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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

THE *KIMBELL-DIAMOND* DOCTRINE

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New York State Bar Association Tax Section

Report on the *Kimbell-Diamond* Doctrine

Introduction

This report[1] of the Tax Section of the New York State Bar Association discusses the continuing application (if any) of the *Kimbell-Diamond* doctrine (the "KD doctrine"). The KD doctrine refers to an application of the step transaction doctrine pursuant to which the acquisition of the stock of a target corporation by an acquirer followed by a liquidation or merger of the target corporation into the acquirer pursuant to an integrated transaction is treated as an acquisition of the target corporation's assets.

If KD doctrine applies, the acquirer is treated as acquiring the target corporation's assets for the consideration that the acquirer, in form, paid to the target corporation's stockholders. In a taxable transaction, application of the KD doctrine results in the acquirer taking a tax basis in the target corporation's assets equal to the acquirer's purchase price for the stock rather than the target corporation's historic basis in its assets.

The tax consequences of an application of the KD doctrine to the target corporation and its shareholders are less settled. Under one approach, the tax effect of the recast applies only to the acquirer, and the transaction is not recast with respect to the target corporation or its shareholders. Under this approach, in accordance with the form of the transaction, the target corporation's shareholders are treated as transferring their stock to the acquirer in exchange for consideration provided by the acquirer, and the target corporation is then treated as transferring its assets to the acquirer by liquidation or merger. In this report, we refer to this approach as an "asymmetric" application of the KD doctrine. Under a second approach, which we refer to as a "symmetric" application of the KD doctrine, the tax effect of the recast applies not just to the acquirer, but also to the target corporation and its shareholders. Under a symmetric application of the KD doctrine, the acquirer is treated as acquiring the assets of the target corporation in exchange for the consideration that the acquirer, in form, provided to the target

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[1] The principal author of this report is Peter F.G. Schuur. Significant contributions were made by Joe Binder and Munir Zilanawala. Helpful comments were received from Neil J. Barr, Charles I. Kingson, Stephen B. Land, Matthew A. Rosen, Michael L. Schler, Eric Sloan, Eric Solomon, Karen Gilbreath Sowell, Linda Z. Swartz, and Joe Toce. This report reflects solely the views of the Tax Section of the New York State Bar Association (the "NYSBA") and not those of the NYSBA Executive Committee or House of Delegates.

shareholders, and the target corporation is then treated as distributing the consideration to its shareholders pursuant to a liquidating distribution.

Since the enactment of Section 338,[2] the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") have issued regulations and other administrative guidance confirming that the KD doctrine was repealed in relation to a qualified stock purchase ("QSP") of a target corporation. However, it is not entirely clear whether the KD doctrine has continuing application to acquisitions that do not qualify as QSPs, and the recent issuance of regulations under Section 336(e) has reinvigorated the importance of addressing this gap.

This report is divided into four parts. Part I provides a summary of our recommendations. Part II summarizes the history of the KD doctrine in common and statutory law and administrative guidance. Part III describes the administrative guidance confirming the repeal of the KD doctrine in the case of QSPs and describes the continuing application of recast principles similar to a symmetric KD doctrine in the case of multi-step transactions that are treated as reorganizations under Section 368(a). Part IV includes a detailed discussion of our recommendations.

I. Summary of Recommendations

We believe that the KD doctrine should not apply to recast, as a taxable acquisition of the target corporation's assets, the acquisition of the stock of a target corporation by an acquirer that is followed by a liquidation or merger of the target corporation into the acquirer pursuant to an integrated transaction. In these circumstances, the step transaction doctrine should not apply and the federal income tax consequences should follow the form of the transactions. As a result, the transaction generally should be treated as an acquisition of the stock of the target in exchange for the consideration provided by the acquirer, followed by a liquidation of the target into the acquirer. This result should apply even if the acquisition is neither a QSP nor a qualified stock disposition ("QSD") and even if the acquirer is not a corporation.

More specifically, to eliminate ambiguity regarding the possible application of the KD doctrine outside the context of transactions involving a first-step QSP, we recommend that Treasury and the IRS issue guidance confirming that, if the integrated transaction does not qualify as a reorganization under Section 368(a), the federal income tax consequences of the acquisition of the stock of a target corporation by an acquirer in a QSD or any other transaction that is not a QSP, followed by a liquidation or merger of the

[2] Unless the context indicates otherwise, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

target corporation into the acquirer, should follow the form of the transactions, taking into account all other relevant transactions that occur in connection with the acquisition and the subsequent liquidation or merger.

We believe that our recommendations do not require any change to current law pursuant to which the acquisition of the stock of a target corporation by an acquirer, followed by a liquidation or merger of the target corporation into the acquirer, is treated as a reorganization under Section 368(a) if, under the step transaction doctrine, the integrated transaction satisfies the requirements of the reorganization provisions.

II. History of the KD Doctrine in Common and Statutory Law and Administrative Guidance

A. 1950: *Kimbell-Diamond Milling Co. v. Commissioner*

1. The *Kimbell-Diamond* Cases

In August 1942, the mill and milling equipment of the Kimbell-Diamond Milling Company ("KD") were destroyed by fire, and KD received insurance proceeds attributable to the destroyed assets. Shortly thereafter, KD's board of directors approved the purchase of all of the stock of Whaley Mill & Elevator Company ("Whaley"), which held assets substantially similar to KD's destroyed mill and milling equipment. In its resolution authorizing the transaction, KD's board resolved that the purchase price for the stock of Whaley should be paid, to the extent possible, from the insurance proceeds (together with additional funds) and "that as soon as practicable after the purchase … all necessary steps be taken to completely liquidate the [purchased] corporation."[3]

KD acquired all of Whaley's stock on December 26, 1942, and entered into a plan of liquidation with Whaley three days later. KD did not acquire Whaley's stock directly from its historic shareholders but instead acquired Whaley from Kimbell Milling Co., an affiliate of KD that had previously acquired the stock from the historic shareholders of Whaley.[4] On December 31, 1942, the liquidation was completed and the state government certified that Whaley was dissolved as of that date.

3 *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, 76 (1950).

4 As of early 1942, Whaley was owned by approximately 60 shareholders. By December 15, 1942, Whaley had been acquired by Kimbell Milling Co., a 43% shareholder of KD that in turn was owned 100% by another shareholder of KD. This other shareholder and Kimbell Milling Co. together owned the majority of KD's stock. *Kimbell-Diamond Milling Co. v. Commissioner*, 10 T.C. 7, 8-9 (1948).

The Tax Court issued two opinions with respect to this transaction. In the first KD opinion,[5] the Tax Court considered whether KD could avoid recognizing gain on the insurance proceeds it received under Section 112(f) of the 1939 Code, which is today Section 1033(a). Like Section 1033(a), Section 112(f) provided that a taxpayer generally was able to avoid recognizing gain on insurance proceeds received for destroyed property if the proceeds were used to acquire qualified replacement property or control of a corporation owning such property. Over the IRS's contention that KD's method of acquiring control of Whaley, which involved the intermediate acquisition by Kimbell Milling Co., did not satisfy the statutory requirements, the Tax Court concluded that KD had acquired control of Whaley and therefore KD did not recognize gain with respect to the insurance proceeds.

In the second, now familiar KD opinion ("*Kimbell-Diamond*"),[6] the Tax Court addressed the question of KD's tax basis in the assets acquired from Whaley in the liquidation. KD argued that it was entitled to use Whaley's historic tax basis in its assets because it acquired the assets in a transaction described in Section 112(b)(6) of the 1939 Code, which is today Section 332(a). The IRS countered that if an involuntary conversion had occurred, as the Tax Court had ruled in the first KD opinion, then Section 113(a)(9) of the 1939 Code, which is today Section 1033(b)(2), would apply to give the taxpayer a tax basis in the target assets equal to the taxpayer's basis in the destroyed assets plus the amount it spent in excess of the insurance proceeds. The IRS's argument produced a lower asset basis than KD's theory.

Citing *Commissioner v. Ashland Oil & Refining Co.*,[7] the Tax Court applied the step transaction doctrine and held that "the purchase of Whaley's stock and its subsequent liquidation must be considered as one transaction, namely, the purchase of Whaley's assets which was [KD's] sole intention."[8] The Tax Court therefore sustained the IRS's position that KD's tax basis in the Whaley assets was determined under Section 113(a)(9) by reference to the basis of the destroyed assets plus the additional cash paid by KD. In doing so, it would appear that the Tax Court intended to fill the statutory gap in Section 113, which provided for a tax basis adjustment for replacement assets that were acquired directly, but which did not include a mechanism to apply the relevant tax basis adjustments to assets held by an acquired corporation. The inconsistency was

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[5] *Kimbell-Diamond Milling Co. v. Commissioner*, 10 T.C. 7 (1948).

[6] *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951).

[7] 99 F.2d 588 (6th Cir. 1938), *cert. denied*, 306 U.S. 661 (1939).

[8] 14 T.C. at 80.

particularly evident under the facts before the court because the liquidation of Whaley resulted in KD holding the replacement assets directly.

The gap in Section 113 was subsequently addressed by Congress through the enactment of Section 1033(b)(3), which provides that if a taxpayer acquires control of a corporation that holds replacement property, the reduction in the taxpayer's basis in the stock of the corporation under Section 1033(b)(2) (to reflect the unrecognized gain amount) is generally pushed down to reduce the corporation's basis in its assets. The effect of this statutory change was to make the holding of *Kimbell-Diamond* obsolete.

While the Tax Court framed its holding in *Kimbell-Diamond* regarding the substance of the transaction in general terms, it was only required, as a technical matter, to determine KD's tax basis in Whaley's assets under the involuntary conversion rules (i.e., the basis of the destroyed assets plus KD's purchase price). If the transaction was recast as an asset purchase for both KD and Whaley, Whaley would have been subject to tax on gain on the deemed sale under the law in effect at the time. There is no suggestion in *Kimbell-Diamond* that the Tax Court considered the consequences of its holding outside of the context of the involuntary conversion rules, and in particular whether a recast could apply on a symmetric basis, thereby subjecting the target corporation to tax on the deemed asset sale.

