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Step Transactions

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I. INTRODUCTION

Federal Taxation is, of course, a creature of statute, but so ingenious have been man’s efforts to deal with this particular statute that a body of common law principles in the form of “judicial gloss” has been engrafted onto the Code. Thus, for example, when a man deals with related parties or with his alter ego, such as a wholly-owned corporation, it is settled that the transaction must be cast in such a
manner as if he were dealing “at arms length.” In addition to man’s ingenuity, the very extent and complexity of the Code (especially the more modern statutes) is such that ambiguity is inevitable. To confront such ambiguity, the courts have created doctrines to be used for interpretation of and testing standards for transactions in their tax setting. Again, by way of example, a taxpayer on the cash basis is not taxed until he has received payment. But to prevent abuse of this law, the doctrine of constructive receipt provides that a taxpayer may not avoid taxation by refusing to receive payment if it is tendered, or capable of being received but for his own desire not to receive it.

One of the omnipresent judicial doctrines which has received much attention by courts is the subject of this paper: step transactions. The doctrine has been explained in numerous decisions, and in fact was “developed as part of the broader tax concept that substance should prevail over form.” It has been said, in speaking of multiple-step transactions, that:

A given result at the end of a straight path is not made a different result because reached by following a devious path. We must regard matters of substance and not mere form. Without regard to whether the result is imposition or relief from taxation . . . closely related steps will not be separated either at the instance of the taxpayer or the taxing authority.

II. PRINCIPAL AREAS INVOLVED

It has been said that the step transaction doctrine “crops up at so many points in the law of federal taxation as to defy summary . . . .” It is clear, however, that its principal application is in areas involving tax-free transactions.

While there is nothing inherently wrong with multiple steps to accomplish a result, a problem arises when the steps taken are used to hide the true effect of the transaction. As the term implies, step transactions relate to those cases where two or more transactions which are independent in form are deemed to be so dependent in substance as

4. In Campana Corp. v. Harrison, 114 F.2d 400, 408 (7th Cir. 1940), an arms-length transaction was defined as follows:
A sale at arm’s length connotes a sale between parties with adverse economic interests. To determine whether a sale between two corporations is at arm’s length, it is necessary to look at the stockholders behind the corporate structures.
5. INT. REV. CODE OF 1954, § 446(c)(1); Treas. Reg. § 1.446-1(c)(1)(i) (1957).
6. United States v. Britt (5th Cir. 1964); Ross v. Commissioner, 169 F.2d 483 (1st Cir. 1948); Treas. Reg. § 1.451-2(a), T.D. 6723, 1964-1 CUM. BULL. 73.
to require the tax consequences to be measured by viewing the overall transaction from beginning to end without according any independent significance to the steps in between.

Although the doctrine continues to be a major item of inquiry in specific tax disputes, very little has been written or said about it as a concept. Perhaps, as has been indicated, this is because it is so closely akin to, if not subsumed by, the broader doctrine of substance versus form. Or perhaps it is because the doctrine cannot, once stated, be applied carte blanche as some immutable tenet of construction, but must be considered in the light of the varied facts of each case. The question whether multiple steps will be integrated into one or the converse, whether the whole of a transaction will be divided into its several elements, may have to be answered against a background of the substantive area of taxation in which a controversy arises.

III. Tests in Application

There have been several attempts to categorize "universal tests" which can be utilized in analyzing step transaction cases. But aside from some broad generalizations and the synthesizing of certain jargon which is useful in discussing the subject, it is apparent that no "universal tests," independent of the substantive transaction, have been achieved and probably none is practicable. Nevertheless, a review of those tests which have been categorized seems a prerequisite to any further exploration of the step-transaction doctrine.

