—in the building construction industry.

To illustrate, a real estate development corporation would be formed to construct a housing project. Upon completion of the same, and before any sales and leases were made, the corporation would be liquidated and dissolved, and the assets would be distributed to the shareholders. They would report as long term capital gain the difference between the original cost of the stock and the value of the assets received, the latter figure representing their proportionate share of the value of the completed product. Then, owning the property individually, with a stepped-up cost basis, they would sell at a price comparable to the stated value

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3. Int. Rev. Code of 1939, § 115(d), 53 STAT. 47 (now INT. REV. CODE OF 1954, § 301(c) (3)); but note also INT. REV. CODE OF 1954, § 311(c), conferring a tax liability upon the corporate distributor for transfers made during taxable years ending after June 22, 1954. Cf. also *Randall v. Bailey*, 288 N. Y. 280, 43 N. E. 2d 43 (1942).

4. Int. Rev. Code of 1939, § 115(c), 53 STAT. 46 (now INT. REV. CODE OF 1954, § 302(a)).

5. *General Utilities and Operating Company v. Helvering*, 296 U. S. 200 (1935).

6. *Commissioner v. Estate of Timken*, 141 F. 2d 625, (6th Cir. 1944); see also Miller, *Capital Gain Taxation Under the Revenue Act of 1950*, N. Y. U. 9TH INST. ON FED. TAX. 675 (1951).

7. H. R. REP. No. 2319, 81st Cong., 2d Sess. (1950), as in 1950-2 CUM. BULL. 380, 422.

8. See PAUL, *TAXATION IN THE UNITED STATES*, c. 8 (1953); also Bittker and Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437 (1949) and especially *Herbert v. Riddell*, 103 F. Supp. 369 (1952).

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of the completed product. Gain at this stage, if any, would be ordinary income. If the project were financed by a mortgage loan, one which proved to be in excess of the estimated cost of construction, monies so distributed to shareholders without surrender of their stock would accomplish much the same purpose as collapse itself.<sup>9</sup>

The response of the Commissioner served to illustrate the various avenues of attack available to the Government as it attempted to meet the problem. In *Gilman v. Commissioner*,<sup>10</sup> the Commissioner not only paid high regard to the corporate entity, but in a sense, he tried to extend its *de facto* existence in order to attribute to the corporation the sale of the assets.<sup>11</sup> Yet, in *Herbert v. Riddell*,<sup>12</sup> he attempted to disregard the corporate entity as a mere sham, and to tax the profits as ordinary income to the shareholders.<sup>13</sup> The Commissioner also might argue that any income so realized by the former shareholders from the corporate assets should be allocable to the corporation under Section 45 of the 1939 Code. Such, of course, would involve acceptance of the corporate being, and attribution to it of the realized proceeds as ordinary income under the familiar "fruit of the tree" argument.<sup>14</sup> Furthermore, argument could be advanced that gain realized on liquidation or sale is to be taxed to the shareholder as ordinary income representing compensation for services rendered, to the extent the reasonable value of such services exceeds amounts actually received as salary during the corporate existence.<sup>15</sup>

### CURATIVE LEGISLATION

Despite the availability of the above, Congress passed curative legislation.<sup>16</sup> The result was Section 212(a) of the Revenue Act

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9. *Supra* note 3. For more on this, see Greenfield, *Effect of Collapsible Corporation Provisions on Real Property Holdings*, N. Y. U. 10TH INST. ON FED. TAX. 91 (1951) and Freeman, *Collapsible Corporations*, N. Y. U. 11TH INST. ON FED. TAX. 407 408 (1952).

10. 14 T. C. 833 (1950).

11. Such would not be unlike the ruling in *Commissioner v. Court Holding Company*, 324 U. S. 331 (1945); but *cf.* *United States v. Cumberland Public Service Company*, 338 U. S. 45 (1950).

12. *Supra* note 8.

13. The personal service aspect there may well provide reason for the attempt to add directly to the individual's tax burden. Freeman, *supra* note 9, at 417. Argument that the corporate entity should be disregarded since it was but a conduit to transform ordinary income into long term capital gain, serving no true business purpose, was approved recently in *Jacobs v. Commissioner*, 21 T. C. 165, 169 (1953).

14. *Cf. Lucas v. Earl*, 281 U. S. 111 (1930).