2. Predecessor Cases and the Development of Asymmetry

Kimbell-Diamond relied on the Sixth Circuit's decision in *Commissioner v. Ashland Oil & Refining Co.*[9] Under the facts of the case, the Swiss Oil Corporation ("Swiss") purchased the stock of the Union Gas & Oil Company ("Union") after several unsuccessful attempts to purchase Union's assets directly. Swiss held the stock of Union for almost a year before liquidating Union in order to hold the assets directly (the liquidation could not be effected until various earnout payments were made by Union to its old stockholders). The IRS asserted that in the liquidation Swiss should recognize gain on its stock of Union based on the difference between the value of Union's assets at the time of the liquidation and Swiss's cost basis in the stock of Union. The taxpayer argued that the acquisition and liquidation were merely steps in a unitary plan to acquire Union's oil-producing properties and therefore Swiss could not recognize gain with respect to the properties.[10] The Sixth Circuit applied the step transaction doctrine[11] and

[9] 99 F.2d 588 (6th Cir. 1938), *cert. denied*, 306 U.S. 661 (1939).

[10] Id. at 590.

[11] Id. at 591. "[A] single transaction must be considered singly and not be divided into its several steps, each to be considered as a separate transaction in respect to tax liability."

held that in substance the transaction was a direct acquisition of Union's assets by Swiss; therefore, as owner of the assets, Swiss could not recognize gain on the liquidation.[12]

Notwithstanding the Sixth Circuit's conclusion that Swiss could not recognize gain on the liquidation because it acquired the assets directly, it appears that Union was treated as the owner of the assets for tax purposes during the period between Swiss's acquisition of the stock of Union and the liquidation of Union.[13] Thus, like *Kimbell-Diamond*, *Ashland Oil* implicitly applied an asymmetric recast. The dissenting opinion in *Ashland Oil* recognized the consequences of the asymmetry, noting that the asymmetric recast led to an "entire escape from tax liability on the profits realized in the exchange of assets between Union and Swiss except that paid by Union stockholders on the sale of their stock."[14]

In *Dallas Downtown Development Co. v. Commissioner*,[15] which pre-dated *Kimbell-Diamond*, the Tax Court addressed the tax consequences to the target corporation under the *Kimbell-Diamond* fact pattern. In *Dallas Downtown Development,* the IRS sought to recast the transactions on a symmetric basis, asserting that the target recognized long-term capital gain on the deemed sale of its assets, a single office building, to the acquirer. The Tax Court, however, held that the tax consequences to the target should follow the form of the transaction. As a result, the target could not be treated as selling its property when the stockholders sold their shares and the target also could not be taxed upon the subsequent liquidating distribution of the office building to the acquirer.[16] The Tax Court concluded that the transaction was best viewed as an application of the *General Utilities* doctrine:

> we think the only realistic summarization of the entire transaction is that the principal tenant of a business building decides to attempt to acquire it as its headquarters, and being unsuccessful in buying the property itself from the corporate owner, secures all the stock by purchase from the individual holders, and, as sole stockholder, then dissolves the corporation, and … acquires the property as a liquidating dividend. So stated, it seems clear that there was no sale of the property by the

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[12] Id. at 591-92.

[13] Id.

[14] Id. at 595.

[15] 12 T.C. 114 (1949), acq. 1950-2 C.B. 2.

[16] Id. at 126.

corporation at any time, no capital gain to it, *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200.[17]

Under the holding of *General Utilities*, which was decided in 1935, a corporation was not subject to tax on a liquidating distribution of its property. As a result, a corporate liquidation followed by a sale of the distributed assets would only be subject to one level of tax, when the shareholder sold the assets. Prior to the enactment of the Internal Revenue Code of 1954, this principle did not apply if the corporation sold (or was treated as selling) its assets before liquidating.[18] As a result, the Tax Court in *Dallas Downtown Development* could only invoke *General Utilities* by analogy, comparing the transaction at issue to a liquidating distribution of property, followed by a sale of the corporation's assets by the shareholder.

The 1954 Code both codified the holding of *General Utilities*—that a corporation could liquidate without recognizing any gain or loss on its assets—and expanded this principle to cover certain asset sales by a corporation in connection with a liquidation. Under Section 336 of the 1954 Code, a corporation generally did not recognize any gain or loss on the distribution of its assets in partial or complete liquidation,[19] and under Section 337 of the 1954 Code, a corporation generally did not recognize any gain or loss on any sale or exchange of property if, within a twelve-month period, it adopted a plan of

[17] Id. at 124-25. The Tax Court also noted, in a dictum, that it did not have to face the issue that arose under *Ashland Oil*, of whether the purchaser should recognize gain on the liquidation of target because the stock of target (which included the net liabilities of the corporation) was fundamentally different from the office building that the purchaser wished to acquire.

[18] *See Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) (corporation treated as seller of assets formally sold by shareholders by way of liquidating dividend); cf. *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950) (shareholder respected as seller of assets).

[19] A distributee shareholder would recognize gain or loss on its stock under Section 331(a) and would receive a fair market value basis in the assets under Section 334(a), unless the liquidation satisfied the requirements of Section 332 and the distributee was an 80% corporate shareholder. In that case the distributee would recognize no gain or loss on its stock and would receive a carryover basis in the assets under Section 334(b)(1), unless Section 334(b)(2) (the codification of the KD doctrine) applied to provide a fair market value basis. Section 334(b)(2) is discussed below in Part II.B.

complete liquidation and distributed all of its assets (including the proceeds of any asset sales) in complete liquidation.[20]

Together, these provisions of the 1954 Code would have afforded nonrecognition treatment to a target corporation, even if the KD doctrine applied on a symmetric basis. Within this framework, it was reasonable for courts to approach the KD doctrine fact pattern from an asymmetric perspective, and the Tax Court, reviewing the operation of the KD doctrine in 1976, stated that it should be applied on an asymmetric basis:

> While under *Kimbell-Diamond* or section 334(b)(2), its statutory counterpart, [acquirer's] purchase of the [target] stock and subsequent liquidation of [target] may be considered a purchase of [target's] assets, neither authority warrants recharacterization of the transaction for other than basis purposes.[21]

B. 1954: Codification of the KD Doctrine in Section 334(b)(2)

Section 334(b)(2) was enacted in 1954, four years after the Tax Court's decision in *Kimbell-Diamond*. Under Section 334(b)(2), if an acquiring corporation acquired control[22] of the stock of a target corporation by purchase within a 12-month period and

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20 Just as in a Section 336 liquidation, a distributee shareholder in a Section 337 liquidation would realize gain or loss on its stock and would receive a fair market value basis in the assets. Section 337 generally did not apply to a sale or exchange by the corporation following the adoption of a plan of liquidation if the liquidation was a complete liquidation of a subsidiary to which Section 332 applied.

21 *Pittsburgh Realty Investment Trust v. Commissioner*, 67 T.C. 260, 276 (1976). The application of step transaction doctrine principles on an asymmetric basis is not limited to the KD doctrine. In *McCauslen v. Commissioner*, 45 T.C. 588 (1966), the Tax Court adopted a similar construct for analyzing the tax consequences of the purchase by the surviving partner of the partnership interest of his deceased partner. The Tax Court held that the surviving partner did not purchase his deceased partner's interest in the partnership, but instead that the surviving partner purchased the partnership assets relating to such interest (rather than received such assets by any distribution from the partnership). As a result, the surviving partner was not permitted to succeed to the partnership's holding period with respect to such assets. *See also* Rev. Rul. 99-6, 1999-1 C.B. 432 (purchase by one partner of the interest of the other partner in a two-member partnership treated, as to seller, as a sale of a partnership interest, but, as to buyer, as a purchase of assets that were deemed distributed to the selling partner in liquidation of the latter's partnership interest).

22 For this purpose "control" was defined as 80% of the voting power and 80% of the number of shares of all other classes of stock of the target corporation.

subsequently liquidated target, the acquirer's tax basis in the target assets generally would equal the cost of the purchased target stock. To satisfy the requirements of Section 334(b)(2), the target corporation had to be liquidated pursuant to a plan of liquidation adopted within two years after the completion of the qualifying purchase. However, liquidating distributions could be made over a three-year period beginning with the close of the taxable year during which the first liquidating distribution was made.

Section 334(b)(2) was a rule for determining the tax basis of the "purchased" assets of the target corporation in the hands of the acquiring corporation that applied in lieu of Section 334(b)(1), which would have provided the acquiring corporation with a carryover tax basis. Section 334(b)(2) did not apply the KD doctrine recast to treat the acquiring corporation as directly acquiring the assets of the target corporation for tax purposes. Instead, the target corporation's ownership of its assets (which could extend over a five-year period) was taken into account for federal income tax purposes and the acquiring corporation's basis in the target corporation's assets was adjusted for dividend distributions to the acquiring corporation and post-acquisition earnings and profits of the target corporation.[23]

The legislative history to Section 334(b)(2) is not clear on whether the enactment of Section 334(b)(2) repealed the KD doctrine. The House version of the bill would have applied to both individual and corporate acquirers. The House Report stated that "under the bill, a shareholder will in general be permitted to receive the purchase price for his stock as his basis for the assets distributed to him in liquidation irrespective of the assets' cost to the corporation. In this respect, the principle of *Kimbell-Diamond Milling Co.* (187 F.2d 718) *is effectuated*."[24]

The Senate version limited Section 334(b)(2) to corporate purchasers. The Senate Finance Committee's report explained the reason for the change: "Under the House bill, a shareholder would in all cases be permitted to receive the purchase price for his stock as his basis for the assets distributed to him regardless of the assets' cost to the corporation. In this respect the principle of *Kimbell-Diamond Milling Company* (187 F.2d 718) was effectuated. Since the application of the rule of this case is primarily in the area of liquidations by a parent corporation of its subsidiary, the rule has been limited by your committee to liquidations of this type." The Senate Report went on to say that the revised statute "incorporates … rules effectuating principles derived from *Kimbell-Diamond Milling Co*."[25] Thus, as enacted, Section 334(b)(2) represented a specific

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[23] Under the Section 334(b)(2) framework, upon liquidation the target corporation was also taxed on any recapture income attributable to the liquidation, and the tax attributes of the target corporation were eliminated.

[24] H. Rep. No. 1337, 83d Cong., 2d Sess. 38 (1954) (emphasis supplied).

[25] S. Rep. No. 1622, 83d Cong., 2d Sess. 257 (1954).

application of the KD doctrine to corporate acquirers that did not preclude the application of the KD doctrine in other cases, such as acquisitions by non-corporate acquirers.