15. Generally, see 3 MERTENS, FEDERAL INCOME TAXATION 370 (Supp. 1954).

16. The statute was drafted before the *Gilman* case was reported in May 1950. H. R. REP. No. 2319, *supra* note 7, at 451, theorized that it was uncertain whether or

(Footnote continued on following page.)

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of 1950, embodied in the 1939 Code as Section 117(m). It was estimated that the plugging of the loophole would "produce approximately \$3 million additional revenue annually".<sup>17</sup> Within a year it was noted that the technique of collapse was used elsewhere than in the two areas noted, and that Section 117(m) would have to be amended to meet the situation where inventory profits were converted into capital gains, chiefly within the whiskey industry. Thus, Section 326 of the Revenue Act of 1951 was added to Section 117(m) of the 1939 Code.<sup>18</sup> Such was calculated to add another \$5 million to Treasury coffers.<sup>19</sup> Section 117(m) of the 1939 Code as amended, has been embodied in Section 341 of the 1954 Code. Its basic provisions have been retained,<sup>20</sup> along with important additions and some minor changes attempting to strengthen the overall effectiveness of the law with regard to sales, exchanges, and distributions executed on or after June 22, 1954.

Although the statute was enacted in 1950, the first proposed United States Treasury Regulations did not appear until October, 1952, and they were not officially issued until the following March.<sup>21</sup> The regulations, somewhat vague and confusing, illustrate the difficulty of concise definition and/or explanation of the statute. It might also be noted that the proposed regulations to the 1954 Code essentially merely echo the statements in the prior regulations.<sup>22</sup>

Section 341(d) (1) of the 1954 Code reduced the requisite holdings of a shareholder from more than 10% in value of the outstanding corporate stock to but more than 5% in value of such stock. By far the most important addition is Section 341(c) providing for a rebuttable presumption that a corporation is collapsible if certain conditions are found to exist. Sections 341(b) (3) and (4) merely set out what assets are to be considered in ascertaining the aforementioned conditions. These provisions, along with Section 341(a) (3) regarding a distribution not in

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(Footnote continued from preceding page.)

not use of the device would be favorably viewed by the courts. In view of such uncertainty, the committee felt that a specific statute dealing with collapsible corporations "is desirable . . . to insure that the use of the device in the future will result in no tax advantage". (emphasis added.)

17. *Id.* at 423.

18. H. R. REP. No. 586, 82nd Cong., 1st Sess. (1951), as in 1951-2 CUM. BULL. 357, 375.

19. S. REP. No. 781, 82nd Cong., 1st Sess. (1951), as in 1951-2 CUM. BULL. 458 ff.

20. Retention was had by the Senate which did not approve of the plan submitted by the House. See S. REP. No. 1622, *supra* note 2, at 48.

21. As noted by MacLean, *Collapsible Corporations*, 67 HARV. L. REV. 55 (1954); also Greenfield, *supra* note 9, at 98 and comments by Freeman, *supra* note 9, at 417.

22. Compare prior U. S. TREAS. REG. 118, §39.117(m) with proposed U. S. TREAS. REG. §1.341.

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liquidation and not a dividend,<sup>23</sup> constitute the only major additions in the new statute to Section 117(m) of the prior statute.

Generally, gain realized from the sale or exchange of stock, from distributions in liquidation, or from distributions of proceeds of loans in excess of the bases of the property by which they are secured will, in the case of a collapsible corporation, be treated as ordinary income as regards a shareholder owning more than 5% of the outstanding stock of the corporation, provided that the gain realized is more than 70% attributable to the property of the corporation, and that such gain is realized within three years following the completion of the manufacture of such property.<sup>24</sup> Three matters ought to be noted. First, the corporation need not, in fact, collapse, for the statute to apply. A sale of stock in a collapsible corporation may suffice.<sup>25</sup> The breadth of the statute is likewise illustrated by provision that gain from distributions by collapsible corporations of the proceeds of loans had in excess of the bases of the appreciated property by which they are secured will not receive capital gain preference.<sup>26</sup> Such, of course, leads to the final consideration of what is a collapsible corporation. The statute defines it as one

formed or availed of principally for the manufacture . . . of property . . . with a view to the sale or exchange of stock . . . or a distribution to its shareholders, before the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property, and the realization by such shareholders of gain attributable to such property.<sup>27</sup>

It should be recognized that Section 341 of the 1954 Code has clarified to a great degree the prior subjectivity of Section 117(m) of the 1939 Code by providing that a corporation will be deemed to be collapsible if certain objectively ascertainable standards are in evidence.<sup>28</sup> If the fair market value of the "section 341 assets" (generally non-capital assets, including unrealized receivables and fees)<sup>29</sup> which are held for less than three years<sup>30</sup> is 50% or more

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23. Formerly INT. REV. CODE OF 1939, § 115(d), 53 STAT. 47 (now INT. REV. CODE OF 1954 § 301(c)).