C. Post-Section 334(b)(2) Application of the KD Doctrine to Corporate Acquirers

Following the enactment of Section 334(b)(2), a number of courts faced the issue of whether Section 334(b)(2) had preempted the KD doctrine. In the case of a corporate acquirer, the courts generally concluded that Section 334(b)(2) was the exclusive means for the acquirer to obtain a tax basis in the target's assets equal to the purchase price for the target stock.[26] These holdings generally relied on the premise that, in enacting a specific statutory framework, Congress had intended to preempt the subjective, judicially created KD doctrine for corporate acquirers. As the Tax Court stated in *International State Bank v. Commissioner*:

> While the question is not entirely free of doubt, we believe the better view is that Congress, by enacting section 334(b)(2), intended the statute to supplant the subjective intent test of *Kimbell-Diamond* with a series of

[26] *See In re Chrome Plate, Inc.*, 614 F.2d 990, 1000 (5th Cir. 1980) (intervening Section 351 transaction that occurred between acquisition of control and subsequent liquidation of target corporations into subsidiary of corporate acquirer prevented transactions from satisfying requirements of Section 334(b)(2); court held "definitively and absolutely that the Kimbell-Diamond doctrine is extinct under the 1954 code regarding corporate taxpayers"); *Broadview Lumber Co., Inc. v. United States*, 561 F.2d 698 (7th Cir. 1977) (acquisition of stock of target from a person the ownership of whose stock was attributed to corporate acquirer followed by merger of target into acquirer did not satisfy "purchase" requirement of Section 334(b)(2); court held KD doctrine no longer applicable to corporate acquirers and Section 334(b)(2) provided exclusive pathway for obtaining cost basis in assets of target corporation); *International State Bank v. Commissioner,* 70 T.C. 173, 180 (1978) (facts similar to *Broadview Lumber*, except that target was liquidated into corporate acquirer; KD doctrine found to have "no present vitality with respect to the determination of the basis of property received by a corporation in a liquidation which meets the requirements of section 332"). Each of these courts rejected the holding of *American Potash* (discussed below). *See also Supreme Investment Corp. v. United States*, 468 F.2d 370, 377 (5th Cir. 1972) ("In codifying the *Kimbell-Diamond* rule Congress made a major change: it substituted a series of objective tests in place of a determination of the taxpayer's subjective intent to obtain corporate assets…."); *Pacific Transport Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974) (citing an earlier case for proposition that "'Section 334(b)(2) was passed by Congress to eliminate a subjective intent test enunciated in *Kimbell-Diamond*'").

> objective tests. Thus, we agree with the conclusion reached by the Circuit Courts of Appeal that the *Kimbell-Diamond* doctrine has no present vitality with respect to the determination of the basis of property received by a corporation in a liquidation which meets the requirements of section 332.[27]

The courts were not unanimous in concluding that Section 334(b)(2) had preempted the KD doctrine for corporate acquirers. In *American Potash & Chemical Corp. v. United States*, the Court of Claims determined that the KD doctrine could apply to a corporate acquirer in situations where Section 334(b)(2) did not apply.[28] Under the facts at issue, American Potash & Chemical Corporation ("Potash") had acquired all of the stock of Western Electrochemical Company ("Wecco") in consideration for Potash shares, with the intent of obtaining the assets of Wecco.[29] Potash effected the acquisition in two tranches, first acquiring 48% of Wecco's stock and then acquiring the remaining 52% of the stock fourteen months later, thereby failing to satisfy the requirement of Section 334(b)(2) that the acquisition of "control" occur within a twelve-month period. Seven months after it completed the acquisition, Potash liquidated Wecco.

The Court of Claims first rejected various arguments for treating the transaction as a reorganization.[30] Having concluded that the transaction was not a reorganization, the

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[27] 70 T.C. 173, 180 (1978).

[28] 185 Ct. Cl. 161 (1968).

[29] A very small amount of cash was also paid for fractional shares.

[30] The court first rejected the IRS's argument that the transactions should be treated as an integrated reorganization under Section 368(a)(1)(C). The court reasoned that a Section 368(a)(1)(C) reorganization was designed to be a "practical merger" alternative and therefore should be effected through a single exchange of assets for stock, rather than through a "creeping" transaction occurring over a 14-month period. Id. at 201-02. The court also declined to apply *Ashland Oil* or the KD doctrine to recast the steps of the creeping transaction as a reorganization, holding that even if the steps of the transactions were integrated, a core technical requirement of Section 368(a)(1)(C)—the acquisition of assets for voting stock "in connection with a reorganization"—was not satisfied because Potash acquired Wecco over an extended period of time. The court viewed the KD doctrine as a guide for purposes of determining whether the purchasing corporation acquired assets, rather than stock, but determined that the doctrine "cannot help to resolve the question of whether a set of steps resulting in a property acquisition took place by purchase or 'in connection with a reorganization.'" Id. at 205 (internal citation omitted). The court further stated that the IRS's symmetric recast in Rev. Rul. 67-274, which had recently been published (see discussion in Part III.B, below), could only apply in the case of a

Court of Claims held that the KD doctrine had not been preempted by the enactment of Section 334(b)(2).[31] In reaching its holding, the court reviewed the House and Senate legislative history to Section 334(b)(2) and found that (i) the KD doctrine unquestionably remained viable for non-corporate taxpayers (a dictum since the case dealt with a corporate acquirer) and (ii) the legislative history did not show that Congress had any intent other than to establish a precise rule under which a taxpayer could obtain a tax basis in assets received in liquidation equal to its cost basis in the stock it acquired.[32] The court's holding was partly attributable to a concern that, if Section 334(b)(2) had indeed preempted the KD doctrine, taxpayers could elect between cost and carryover basis at will by structuring their transactions to comply with or fail the requirements of Section 334(b)(2) as desired, and that it would be preferable from the IRS's point of view to retain the flexibility to recast the form of the transaction where a taxpayer intentionally structured it to fail Section 334(b)(2).[33]

D. **Application of the KD Doctrine to Non-Corporate Acquirers**

A number of courts have applied the KD doctrine, both before and after the enactment of Section 334(b)(2) in 1954, to recast the acquisition of the stock of a target corporation by a non-corporate acquirer followed by a liquidation of the target as an acquisition of the target corporation's assets. As in the cases involving corporate acquirers, the KD doctrine was generally applied on an asymmetric basis.[34] It is not

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multi-step transaction that occurred over a short period of time so that the integrated transaction could properly be viewed as a reorganization.

[31] Id. at 209.

[32] Id. The court also stated, "There is no instance in the legislative history where Congress states either that section 334(b)(2) is the exclusive exception to the carryover rule, or that the Kimbell-Diamond rule is superseded or, on the other hand, that it is viable." Id. at 207.

[33] Id. at 208. The court did not mention that taxpayers could exercise the same electivity by choosing to maintain in existence or to liquidate the target corporation (putting aside commercial and operational considerations).

[34] *See*, *e.g.*, *Fox & Hounds, Inc. v. Commissioner*, 21 T.C.M. 1216 (1962), a case involving the acquisition of the stock of the Fox and Hounds Restaurant Company, which owned a restaurant in Santa Monica, California, that was operated by its shareholders, Harold and Elsie Gelber. Fox and Hounds had an excellent regular following that catered largely to people in the upper income strata, and received favorable national publicity upon being mentioned by such newspaper columnists as Walter Winchell, Hedda Hopper, and Jimmy Starr. The case principally involved whether a portion of the purchase price could be allocated to a non-compete that the

always clear that the KD doctrine recast was required in these cases since, if the form of the transactions was given effect for tax purposes, a non-corporate acquirer would take a fair market value tax basis in the assets of the target corporation in connection with the liquidation pursuant to Section 334(a), while the seller would be treated as selling stock, which gives the same end result as an asymmetric recast under the KD doctrine. However, in some cases involving non-corporate acquirers, courts invoked the KD doctrine for other purposes, such as to prevent the acquirer from recognizing gain or loss in connection with the subsequent liquidation.[35] Collectively, these authorities illustrate

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acquirers entered into with the Gelbers, but at the outset, citing *Kimbell-Diamond* and *Ashland Oil*, the Tax Court described the transaction as an asymmetric application of the KD doctrine:

> The parties are in apparent agreement, no issue being raised or argument made to the contrary, that though as to the Gelbers the transaction between them and the [acquirers] was a sale of Restaurant Company stock, it was for the [acquirers] a purchase of the business and assets of Restaurant Company.

See also PLR 8707156, a ruling issued after the enactment of Section 338 concerning a partnership that acquired stock of a target corporation and transferred the stock to a second partnership in exchange for substantially all of its partnership interests. The second partnership liquidated the target in order to obtain its assets. The IRS applied the KD doctrine on an asymmetric basis, disregarding the stock transfer and treating the transaction as an asset purchase by the first partnership. It also cited *Dallas Downtown Development* to support the asymmetrical conclusion that the seller would be treated as selling stock.

[35] *See, e.g., Cullen v. Commissioner*, 14 T.C. 368 (1950), acq. 1950-2 C.B. 1. Charles Cullen owned 25% of a corporation whose business he personally managed and operated. After acquiring the remaining 75% of the corporation, Cullen liquidated the corporation in order to operate the business as a sole proprietorship. Cullen claimed a capital loss equal to the amount by which the fair market value of the stock he purchased exceeded the book value of 75% of the tangible assets that the corporation distributed in liquidation. Cullen took the position that the corporation's assets had no value in excess of their book value and that any goodwill implied in the purchase price (which significantly exceeded 75% of the book value of the tangible assets) was personal to him. The Tax Court denied Cullen the capital loss and found that the sequence of actions comprised only a single transaction. In the court's view, Cullen paid more than the fair market value of the corporation's tangible assets because he was also acquiring the rights to operate the business without interference from other shareholders, sharing the business's profits, and corporate-level tax. It is worth noting that the Tax Court invoked a KD doctrine recast to deny Cullen a

that the KD doctrine applied to non-corporate acquirers as well, albeit on a somewhat ad hoc basis.[36]

The cases involving non-corporate acquirers also generally recognized the target corporation's continuing existence as a subsidiary of the acquirer during the period between the acquisition of the target's stock and the target's liquidation.[37] This construct is consistent with the framework for corporate acquirers adopted in Section 334(b)(2).[38] The recognition of the continuing existence of the target corporation for tax purposes is also consistent with the general asymmetric approach of the KD doctrine. In contrast, under a symmetric recast, there would be no need to give effect to the target's continuing existence as a subsidiary of the acquirer because the acquirer would be treated as purchasing directly the target corporation's assets for the consideration that was provided

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capital loss from the liquidation, not to determine Cullen's tax basis in the assets received, which the court did not address. *See also Snively v. Commissioner*, 19 T.C. 850 (1953), *acq.* 1956-2 C.B. 8 (non-corporate purchaser did not recognize gain upon liquidation of target corporation).

36 *See*, *e.g.*, *United States v. Mattison*, 273 F.2d 13, 20 (1959), in which the Ninth Circuit discussed the diverse application of the doctrine: "The *Kimbell-Diamond* rule has been applied in solving a wide variety of tax problems … novelty in this [case] does not appeal to us as a reason for disregarding the rule if otherwise applicable. If the facts call the rule into play, the tax consequences should follow, whatever they may be." *See also* Rev. Rul. 69-242, 1969-1 C.B. 200 (citing *Cullen* and applying the KD doctrine to resolve issue relating to replacement property under Section 1033(a)).

37 *See*, *e.g.*, *Snively v. Commissioner*, 19 T.C. 850 (1953), *acq*. 1956-2 C.B. 8. Under the facts of the case, H.B. Snively purchased stock of the Meloso Fruit Company ("Meloso") with the purpose of liquidating it. After Snively acquired Meloso, he continued to operate it and reported on his personal income tax return some of its income during the period between the acquisition and liquidation. The Tax Court held that the transaction was, in substance, a purchase of Meloso's assets under *Kimbell-Diamond* and *Ashland Oil* and, as a result, that Snively did not recognize gain on the liquidation of Meloso. Despite the application of the KD doctrine, the Tax Court found that the recast "did not … destroy the existence of the corporation as a taxable entity or permit [Snively] to appropriate as his own income which would otherwise be taxable to [Meloso]." Instead, the court respected Meloso's continued existence during the period between the stock purchase and liquidation and ruled that the business's earnings during that period were properly taxable to Meloso. 19 T.C. at 859.

38 *See* footnote 23, above, and accompanying text.

(in form) to the target shareholders, and the target would be treated as liquidating to deliver the consideration to the selling shareholders.

E. 1982-86: Repeal of Section 334(b)(2) and Enactment of Section 338; Repeal of the *General Utilities* Doctrine

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") repealed Section 334(b)(2) and replaced it with Section 338. Section 338 eliminated the Section 334(b)(2) stock purchase-and-liquidation mechanism in favor of an election that allows a corporate purchaser to treat a QSP of a corporate target as an asset purchase. Under Section 338, the purchaser is not required to liquidate the target corporation.

TEFRA originated in the Senate, and the Senate Report stated that one purpose of replacing Section 334(b)(2) with Section 338 was to address problems of inconsistency arising from the asymmetric nature of the Section 334(b)(2) regime, which generally respected the acquisition of the target corporation's stock and the continued separate existence of the target corporation during the period between acquisition and liquidation, while treating the acquiring corporation as acquiring target's assets for purposes of determining the acquiring corporation's tax basis in the assets.[39] The Senate Report noted, in particular, that (i) the Section 334(b)(2) rules required a complex investment adjustment system for properly taking into account earnings or deficits of the target corporation and sales of target corporation assets prior to liquidation; (ii) if the acquiring corporation filed a consolidated return with the target corporation, the acquiring consolidated group's returns would reflect target tax attributes such as carryovers for periods prior to the complete liquidation; and (iii) the acquiring consolidated group could offset recapture income attributable to the liquidation with losses of other members of the group.[40] The Senate Report also expressed concern that the investment adjustment rules could allow an acquiring corporation to obtain a tax basis in excess of the cost basis that would have been available in a direct asset purchase or to achieve selective step-ups through the purchase of a mixture of stock and assets or the purchase of several corporations historically operated as a unit.[41]

The Senate Report, in its description of the law in effect at the time of the enactment of TEFRA, referred to the pre-Section 334(b)(2) KD doctrine and noted, "It is not clear whether [the treatment of a purchase of stock and prompt liquidation as a

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[39] S. Rep. No. 97-494, Vol. 1, 97th Cong., 2nd Sess. 191-92 (1982).

[40] S. Rep. at 192.

[41] Id.

purchase of assets] may still apply in some cases where the requirements of section 334(b)(2) are not met."[42]

In the explanation of the provisions of the bill, the Conference Committee Report stated:

> The Senate amendment repeals the provision of present law (sec. 334(b)(2)) that treats a purchase and liquidation of a subsidiary as an asset purchase. *The bill is also intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine*. Instead, an acquiring corporation [pursuant to section 338] may elect to treat an acquired subsidiary (target corporation) as if it sold all its assets in a complete liquidation on the stock acquisition date. The target corporation will be treated as a new corporation that purchased the assets on such date.[43]

In 1986, just a few years after the enactment of Section 338, Congress repealed the *General Utilities* doctrine (discussed in Part II.A.2 above) by repealing Section 337 of the 1954 Code and broadening the scope of Section 311(b) of the 1986 Code. The repeal of the *General Utilities* doctrine fundamentally changed the statutory framework within which the KD doctrine had developed. As a result of the changes, if a Section 338 election is made with respect to a target corporation, the corporation is subject to tax on the deemed asset sale. Likewise, application of the KD doctrine has very different tax consequences to the target corporation depending on whether the recast is symmetric or asymmetric. Under a symmetric recast, as in the case of a Section 338 election, the target corporation is treated as selling its assets to the acquirer in exchange for the consideration paid to the shareholders of the target corporation and then liquidating, thereby potentially resulting in two levels of tax.

Also as part of the repeal of the *General Utilities* doctrine in 1986, Congress enacted Section 336(e), which grants Treasury and the IRS the authority to issue regulations to treat certain sales, exchanges, and distributions of stock of a corporation as a disposition of all of the assets of the corporation. Final regulations under Section 336(e) were issued in 2013. Under Section 336(e) and the regulations, a corporate seller may elect to treat a QSD of a domestic target corporation as an asset sale. Unlike Section 338, under the Section 336(e) regulations, the acquirer need not be a corporation, and

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[42] Id. at 191.

[43] S. Rep. No. 97-530, Vol. 1, 97th Cong., 2nd Sess. 536 (1982) (emphasis added). The Conference Committee Report also indicated that the conference agreement followed the Senate amendment with technical modifications.

multiple acquirers may purchase the stock of the target corporation.[44] The Section 336(e) regulations complement Section 338. Together, the two regimes contain detailed rules that provide an avenue to obtain asset purchase treatment in connection with a QSD or QSP, respectively, without liquidating the target corporation.

III. Administrative Confirmation of Repeal of the KD Doctrine for QSPs; Continuing Application of Step Transaction Doctrine Principles to Reorganizations

A. QSPs

Following the enactment of Section 338, Treasury and the IRS confirmed that the KD doctrine does not apply to a purchase of target stock followed by a liquidation or merger of target where (i) the first-step purchase (viewed independently) is, or is deemed to be, a QSP and (ii) the integrated transaction does not qualify as a reorganization under Section 368(a).

Rev. Rul. 90-95[45] deals with a corporation that acquires all the stock of a target corporation in a QSP and immediately liquidates the target as part of a plan to acquire the assets of the target. The ruling concludes that the step-transaction doctrine does not apply to treat the transaction as an asset purchase:

> Section 338 of the Code replaced the Kimbell-Diamond doctrine and governs whether a corporation's acquisition of stock is treated as an asset purchase. Under section 338, asset purchase treatment turns on whether a section 338 election is made (or is deemed made) following a qualified stock purchase of target stock and not on whether the target's stock is acquired to obtain the assets through a prompt liquidation of the target. The acquiring corporation may receive stock purchase treatment or asset purchase treatment whether or not the target is subsequently liquidated.[46]

As a result, the acquiring corporation is treated as having acquired the stock of the target and then target is treated as liquidating into the acquiring corporation in a tax-free liquidation under Section 332.

In 1995, Treasury and the IRS issued regulations under Section 338 that follow the analytical framework of Rev. Rul. 90-95. Under Treas. Reg. § 1.338-3(c), a

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[44] T.D. 9619.

[45] 1990-2 C.B. 67 (Issue 2).

[46] Rev. Rul. 90-95.

purchasing corporation may make a Section 338 election in respect of a QSP of the target corporation even if the target is liquidated on or after the acquisition date.[47] Treas. Reg. § 1.338-3(d) provides rules that apply in relation to a post-acquisition liquidation or reorganization involving the target corporation, if the purchasing corporation does not make a Section 338 election in respect of a QSP. The regulations provide, in effect, that the purchaser will be treated as an "old and cold" shareholder of the target corporation for purposes of determining, solely with respect to the purchasing corporation and the other members of its affiliated group, whether the continuity of interest requirement of Treas. Reg. § 1.368-1(b), the control requirements of Section 368(a)(1)(D), and the "solely for voting stock" requirement of Section 368(a)(1)(C) are satisfied in a subsequent transfer of assets from the target corporation to the purchasing corporation or another member of the purchasing corporation's affiliated group. The effect of Treas. Reg. § 1.338-3(d) is to treat an asset transfer following a QSP where no Section 338 election is made as a transfer that is separate from the acquisition. While Treas. Reg. § 1.338-3(d) was issued to reverse the result of *Yoc Heating v. Commissioner*[48] in connection with a QSP, it also has the effect of confirming the IRS's position in Rev. Rul 90-95 that the KD doctrine has no continuing application in connection with a QSP.[49]

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[47] Treas. Reg. § 1.338-1(c)(1)(i). The regulations provide a timing rule that, if the liquidation occurs on the acquisition date, the liquidation is considered to occur on the following day and immediately after new target's deemed purchase of assets.

[48] 61 T.C. 168 (1973).

[49] In *Yoc Heating*, the Tax Court held that the continuity of interest requirement for reorganizations under Section 368 was not satisfied where a corporate acquirer of 85% of target stock for cash and notes, as part of the same plan, caused the target to transfer its assets to a newly formed subsidiary of the purchaser in exchange for shares in such subsidiary (and cash payments to minority shareholders of target) and then to liquidate. The corporate acquirer could not satisfy the continuity of interest requirement because it had just acquired the stock of target, and the transaction also could not be treated as a reorganization with respect to the former shareholders of the target corporation because they received only cash and notes in consideration for their target stock. As a result, the subsidiary that was the transferee of the target's assets received a cost basis in the assets. Id. at 178.