24. INT. REV. CODE OF 1954, §§ 341(a) & (d).

25. *Ibid.*, see also comment in *MacLean, supra*, note 21.

26. INT. REV. CODE OF 1954, § 341(a) (3), with reference to § 301(c) (3) (A).

27. INT. REV. CODE OF 1954, § 341(b).

28. INT. REV. CODE OF 1954, § 341(c), in effect an affirmation of Freeman, *supra* note 9, at 447.

29. S. REP. NO. 1622, *supra* note 2, at 260 points out that such assets generally will include inventories plus property described in Section 1231(b) of the 1954 Code (old Section 117(j)), except that it will exclude property which is or has been used in connection with the manufacture of other Section 341 assets as inventory or property held primarily for sale to customers.

30. *Id.*, pointing out that reference should be had to Section 1223 of the 1954 Code and that the holding period will not begin until completion of the "manufacture" of the property.

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of the total corporate assets, excluding cash, stock holdings, and obligations defined in Section 341(c) (2) (B); and the appreciated value of such is 120% or more of their adjusted base, the corporation is deemed to be collapsible.<sup>31</sup>

The presumption apparently is a procedural aid for the Commissioner. If the aforementioned conditions exist, the burden of going forward with the evidence will shift to the taxpayer. Absence of conditions giving rise to the presumption will not give rise to the converse.<sup>32</sup> Hence, a corporation still could be found collapsible without resort to the presumption. Presence of conditions leading to the operation of the presumption merely allows the Commissioner to sidestep the necessity of proving a corporation collapsible by resort to the weasel wording of Section 341(b).<sup>33</sup>

The collapsible corporation is one principally engaged in the manufacture of property "with a view to" certain specified dispositions. The statute does little to qualify the noun "view". The term "principally" appears out of position to modify it. There is no reference to "the view", or "principal view", or even "substantial view".<sup>34</sup> The statute merely refers to "a view". Since the phrase does refer to the subjective intent of the agents of the corporation, it is clear that the requirement of the existence of "a view" rather than the above mentioned possibilities, lessens appreciably the burden of proof upon the Commissioner. The Commissioner's regulations in proposed form take full advantage of this. They state that:

the existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 341(b).<sup>35</sup>

To further "clarify" the meaning of the term in question, the Regulations provide that:

this requirement is satisfied in any case in which such action was *contemplated* by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise.

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31. *Id.*, at 261, the Committee states that "it is intended that if either of the conditions described are not met a presumption that the corporation is not a collapsible corporation shall not arise".

32. INT. REV. CODE OF 1954 § 341(c) (1). Also, *supra* note 31.

33. Much of the weasel wording of the statute has been adequately commented upon by others, e. g. Freeman, *supra* note 9, and MacLean, *supra* note 21, and will not be considered at length here.

34. MacLean, *supra* note 21, at 60.

35. Proposed U. S. TREAS. REG. § 1.341-2(2).

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The requirement is satisfied whether such action was *contemplated* unconditionally, conditionally, or as a *recognized possibility*.<sup>36</sup> [Emphasis added.]