If *Yoc Heating* applied following a QSP, a purchasing corporation could obtain a cost basis in a target corporation's assets, without making a Section 338 election, through a post-acquisition asset transfer to an affiliate because the integrated transaction would not be a reorganization. Treasury and the IRS believed that the result in *Yoc Heating* was inconsistent with the legislative intent behind Section 338 and that "applying the reorganization rules to the target and purchasing group in mergers and similar transactions following a QSP is the simplest and most effective

More recently, in Rev. Rul. 2008-25[50] the IRS addressed a first-step reverse merger of an acquiring corporation's transitory subsidiary into a target corporation, in which the shareholders of the target corporation received 10x cash and 90x voting stock, followed by a second-step liquidation of the target into the acquiring corporation that was not accomplished through a statutory merger. The IRS first analyzed whether the reverse merger could qualify as a reorganization under Section 368(a)(1)(A) and Section 368(a)(2)(E). The IRS noted that Treas. Reg. § 1.368-2(k) provides, in part, that a transaction otherwise qualifying as a reorganization under Section 368(a) is not disqualified or recharacterized as a result of one or more distributions to shareholders if, among other requirements, the aggregate of such distributions does not consist of an amount of assets of the target corporation (disregarding assets of the transitory subsidiary) that would result in a liquidation of the target corporation for tax purposes. The IRS applied the step transaction doctrine to the reverse merger and the subsequent liquidation and concluded that, because the target liquidated immediately following the first step of the transaction, Treas. Reg. § 1.368-2(k) did not protect the merger from being disqualified as a reorganization, and therefore the merger did not qualify as a reorganization on a stand-alone basis.[51]

The IRS then tested whether the merger and the liquidation could qualify as an asset reorganization under Section 368(a) on an integrated basis, under the principles of Rev. Rul. 67-274,[52] by recasting the transactions as (i) an acquisition by the acquiring corporation of the assets of the target corporation in exchange for the consideration provided to the shareholders of the target corporation, followed by (ii) a liquidation of target corporation. However, the IRS determined that the recast merger and liquidation also could not satisfy the requirements of Section 368(a).[53] Consequently, since the

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means of achieving the congressional intent in repealing the *Kimbell-Diamond* doctrine." 60 F.R. 9310 (1995).

50 2008-1 C.B. 986.

51 The acquiring corporation's acquisition of the target corporation pursuant to the merger also failed to qualify as a Section 351 transaction on a stand-alone basis because the former shareholders of the target corporation did not control the acquiring corporation immediately after the merger.

52 1967-2 C.B. 141. *See* discussion in Part III.B, below.

53 Since the acquiring corporation did not acquire the target corporation's assets through a statutory merger, Section 368(a)(1)(A) could not apply; Section 368(a)(1)(C) was not available, and thus Rev. Rul. 67-274 did not apply, because the transaction did not satisfy the "solely for voting stock" requirement (the magnitude of the target corporation's liabilities prevented the recast transaction from satisfying the boot relaxation rule of Section 368(a)(2)(B)); and Section 368(a)(1)(D) was not

merger and the liquidation could not qualify as a reorganization on an integrated basis, the IRS concluded, under the principles of Rev. Rul. 90-95 and Treas. Reg. § 1.338-3(d), that the step transaction doctrine should not apply, and therefore the transactions should be treated as a QSP followed by a Section 332 liquidation.

To summarize the effect of Rev. Rul. 2008-25 and the other authorities relating to QSPs on a stock acquisition followed by an integrated liquidation or merger: if the form of the transaction qualifies as a reorganization under Section 368(a), taking into account the application of Treas. Reg. § 1.368-2(k), then the form will be respected; if not, the transaction may still qualify as a reorganization if the integrated steps can be recast as a reorganization under the step transaction doctrine (e.g., based on the asset reorganization recast described in Rev. Rul. 67-274). However, if reorganization treatment is not available under either of the two pathways described above, then the step transaction doctrine will not apply and the first step will be treated as a QSP and the subsequent merger or liquidation will be treated as a liquidation under Section 332.[54]

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available because neither the target nor the former shareholders of target were in control of the acquiring corporation following the transaction. The IRS's analysis also suggested that a Section 368(a)(1)(B) reorganization recast could have been relevant but for the failure to satisfy the "solely for voting stock" requirement. *Cf.* Rev. Rul. 74-35 (first step Section 368(a)(1)(B) reorganization followed by non-liquidating dividend treated as Section 368(a)(1)(B) reorganization and Section 301 distribution to acquirer).

[54] Treas. Reg. § 1.197-2(h)(6)(iii) and Treas. Reg. § 1.197-2(k), Example 26, are also instructive. This regulation provides that if a person acquires an intangible in a series of related transactions in which the person acquires Section 1504(a)(2) control of a target corporation in a fully taxable transaction followed by a liquidation of the target corporation under Section 331, any relationship created as part of the series of transactions is disregarded in determining whether any person is related to such target corporation immediately after the last transaction. While the effect of the regulation is to deem the assets of the target corporation to be transferred directly to the acquirer, a premise of the regulation is that the KD doctrine does not apply to treat the acquirer as acquiring the assets of the target corporation directly, as such treatment would render the regulation unnecessary. Accordingly, the regulation applies the anti-KD doctrine approach of Rev. Rul. 90-95 and Treas. Regs. § 1.338-3(d) to a transaction that is not treated as a QSP.

See also Rev. Rul. 77-427, 1977-2 C.B. 100, in which the IRS respected the form of the transaction and did not integrate the separate steps to find an asset purchase. In the ruling, the shareholders of one corporation ("X") sold all of their stock to a second corporation ("Y") for cash. Immediately thereafter, Y liquidated X. There was overlap between the shareholders of X and Y (including by attribution), such

B. **Reorganizations**

Case law, Treasury regulations, and IRS administrative guidance make clear that the acquisition of the stock of a target corporation by an acquirer, followed by a liquidation or merger of the target corporation into the acquirer, is recast as a reorganization under Section 368(a) pursuant to the step transaction doctrine if the integrated transaction satisfies the requirements of the reorganization rules, and that the enactment of Section 338 has not altered this principle.

Under the facts of Rev. Rul. 67-274,[55] which pre-dated the repeal of Section 334(b)(2) and the enactment of Section 338, pursuant to a plan of reorganization an acquiring corporation acquired all of the stock of the target corporation in exchange for some of the voting stock of the acquirer. Thereafter, the target corporation was liquidated as part of the same plan. The IRS determined that under the circumstances the acquisition and liquidation of target were part of the overall plan of reorganization and could not be considered independently. The ruling concluded that the transaction was in substance an acquisition of assets to which Section 368(a)(1)(B) could not apply and that, instead, the stock acquisition "will be considered an acquisition of the assets of [target] which in this case is a reorganization described in section 368(a)(1)(C)."[56] Unlike the KD doctrine cases, which, as discussed in Part II.C above, are at best unclear on the issue of symmetry, Rev. Rul. 67-274 recasts the transaction as to both the acquiring corporation and the target corporation in order to satisfy the C reorganization requirements that the acquiring corporation acquire substantially all of the properties of the target corporation solely for voting stock and that the target corporation distribute the stock it receives pursuant to the plan of reorganization. Under this construct, the target corporation's assets are deemed to be transferred by the target corporation to the acquiring corporation in exchange for the consideration furnished by the acquiring

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that Section 304(a)(1) applied to treat the sale as a contribution to the capital of Y followed by a redemption of Y stock. The IRS concluded that the steps should not be integrated, reasoning that the acquisition of X stock was not a "purchase" under Section 334(b)(3) because the application of Section 304(a)(1) caused the basis of the X stock in the hands of Y to be determined by reference to its basis in the hands of the former X shareholders.

[55] 1967-2 C.B. 141. *See also* Treas. Reg. 1.1361-4(a)(2)(ii), Ex. 2, which incorporates the results of the ruling.

[56] Id.

corporation, followed by a deemed distribution of such consideration in connection with the liquidation of the target corporation.[57]

In *King Enterprises, Inc. v. United States*,[58] shareholders of the target corporation signed an agreement with a corporate acquirer to sell all their target shares for a mixture of cash and acquirer stock, with acquirer stock consisting of more than 50% of the total consideration. A few months later, the acquirer merged the target corporation, along with several other subsidiaries of the acquirer, into the acquirer. The acquirer requested and received an IRS ruling that Section 334(b)(2) would apply to determine the basis of target assets received in the merger. Meanwhile, King Enterprises, a shareholder of target, treated the entire transaction as a reorganization under Section 368(a)(1)(A), relying on Rev. Rul. 67-274 to argue that the substance of the transaction was an acquisition by acquirer of the target corporation's assets in exchange for acquirer stock and boot. Accordingly, it reported the non-stock consideration it received in the stock sale as a dividend under Section 356(a)(2) (for which it claimed a dividends received deduction) and the stock consideration as nontaxable under Section 354(a)(1). The IRS claimed King Enterprises was taxable on capital gain in the amount that the value of the total consideration it received exceeded its basis in its target shares.

The Court of Claims agreed with the taxpayer, holding that the merger of target into acquirer "was the intended result of the transaction in question from the outset, the initial exchange of stock constituting a mere transitory step" and that the stock sale and merger "were steps in a unified transaction qualifying as a Type A reorganization."[59] The court was silent as to the treatment of the transactions to the acquirer, which had received an IRS ruling confirming Section 334(b)(2) treatment, and also did not discuss

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[57] Sections 368(a)(1)(C) and (a)(2)(G). *See also* Rev. Rul. 72-405, 1972-2 C.B. 217, in which the IRS ruled that the forward triangular merger of a target corporation into the acquiring corporation's transitory subsidiary, followed by the subsidiary's liquidation into the acquirer, was an integrated reorganization under Section 368(a)(1)(C) rather than a reorganization under Section 368(a)(1)(A) and Section 368(a)(2)(D) followed by a liquidation of the subsidiary into the acquirer.

The principles of Rev. Rul. 67-274 are also embedded in Treas. Reg. § 1.368-2(k)(1). In order to preserve the Rev. Rul. 67-274 recast, the regulation does not apply to distributions of property from the target corporation that would result in a liquidation of the target for federal income tax purposes. Treas. Reg. § 1.368-2(k)(1)(i)(B)(1).

[58] 189 Ct. Cl. 466 (1969). The IRS relied on *King Enterprises* in Rev. Rul. 2001-46, discussed infra.

[59] Id. at 519.

whether shareholders of target other than King Enterprises would be treated as exchanging their target stock for acquirer stock in a reorganization.

The Court of Claims's holding in *King Enterprises* illustrates two difficulties associated with applying the step transaction doctrine to an acquisition of a target corporation that is not closely linked to the subsequent liquidation or merger of the target into the acquirer. First, the facts and circumstances may not clearly demonstrate that the transactions should be integrated, leading to uncertainty as to the outcome. Second, the parties to the transactions may inadvertently or intentionally take inconsistent positions with respect to the tax treatment of the transactions.