The requisite view need not be in existence at the time of the formation of the corporation. The statute is read with the phrase "with a view to" modifying generally the phrase "formed or availed of principally". Hence, the new proposed regulations provide only that the view needs exist at any time during the manufacture.<sup>37</sup> The Commissioner condescended to provide that if the sale or distribution is necessitated solely by circumstances arising after the manufacture, the corporation shall be considered not to have been so formed or availed of. Yet, he qualifies this by providing that such circumstances must not have been reasonably anticipated at or during manufacture, and he also provides that such conclusion, i. e., not collapsible, will be reached only in the "absence of compelling facts to the contrary".<sup>38</sup>

The statute requires the corporation be principally engaged in the manufacture of property with the necessary view to transfer or collapse *before* it realizes a "substantial part" of the net income to be derived from such property.<sup>39</sup> Clearly, "substantial" can not be blessed with any precise meaning in the abstract. Moreover, it appears that the proposed regulations equate "substantial" with "principally"<sup>40</sup> which may be viewed as being contrary to the intent of the draftsmen. If one accepts the premise that "principally" means something more than "substantial", it can be argued that the consequence of the equation is to weaken the meaning of the term "principally", to the resultant benefit of the Commissioner. The 70% rule in Section 341(d) (2) is illuminating. The House Committee has reported that:

Both the second and third limitations relate to the gain realized from the sale or exchange of stock, the second limitation being designed to insure that the application of the subsection will be limited to those corporations where the relationship between the gain realized and the property manufactured, constructed, or produced is substantial.<sup>41</sup>

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36. *Ibid.*

37. *Id.* § 1.341-2(3).

38. *Ibid.* For illustration, see § 1.341-5, ex. #3.

39. Once it is determined that the corporation itself has realized a substantial part of such taxable income to be derived from its property, it will be deemed an ordinary business corporation and all other considerations become "academic". (Freeman, *supra* note 9, at 428.)

40. See proposed U. S. TREAS. REG. § 1.341-5(b) (3); and MacLean, *supra* note 21, at 71.

41. H. R. REP. 2319, *supra* note 7, at 451.



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This is the strongest official indication that the 70% requirement is to be cross-referenced with the term under consideration. In any event, it still is unclear as to where between 10% and 70% the minimum is reached which will satisfy the Commissioner as to what is "substantial".<sup>42</sup>

### LIMITATIONS

Although a corporation be collapsible in all respects, gain had by a shareholder still may be long term capital gain if the shareholder in question did not own or was not considered as owning more than 5% in value of the total outstanding stock of the corporation.

If the corporation be collapsible, and if the particular shareholder own or is considered as owning the requisite amount of stock, the applicability of the statute can be avoided if it can be shown that at least 30% of the gain realized in any taxable year on a distribution from the corporation or on a sale or other disposition of the stock is not attributable to the property so produced by the corporation. Basically, this is an all or nothing approach.<sup>43</sup> It is of course conjectural as to how the Commissioner and courts ultimately will view the term "attributable".<sup>44</sup>

Finally, even if the corporation be collapsible, even if the particular shareholder does own the requisite amount of stock, and the gain from the stockholding is more than 70% attributable to the property produced, the effect of the statute can be avoided if such gain is "realized after the expiration of three years following the completion of such manufacture. . . ."<sup>45</sup> It has been rather strongly suggested that this limitation may well be one

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42. It can be implied from proposed U. S. Treas. Reg. § 1.341-5, ex. #4 that 10% is not to be regarded as "substantial". See also comment by MacLean, *supra* note 21, at 70, and *cf.* Boland, *Practical Problems of the Collapsible Corporation*, N. Y. U. 10TH INST. ON FED. TAX. 536 (1951). The former also makes the point that under the peculiar wording of the statute such realization, or lack of it, need not in fact occur. All that may be required he submits, is that a view to such be present at some time or other. Such lends added meaning to the phrase "with a view to". Hence, even if a corporation has realized such a "substantial" part of the income, it is conceivable, though highly improbable, that the statute could apply. However, the author appears to agree with Freeman, *supra* note 9, that the above is mere academic speculation.

43. Cohen, *A Proposed Revision of the Federal Income Tax Treatment of the Sale of a Business Enterprise—A. L. I. Draft*, 54 COL. L. REV. 157, 172 (1954).

44. The proposed Treasury Regulations are of little aid here. (See § 1.341-4.) An example of possible application of the 70% rule is provided in 2 CCH 1955 STAND. FED. TAX REP.

2490 Greenfield, *supra* note 9, comments that in *re*: real estate development sales, the limitation might apply if 30% of the gain be attributable merely to the appreciation in value of the land.

45. INT. REV. CODE OF 1954, § 341(d) (3). Also H. R. REP. NO. 2319, *supra* note 7, at 451. The computation of the period is to begin at the time of the completion of the manufacture, not the time of the sale or distribution.