The IRS applied the principles of Rev. Rul. 67-274 in Rev. Rul. 2001-46.[60] Under the facts of Rev. Rul. 2001-46, the acquiring corporation acquired the stock of the target corporation pursuant to a first-step reverse merger. Thereafter, and pursuant to an integrated plan, the target corporation merged into the acquiring corporation. Standing alone, the first-step merger could not qualify as a tax-free reorganization under Section 368(a)(1)(A) and Section 368(a)(2)(E) because of the amount of cash consideration paid to the shareholders of the target. The ruling recast the transaction as a merger of the target corporation into the acquiring corporation in consideration for shares of the acquiring corporation and cash that is treated as a reorganization under Section 368(a)(1)(A).[61] The ruling relied on Rev. Rul. 67-274 and *King Enterprises*, and distinguished Rev. Rul. 90-95 and Treas. Reg. § 1.338-3(d), holding that it was appropriate to apply the recast:

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[60] 2001-2 C.B. 321.

[61] *Cf.* Rev. Rul. 70-140, 1970-1 C.B. 73, which applied the step transaction doctrine to recast a first-step contribution of assets by an individual to a newly formed corporation ("X") in exchange for stock of X, followed by a transfer of all of the stock of X to a second corporation ("Y") in exchange for Y voting stock in a purported reorganization under Section 368(a)(1)(B) (in effect, an "inverted" *Kimbell-Diamond* fact pattern). The IRS integrated the two steps and recast the transaction as an asset sale between the individual and Y. The principles of the ruling were later incorporated in the S corporation context under Treas. Reg. § 1.1361-5(b)(3), Ex. 9. We note that, if the form of the transactions were respected for tax purposes, the first-step contribution would be treated as a taxable exchange of assets for stock of X because, under the step transaction doctrine, the subsequent transfer of the stock of X to Y would prevent the individual from satisfying the control immediately after requirements of Section 351(a). For this reason, we do not believe that this Report's recommendations regarding the KD doctrine require the conclusions of Rev. Rul. 70-140 or Treas. Reg. § 1.1361-5(b)(3), Ex. 9 to be revisited.

> The policy underlying § 338 is not violated by treating [the transactions] as a single statutory merger of [target] into [purchaser] because such treatment results in a transaction that qualifies as a reorganization … in which [purchaser] acquires the assets of [target] with a carryover basis under § 362, and does not result in a cost basis for those assets under § 1012. Thus … the step transaction doctrine applies to treat the [acquisition merger] and the [upstream merger] not as a stock acquisition that is a qualified stock purchase followed by a § 332 liquidation, but instead as an acquisition of [target's] assets through a single statutory merger of [target] into [purchaser] that qualifies as a reorganization under § 368(a)(1)(A).

The ruling further noted that because there was no QSP in the transaction, as recast, no Section 338 election could be made.[62]

IV. Discussion of Recommendations

This Part IV is divided into two parts. In Part IV.A, we provide our recommendations regarding the continuing application of the KD doctrine. In Part IV.B, we provide a detailed discussion of our reasons for our recommendations regarding the KD doctrine.

A. Recommendations Relating to Transactions Involving a First-Step Stock Acquisition That Is Not a QSP

1. Principal Recommendation: Confirm Repeal of the KD Doctrine

To remove ambiguity regarding the possible application of the KD doctrine outside of the context of transactions involving a first-step QSP, we recommend that Treasury and the IRS issue guidance confirming that, if the integrated transaction does not qualify as a reorganization under Section 368(a), the federal income tax consequences of the acquisition of the stock of a target corporation by an acquirer in a QSD or any other transaction that is not a QSP and that is followed by a liquidation or merger of the target corporation into the acquirer follows the form of the transactions, taking into account all other relevant transactions that occur in connection with the acquisition and the subsequent liquidation or merger.

[62] Treasury and the IRS subsequently issued regulations providing, in the fact pattern described above, that if the first step of the transaction, viewed independently, would be a QSP, the purchaser may make an election under Section 338(h)(10), even if, under the step transaction doctrine, the integrated transactions would be a reorganization. Treas. Reg. § 1.338(h)(10)-1(c)(2).

As discussed below, notwithstanding Congress's statement of intention that Section 338 replace any nonstatutory treatment of a stock purchase as an asset purchase under the KD doctrine, we believe a confirmation by Treasury and the IRS that the KD doctrine has no continuing application in the fact pattern described above, where the first step is not treated as a QSP, would be helpful to both taxpayers and the IRS because residual uncertainty has lingered in light of (i) the pre-Section 338 KD doctrine cases involving non-corporate purchasers, (ii) the continuing application of the step transaction doctrine and symmetric recast principles to corporate reorganizations involving analogous fact patterns, and (iii) the fact that published guidance outside the context of reorganizations (Rev. Rul. 90-95, Rev. Rul. 2008-25, and Treas. Reg. § 1.338-3) is expressly limited to acquisitions treated as a QSP.

2. Continuing Application of Step Transaction Doctrine to Reorganizations

We believe that our recommendations do not require a change to current law pursuant to which the acquisition of the stock of a target corporation by an acquirer, followed by a liquidation or merger of the target corporation into the acquirer, is treated as a reorganization under Section 368(a) if, under the step transaction doctrine, the integrated transaction satisfies the requirements of the reorganization provisions.[63]

As we have discussed in a prior report, the determination of when and how the step transaction doctrine should apply in a particular situation depends not just on the formal relationship between the steps, but also on the substantive considerations that are relevant to the statutory or regulatory scheme whose application is at issue.[64] Courts have long noted that the step transaction doctrine plays an important role in ensuring the integrity of the exception, embodied by the reorganization provisions, from the general rule that sales and exchanges of property are subject to tax.[65]

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63 *See* discussion in Part III.B, above.

64 *See* New York State Bar Association, Tax Section, *Report on the Step Transaction Doctrine in Section 355 Stock Distributions: Control Requirement and North-South Transactions* (Nov. 5, 2013) (discussion in II.B. and accompanying footnotes).

65 *See*, *e.g.*, *Campbell v. Commissioner*, 15 T.C. 312, 319 (1950). There are also authorities that apply the step transaction doctrine more broadly to situations involving reorganizations than to those involving similar taxable transactions. For example, in Rev. Rul. 75-493, 1975-2 C.B. 109, a target corporation made a distribution of excess cash to its sole shareholder. The next day, the shareholder sold all the target stock to the buyer; there was no binding sale contract at the time of the distribution. The buyer liquidated the target. The IRS respected the form of the transaction as a distribution under Section 301 followed by a stock sale, rather than

The application of the step transaction doctrine to the reorganization rules is reflected in the Treasury regulations under Section 368. The regulations' focus on the readjustment of continuing interests in property under modified forms, within the context of the several forms of reorganization under Section 368, supports the continuing application of symmetric recast principles for purposes of these rules. The regulations under Section 368 also specifically require that a transaction be evaluated under the step transaction doctrine in determining whether the transaction qualifies as a reorganization,[66] and provide that:

> The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms.[67]

The application of the step transaction doctrine to recast an acquisition of target stock followed by a merger or liquidation as a reorganization under Section 368(a) also is

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treating the distribution as part of the sale proceeds. By contrast, in Rev. Rul. 71-364, 1971-2 C.B. 182, the target corporation transferred substantially all of its assets to the acquiring corporation in a transaction that qualified as a reorganization under Section 368(a)(1)(C) and promptly distributed to its shareholders all the acquirer stock received in exchange for all of their target stock. The target retained some cash to pay its dissolution expenses. One year later, it distributed the cash remaining after payment of such expenses to its shareholders as of the date of the adoption of the plan of reorganization. In this case, the IRS integrated the distribution with the initial exchange by target shareholders of their target stock for acquirer stock "since the shareholders of [target] received the cash distribution as part of the plan of reorganization." Accordingly, the shareholders' gain on the initial exchange of stock was subject to Section 356(a) to the extent of the cash received.

[66] Treas. Reg. § 1.368-1(a). This regulation was issued in response to comments suggesting "that the proposed COBE regulations are ambiguous as they could be interpreted to mean that a transfer of stock or assets to a qualified group member after an otherwise tax-free reorganization would be given independent significance and the step transaction doctrine would not apply. Under such an interpretation, the potential reorganization would not be recast as a taxable acquisition or another type of reorganization." T.D. 8760.

[67] Treas. Reg. § 1.368-1(b). As discussed in footnote 57, above, the principles of Rev. Rul. 67-274 and, by extension, the step transaction doctrine, also are embedded in Treas. Reg. § 1.368-2(k)(1).

consistent with both the exclusivity of the Section 338(g) and 336(e) rules for providing asset purchase treatment in connection with a stock purchase and the repeal of the *General Utilities* doctrine. The recast does not provide the acquirer with a purchase price tax basis in the assets of the target corporation, and, following the transaction, the assets of the target corporation remain subject to corporate-level tax in the hands of the acquiring corporation.[68] For all of these reasons, we believe our recommendations do not require a change to current law regarding the application of the step transaction doctrine to reorganizations.

3. **Elective Application of the KD Doctrine**

We considered whether taxpayers should be permitted to elect the application of the KD doctrine with respect to an acquisition of the stock of a target corporation that is followed by a liquidation or merger of the target corporation into the acquirer, if the first-step acquisition is not a QSP or a QSD. However, we do not recommend that taxpayers be permitted to make such an election. Allowing an elective application of the KD doctrine for non-QSP and non-QSD acquisitions would enable taxpayers to benefit from asset purchase tax treatment with respect to stock acquisitions that do not satisfy the requirements of Section 338 or the QSD rules. As discussed below, the legislative history to Section 338 is clear that Section 338 is intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the KD doctrine.[69] In addition, a target corporation generally has the ability to structure a sale of its business as an asset sale without recourse to the KD doctrine through: (i) a forward merger; (ii) the sale of a single member limited liability company that holds the target's business (following a reorganization under Section 368(a)(1)(F) pursuant to which the target corporation converts into a limited liability company that is wholly owned by a newly formed successor corporation); or (iii) a traditional asset sale. For all of these reasons, we see no reason to allow the KD doctrine to survive on a limited, elective basis.

B. **Reasons for Principal Recommendation**

A number of reasons support the repeal of the KD doctrine, each of which is discussed in greater detail below: (i) Congress stated its intention to repeal the KD doctrine in the legislative history to Section 338; (ii) the reasons for the repeal of Section 334(b)(2) also support the repeal of the KD doctrine; (iii) the KD doctrine does not have a strong conceptual foundation; (iv) the enactment of Section 338 and the repeal of the *General Utilities* doctrine altered the statutory framework in which the KD doctrine had developed; (v) the KD doctrine is subjective and its application may be uncertain if the acquisition and the liquidation are not closely linked; and (vi) even if the KD doctrine

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[68] *See* Rev. Rul. 2001-46, discussed in Part III.B, above.