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of the major loopholes allowing for circumvention of the statute.<sup>46</sup> The procedure calls for patience and delay; for an ability to forego immediate use of funds in anticipation of the capital gain benefits later to arise. The corporation could enter into executory contracts to sell with a closing set after the statutory period. Possibly an interim leasehold arrangement also could be utilized.

### CONCLUSION

While the extent to which the concept of collapse in the area of corporate taxation has been arrested by the statute must await judicial expression, the writer believes that reference to the limitations considered above well may allow tax counsel to mold the structure of newly formed corporations in such manner as to avoid entirely the scope and application of the statute. Certainly the statute will serve as a deterrent, and its provisions must be heeded in any situation where capital gain is anticipated from a sale or distribution. Generally, inspection of the corporate balance sheet should suffice to ascertain whether or not a corporation is collapsible. If the presumption that the corporation is collapsible does not apply to the situation at hand, the ordinary taxpayer need entertain no fears. Undoubtedly, it will be a rare case where attempt is made to apply the statute without aid of the presumption.

Due to the three year property holding provision in the presumption and the statements in the proposed regulations regarding prior business histories, it appears that the brunt of the statute is intended to be borne by newly organized corporations. Moreover, because of the general appreciation in values attending an inflationary period, the presumption may well prove most valuable to the Commissioner during such a stage in the business cycle as the present. While it does not appear that the overall effect of the statute may be to stifle investment tainted with hopes of speedy rewards, still it is conceivable that attacks by the Commissioner based upon Section 341 may increase or decrease, through design or otherwise, during the fluctuations of the over all business economy.

It is uncertain whether or not the other avenues of approach to the problem, such as those developed in the *Gilman*<sup>47</sup> and *Herbert*<sup>48</sup> cases, still are available to the Commissioner. The writer does not believe the statute to be preemptory. Had Con-

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46. Cohen, *supra* note 43, at 174 ff, pointing out it never would reach LIFO inventories where ordinary gain has been deferred for more than 3 years. See also Note, *Legislative Response to the Collapsible Corporation*, 51 COL. L. REV. 361 (1951).

47. *Supra* note 10.

48. *Supra* note 8.

gress intended Section 341 to preempt the available avenues of attack upon the collapsible corporation, it is submitted that it would have inserted statutory language to that effect, similar to that inserted in Section 671 of the Clifford Trust provisions of the 1954 Code.

*Irwin E. Ginsberg*

## USE OF MANDAMUS TO REVIEW ADMINISTRATIVE ACTIONS IN NEW YORK

### INTRODUCTION

The growth in number and in influence of administrative bodies in the past few decades has resulted in an ever increasing body of litigation in which those who believe themselves wronged by governmental agencies seek redress in the courts. The extraordinary remedy of mandamus has proved to be a convenient device for obtaining judicial review in many cases.

Although the common law writ of mandamus has been abolished in New York the relief formerly obtainable under that writ is available under the statutory substitute.<sup>1</sup> While the statute has achieved the salutary effect of eliminating the danger of an incorrect selection among the extraordinary remedies it has been recognized by the courts that the relief available under Article 78 of the Civil Practice Act is coextensive with that which existed before the reformed procedure.<sup>2</sup> For this reason no distinction will be made between cases of mandamus and the present cases in the nature of mandamus. The procedural consolidation has quite understandably resulted in a diminishing use of the old label by the courts.<sup>3</sup> For purposes of convenience, however, the term "mandamus" will be used indiscriminately herein to characterize actions of this nature both before and after the passage of Article 78.

### THE MANDATORY-DISCRETIONARY DISTINCTION

A consideration of the factors employed by the courts in deciding whether mandamus should be granted in a particular case must necessarily include a mention of the most common criterion used in deciding cases under the old writ. The old theory was that mandamus could be had only to compel performance of

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1. C. P. A. §1283.

2. *Newbrand v. City of Yonkers*, 285 N. Y. 164, 33 N. E. 2d 75 (1941); see THIRD ANNUAL REPORT N. Y. JUDICIAL COUNCIL 132 (1937).

3. See *Fiore v. O'Connell*, 297 N. Y. 260, 78 N. E. 2d 602 (1948); *New York State Soc. of Prof. Eng. v. Education Dep't*, 262 App. Div. 602, 31 N. Y. S. 2d (3d Dep't 1941).