[69] *See* discussion in Part IV.B.1, below.

were applied on a symmetric basis, the symmetric recast of the transactions does not provide a better explanation of the tax consequences than the actual form of the transactions.

1. **Congressional Intention to Repeal the KD Doctrine**

The statutory basis for the repeal of the KD doctrine lies in the enactment of Section 338. As set out in the Conference Committee Report:

> The Senate amendment repeals the provision of present law (sec. 334(b)(2)) that treats a purchase and liquidation as an asset purchase. The bill is also intended to replace *any* nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine.[70]

This statement, which is repeated in the Conference Committee Report, seems clear on two fronts. TEFRA would repeal Section 334(b)(2), which had been enacted as part of the 1954 Code to "effectuate" the principles of *Kimbell-Diamond* in the case of a purchase of control by a corporate acquirer.[71] Moreover, the new Section 338 regime would extend further than repealed Section 334(b)(2) and would "replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine."[72] In other words, the KD doctrine would no longer be available if the effect of the recast would be to treat an acquirer as having purchased the target corporation's assets.

Even prior to the enactment of Section 338, it was reasonable to interpret the enactment of Section 334(b)(2) as superseding the KD doctrine for corporate acquirers.[73]

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[70] S. Rep. No. 97-530, Vol. 1, 97th Cong., 2nd Sess. 536 (1982) (emphasis added).

[71] *See* discussion in Part II.B, above.

[72] S. Rep. at 536. It is notable that the legislative history refers to "a stock purchase," without limiting "stock purchase" to transactions that would qualify as QSPs. That Congress was considering non-QSP stock purchases is further suggested by the "Present law" section of the Conference Committee Report, which states, "Cases interpreting the law applicable before the rules in section 334(b)(2) were adopted treated the purchase of stock and prompt liquidation in some cases as a purchase of assets (*Kimbell-Diamond Milling Co. v. Commissioner*). *It is not clear whether such treatment may still apply in some cases where the requirements of section 334(b)(2) are not met.*" Id. at 535 (emphasis added).

[73] *See* footnotes 26 and 27, above, and accompanying text. *American Potash* aside, the authorities addressing the KD doctrine in the context of a corporate acquirer recognized that allowing Section 334(b)(2) to act as a non-exclusive pathway for a

The repeal of Section 334(b)(2) and the enactment of Section 338 shows that Congress intended to abolish the KD doctrine entirely.

2. The Reasons for the Repeal of Section 334(b)(2) Support the Repeal of the KD Doctrine

The legislative history to the enactment of Section 338 also mentioned several technical reasons for replacing Section 334(b)(2) with the Section 338 regime. These reasons arise principally because Section 334(b)(2) recognized the continuing existence of the target corporation as a subsidiary of the acquiring corporation during the period between the acquisition of control and the liquidation of the target corporation. As a result, the target corporation could be included in the consolidated group of the acquiring corporation during the period between the acquisition and the liquidation. Also, regardless of whether the target corporation joined the acquirer's consolidated group, the tax basis calculation required complex adjustments for earnings or deficits of the target corporation as well as for sales of assets during the period between the acquisition and the liquidation.[74] These technical reasons for replacing Section 334(b)(2) with the Section 338 regime also support the repeal of the KD doctrine in the case of fact patterns involving first-step stock acquisitions that do not qualify as QSPs.[75]

3. Uncertain Foundation for the KD Doctrine

The IRS and taxpayers have invoked the KD doctrine on a case-by-case basis for various purposes, generally on an asymmetric basis. As a result, the KD doctrine does

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corporate acquirer to obtain a cost basis in the target's assets would have been inconsistent with the statement in the legislative history to the 1954 Code that Section 334(b)(2) was intended to "effectuate" the principle of the KD doctrine. The Senate Report takes a charitable view of the case law: "It is not clear whether [the KD doctrine] may still apply in some cases where the requirements of Section 334(b)(2) are not met." S. Rep. No. 97-494, Vol. 1, 97th Cong., 2nd Sess. 191 (1982).

[74] Id. at 192.

[75] We believe that the technical reasons set out in the legislative history to Section 338 generally are not relevant to the continuing application of the step transaction doctrine to reorganizations under Section 368(a) because of the symmetric recast principles that apply in the case of reorganizations. Under a symmetric recast, the target corporation would be treated as transferring its assets directly to the acquiring corporation, in exchange for the consideration provided by the acquirer, and would not be treated as the owner of the assets following the first-step acquisition. *See* discussion in Part III.B, above.

not have a strong conceptual foundation. The original *Kimbell-Diamond* case was a solution, in the pre-Section 334(b)(2) world, to patch the then-incomplete tax basis provisions of the involuntary conversion rules, which otherwise would have provided the acquirer with a tax basis in the target's assets that was not in line with the target's historic basis plus replacement cost methodology of those rules.[76] As a result of subsequent changes to Section 1033, the rationale for *Kimbell-Diamond* is now obsolete. Subsequent cases extended the KD doctrine to function as a self-help measure, in the pre-Section 338 and 336(e) world, to allow both corporate and non-corporate acquirers to obtain a purchase price tax basis in the assets of the target corporation by effecting an integrated stock acquisition and liquidation. However, the courts also applied the KD doctrine on an ad hoc basis, including to prevent taxpayers from recognizing losses, or to prevent the IRS from successfully asserting gain recognition, with respect to recently acquired target shares in connection with a post-acquisition liquidation.[77]

The cases invoking the KD doctrine generally either (i) did not address the tax consequences to the target corporation of the application of the KD doctrine, or (ii) applied the KD doctrine on an asymmetric basis and, except for purposes of determining the acquirer's tax basis in the target corporation's assets, respected the form of the transactions and analyzed the transaction as a disposition of the stock of target by its shareholders, followed by a liquidation of the target into the acquirer. This approach reflects the tax law of the period during which the KD doctrine developed, since, under the *General Utilities* doctrine as codified in the 1954 Code, a liquidating distribution of corporate assets followed by a sale of those assets, or a sale by the corporation of all its assets after adoption of a plan of liquidation, generally was not taxable to the liquidating corporation and could provide the acquirer with a fair market value basis in the assets.[78] Against this backdrop, the interests of the government generally were not impaired by allowing an acquirer to access a purchase price basis in the assets of the target corporation without subjecting target to tax on the deemed sale. Thus, outside of the context of reorganizations, the KD doctrine can be viewed as a generally asymmetric doctrine that is analytically dependent on the architecture of the *General Utilities* doctrine.

4. The Enactment of Section 338 and the Repeal of the *General Utilities* Doctrine Changed the Operating Landscape for the KD Doctrine

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[76] *See* discussion in Part II.A.1, above.

[77] *See* discussion in Parts II.C and II.D, above.

[78] *See* discussion in Part II.A.2, above.

The enactment of Section 338 and the subsequent repeal of the *General Utilities* doctrine altered the statutory framework in which the KD doctrine had developed. Consistent with this change in the statutory framework, the judicial and administrative authorities applying the KD doctrine to recast a stock purchase as an asset purchase generally are limited to transactions occurring before the enactment of Section 338 in 1982 and the repeal of the *General Utilities* doctrine in 1986.[79] As discussed in Part II.E above, the enactment of Section 338 was intended to provide an exclusive pathway for obtaining asset purchase treatment with respect to a stock acquisition without the need to effect an integrated post-closing liquidation under Section 334(b)(2) or to apply the KD doctrine.[80] Moreover, following the repeal of the *General Utilities* doctrine, the deemed sale consequences of a KD doctrine recast to the target corporation, which had largely been ignored by the *Kimbell-Diamond* authorities, acquired greater significance because, unless a reorganization or other non-recognition provision applies, the deemed disposition of assets by the target corporation would be fully taxable to the target corporation even if the sale were effected in connection with a liquidation.[81] As a result, if the KD doctrine applies, a second-step merger or liquidation can give rise to corporate-level gain at the target corporation, a result that may not be desired or even expected.

The repeal of the KD doctrine as a means to recast a stock purchase as a taxable purchase of the assets of the target corporation produces results that are consistent with the repeal of the *General Utilities* doctrine. In the case of a corporate acquirer that acquires the stock of a target corporation (regardless of whether or not the acquisition is a QSP), followed by a liquidation of the target, if the KD doctrine is not applicable and the form of the transaction is respected, the acquiring corporation and the target generally would not recognize gain or loss in connection with the liquidation under Section 332 and Section 337, respectively, and the acquiring corporation would succeed to the target corporation's tax basis in its assets under Section 334(b)(1). The target's assets would remain in corporate solution following the liquidation, and any built-in gain would remain subject to corporate-level tax in the hands of the acquirer. Moreover, a repeal would protect the target corporation from unexpected corporate-level gain.

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79 The exceptions consist of (i) a private letter ruling involving an S corporation purchaser (since revoked and further obsoleted by the repeal of Section 1371(a)(2)), *see* PLR 8818049, TAM 9245004, and PLR 9323024, and (ii) PLR 8707156, a ruling involving a partnership purchaser, discussed above in footnote 34.

80 The circumstances in which a purchase price tax basis would be available in connection with a stock purchase were subsequently extended by regulations under Section 336(e). See footnote 44, above, and accompanying text.

81 *See* discussion in Part II.E, above.

In the case of the analogous transaction involving a non-corporate acquirer and a liquidation under Section 331, the target corporation generally would recognize gain or loss under Section 336(a) as if the target's assets were sold to the acquirer at fair market value, and the acquirer would take a fair market value tax basis in the assets under Section 334(a). In the case of a QSD with respect to which a Section 336(e) election is made, the Section 331 liquidation would still be a taxable transaction for the target corporation. However, the subsequent taxable liquidation of the "new" target corporation would not have significance as a practical matter since the Section 336(e) election would provide the acquirer with a purchase price tax basis in the target corporation's assets. This treatment is analogous to the case of a corporate acquirer that purchases a target corporation pursuant to a QSP, makes a Section 338(h)(10) election with respect to the acquisition, and then liquidates the target in a Section 332 liquidation.

5. **The KD Doctrine Is Subjective**

The application of the KD doctrine depends on a determination of whether a stock acquisition and a subsequent liquidation of the target corporation should be treated as an integrated transaction. While it may be relatively straightforward to establish integration if the liquidation of the target is effected shortly after the acquisition and pursuant to a plan that includes the acquisition, the question of whether an acquisition and a subsequent liquidation of target should be integrated may become more difficult if a substantial period of time elapses between the two transactions or if the facts and circumstances surrounding the transactions do not provide clear support for integration. For example, the symmetric application of the KD doctrine in a situation where it is not clear whether the post-acquisition liquidation should be integrated with the acquisition could create uncertainty for target shareholders that are not involved in the decision to liquidate the target corporation (such as in connection with a rollover transaction where the target shareholders continue to hold shares in the acquirer). The repeal of the KD doctrine would remove these uncertainties regarding the subjective aspects of the doctrine and would also eliminate the potential for inconsistent treatment of the same transaction.[82]

6. **Even If the KD Doctrine Is Applied on a Symmetric Basis, the Recast Is Not a Better Explanation of the Transactions**

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[82] We note that the subjective determination of whether a stock acquisition and a subsequent liquidation or merger should be integrated also applies with respect to the application of the step transaction doctrine to reorganizations under Section 368(a). *See*, *e.g.*, *King Enterprises*, discussed in Part III.B, above, where the acquirer had obtained a ruling that Section 334(b)(2) applied to treat the stock purchase as an asset purchase, while one of the shareholders of the target corporation treated the entire transaction as a reorganization under Section 368(a)(1)(A).

Even when applied on a symmetric basis, there seems little reason to prefer a symmetric recast under *Kimbell-Diamond* principles over the form of the transactions that actually occurred: an acquisition of the stock of the target corporation, followed by a liquidation of the target. Both pathways have the same number of steps: (i) the actual sale of target stock to the acquirer for the consideration paid by the acquirer directly to the shareholders of target, followed by a liquidating distribution of target's assets to the acquirer, as compared to (ii) a deemed sale of target's assets to the acquirer for the consideration paid by the acquirer, followed by a liquidating distribution of such consideration to the old shareholders of target.[83]

The examples below are intended to illustrate that a KD doctrine recast is not necessary as it does not produce a better explanation of the transactions. The examples compare a form-based characterization of an acquisition by a corporate acquirer ("P") of stock of target corporation ("T") from one or more selling shareholders to a KD doctrine recast of the transactions. For purposes of analyzing the alternative tax consequences, we have assumed that the KD doctrine would apply on a symmetric basis so that the consequences of the deemed asset transaction would apply to all parties involved: the purchaser, the target corporation, and the target's shareholders.

Example 1. Purchaser Is Historic 20%+ Shareholder of Target. P owns 50% of T stock "old and cold." P purchases the remaining 50% of T stock for cash from a seller unrelated to P. Following the purchase and pursuant to an integrated plan, P liquidates T. P's acquisition of T is neither a QSP nor a QSD because P did not acquire Section 1504(a)(2) control of T within a 12-month period. The integrated transaction also does not qualify as a reorganization because all of the consideration is cash and the transaction does not qualify as an all-cash reorganization under Section 368(a)(1)(D).

Analysis. If the form of the transactions is respected, P is treated as acquiring 50% of the stock of T for cash and thereafter T is treated as liquidating under Section 332. P and T do not recognize gain upon the liquidation, and P succeeds to T's tax basis in its assets.[84] Under a symmetric KD recast, P is treated as acquiring the assets of T in a transaction that is fully taxable to T and thereafter T is treated as liquidating under Section 331. In either case, the tax consequence to the seller would be the same—a

83 Although a recast transaction that qualifies as a reorganization under Section 368(a) may have the same number of steps as the transaction before the recast, as discussed in Part IV.A.2 above the policy behind and authorities relating to reorganizations support the application of the step transaction doctrine in that area.

84 These are the facts of Rev. Rul. 75-521, 1975-2 C.B. 120, which gave effect to the form of the transaction and ruled that the 80% stock ownership requirement of Section 332(b)(1) was satisfied and therefore Section 332(a) applied to the liquidation.

taxable disposition of T stock, either directly or under Section 331. From a policy perspective, the purpose of subjecting T to tax in connection with an acquisition to acquire control followed by a liquidation is not clear, since T's assets are retained in corporate solution following the liquidation, and therefore there is no avoidance of *General Utilities* repeal.

Example 2(a). Attribution from Seller. T's stock is owned 30% by S, a wholly owned subsidiary of P, and 70% by unrelated shareholders. The stock that P owns in S, and the stock that S owns in T, is "old and cold." P purchases 100% of T stock for cash. Following the purchase and pursuant to an integrated plan, P liquidates T. S's shares in T are attributed to P under Section 338(h)(3)(A)(iii). As a result, since P does not satisfy the exception in 338(h)(3)(C)(i), the 30% of T stock that P acquired from S is not stock acquired by "purchase." As a result, P is treated as acquiring only 70% of T by "purchase" and the acquisition is not a QSP. As in Example 1, the integrated transaction does not qualify as a reorganization because all of the consideration is cash and the transaction does not qualify as an all-cash D reorganization.

Analysis. The tax treatment of both the form of the transactions and the KD doctrine recast is the same as set forth above in Example 1. As in the case of Example 1, we believe that the form provides a better explanation of the transactions than the KD doctrine recast.

Example 2(b). Attribution from Seller (through Partnerships). P's stock is 100% owned by PRS1, a partnership. T's stock is 100% owned by S, a corporation, and S's stock is 100% owned by PRS2, another partnership. The stock that PRS2 owns in S, and the stock that S owns in T, is "old and cold." One partner (the "overlapping partner") owns a greater than 5% interest in PRS1 and a greater than 5% interest in PRS2. P purchases 100% of T stock from S for cash. Following the purchase and pursuant to an integrated plan, P liquidates T.

Section 318(a)(2) applies to treat the overlapping partner as owning a portion of the S stock held by PRS2, and Section 318(a)(3) applies to treat P as owning the S stock deemed to be held by the overlapping partner. Since ownership of S is attributed to P under Section 318(a), pursuant to Section 338(h)(3)(A)(iii) the acquisition is assumed not to be a "purchase" and therefore is not a QSP or a QSD. As in Example 1, the integrated transaction does not qualify as a reorganization because all of the consideration is cash and the transaction does not qualify as an all-cash D reorganization.

Analysis. If the form of the transactions is respected, the tax consequences to P, S, and T are the same as in Examples 1 and 2(a). However, in this case, a KD doctrine recast would result in a taxable disposition of T's assets followed by a liquidation under Section 332 because T is a wholly owned subsidiary of S. Again, we believe that the form provides a better explanation of the transactions than the KD doctrine recast.

Example 3. Part Purchase/Part Section 351. T is owned 70% by S, a corporation, and 30% by rollover shareholders. An unrelated buyer group forms P, to which the buyer group contributes $75 in exchange for P stock worth $75 and, simultaneously, the rollover shareholders contribute their T stock in exchange for P stock worth $25 and $5 of cash. P purchases the remaining 70% of the T stock from S for $70. Following the contributions and purchase, and pursuant to an integrated plan, P liquidates T.

Analysis. P acquired 30% of T pursuant to a Section 351 transaction with boot and not by "purchase." Accordingly, P acquired only 70% of the stock of T by purchase and the acquisition of T does not qualify as a QSP. The integrated transaction is unlikely to be treated as a reorganization because of the amount of cash and because the former shareholders of T do not control P, preventing the transactions from qualifying as a reorganization under Section 368(a)(1)(D).

If the form of the transactions is respected, P is treated as acquiring 30% of the T stock pursuant to a Section 351 transaction with boot and 70% pursuant to a taxable stock purchase, and thereafter T is treated as liquidating under Section 332. P and T do not recognize gain upon the liquidation and P succeeds to T's tax basis in its assets. Under a symmetric KD doctrine recast, P is treated as acquiring the assets of T in consideration for $75 cash and P stock worth $25 in a Section 351 transaction with boot. Thereafter, T liquidates and distributes $70 of cash to S and P stock worth $25 and $5 of cash to the rollover shareholders. Pursuant to Section 351(c)(1), the liquidation of T does not cause the Section 351 transaction to fail the requirement of Section 351(a) that the buyer group and T control P immediately after the contribution of cash and T assets to P. However, T's distribution of P stock to its shareholders is fully taxable to T under Section 336(a). T's stockholders are also subject to tax on the liquidating distribution under Section 331.

As in Examples 1 and 2, from a policy perspective, the purpose of subjecting T to tax in connection with an acquisition to acquire control followed by a liquidation is not clear, since T's assets are retained in corporate solution, and therefore there is no avoidance of *General Utilities* repeal. The rollover shareholders also potentially recognize more gain under the KD doctrine recast if the built-in gain in their T stock exceeds $5 since the rollover shareholders would be taxed under Section 331 rather than Section 351(b). It is worth noting that whether the form of the transaction or the symmetric KD doctrine recast prevails, P is treated as a transferee in a Section 351 transfer. Like Examples 1 and 2, we believe that Example 3 presents a case of an acquisition of control followed by a Section 332 liquidation that should not be recast under the KD doctrine.

We note that in each of Examples 1 through 3, the acquisitions of T stock could be effected without risk of the application of the KD doctrine if P does not liquidate T following P's acquisition of T stock. In this respect, confirming the repeal of the KD doctrine would eliminate a potential trap for the unwary, i.e., that a liquidation of the target corporation for non-tax reasons following an acquisition of control could trigger

target-level tax on a deemed asset sale, and possibly additional tax at the target shareholder level as well.

Example 4. Non-Corporate Purchaser. PRS, a partnership, which cannot be a purchaser in a QSP but can be a purchaser in a QSD, buys 100% of T stock for cash from S, a corporation, and immediately liquidates T.

Analysis. The transaction is treated as a QSD under Treas. Reg. § 1.336-1(b)(6). If the KD doctrine does not apply and no Section 336(e) election is made, the transaction would be treated as a taxable purchase of T's stock followed by a Section 331 liquidation of T into PRS. Upon the liquidation, T generally would recognize gain or loss under Section 336(a), and PRS would obtain a tax basis in the assets received equal to the fair market value of the assets under Section 334(a). If the symmetric KD doctrine applies, PRS would be treated as acquiring the assets of T in consideration for the cash consideration actually provided to S, and then T would be treated as distributing the cash to S in a liquidating distribution under Section 332. Under Treas. Reg. § 1.336-2(b), the same result—a deemed asset sale by "old" T for the consideration provided by PRS, followed by a liquidating distribution of such consideration by "old" T to S—would apply if a Section 336(e) election is made with respect to the acquisition of T stock.

In our view the transactions in Example 4 should be analyzed in a manner that is consistent with the rules that apply to a QSP of T by a corporate purchaser under the Section 338 regulations, which respect the form of the transactions regardless of whether a Section 338 election is made.[85]

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[85] *See* Treas. Reg. § 1.338-3(d).