A. Time

One might think that whether transactions were separable or indivisible could be objectively inferred from the time relationship of such transactions. Unfortunately, other considerations by the courts make this element less of a guideline than might be hoped. Furthermore, the facts of the cases under consideration inevitably differ and time, as a measuring device in this instance, reacts accordingly. Thus, two months...
have been held a determining factor in deciding that there was no reorganization because the Congressional reports and the Service's regulations suggested that acquisition of stock-for-stock in a "B" reorganization\textsuperscript{18} should be accomplished over a relatively short period of time, such as twelve months, and the acquisitions in the instant case were made in two separate transactions over a fourteen-month period.\textsuperscript{17} Again, where control was relinquished in two steps pursuant to a divisive reorganization\textsuperscript{18} by transferring 57 percent in 1961 and, twenty months later, transferring the remaining 43 percent, it was held that although no time limit is required by statute for relinquishing control\textsuperscript{19}

\[\text{[i]t would be wholly inconsistent with [the premise of annual tax accounting] to hold that the essential character of a transaction, and its tax impact, should remain not only undeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen. This requirement that the character of a transaction be determinable does not mean that the entire divestiture must necessarily occur within a single tax year. It does, however, mean that if one transaction is to be characterized as a "first step" there must be a binding commitment to take the later steps.}\textsuperscript{20}

Apparently, had there been a binding commitment to complete the series of distributions within a reasonable time (or possibly even if future distribution of control had been in the plan adopted by the stockholders), the separate distributions would have been acceptable as if a total relinquishment of control had occurred in one event. Where, under proper circumstances, a delay is explained, steps taken as much as six years apart have been integrated.\textsuperscript{21} And, when found to be prearranged, steps taken within hours have been integrated;\textsuperscript{22} but where not previously com-

\textsuperscript{16. INT. REV. CODE of 1954, § 368(a)(1)(B) provides generally that no gain or loss will result if stock is acquired solely for voting stock of the acquiring corporation, and the acquiring corporation is in control (at least 80% ownership) of the acquired corporation immediately thereafter.}
\textsuperscript{17. American Potash & Chem. Corp. v. United States, 399 F.2d 194 (Ct. Cl. 1968).}
\textsuperscript{18. INT. REV. CODE of 1954, § 368(a)(1)(D) provides, \textit{inter alia}, that a transfer of an active trade or business with a five-year history, to a new corporation in exchange for stock, and the subsequent transfer of such stock to shareholders of the transferor, will not result in gain or loss, if immediately after the transfer of the stock to the shareholders the transferor corporation and the transferee corporation are still engaged in business.}
\textsuperscript{19. See INT. REV. CODE of 1954, § 355(a)(1)(D).}
\textsuperscript{22. Love v. Commissioner, 113 F.2d 236 (3d Cir. 1940).}
mitted to a course of action, steps taken as little as a half hour apart have been held independent.\textsuperscript{23}

B. Intention

The avowed intention of the parties will, of course, be disregarded if the facts controvert it. This is necessarily so since intention, being subjective, is best measured by an objective analysis. Where intention is in issue, reference to the result of the transaction is not an attempt to downgrade the importance of the issue, but merely an attempt to properly infer from the objective acts of the parties what the intention is. After all, whether the parties intended their transaction to be taxable is not relevant, but whether the parties intended to effect a certain result is relevant.\textsuperscript{24} As was said in Commissioner v. Ashland Oil and Refining Co.,

regardless of the form, the substantial result that was intended to be effectuated, was a transfer of the . . . properties . . . [and] . . . no taxable gain has been realized.\textsuperscript{25}

In applying the test of the parties' intention, the general rule is to give an intended result the same tax effect whether the result is accomplished directly or by circuitous steps.\textsuperscript{26} In this connection, most courts have disregarded the stockholder's argument that for a corporate reorganization there must be a corporate business purpose and therefore, for example, since a liquidation-reincorporation is generally prompted by a shareholder motive, the intervening step of liquidation should be accorded the separateness of capital gains treatment and stepped-up basis given assets transferred to the new corporation. But, as one court said,

the character of a reorganization . . . depends not upon the motive of the stockholders but upon "what was done." . . . The motive of the stockholders is immaterial, if a reorganization of the corporate business is in fact accomplished. . . .

. . . [A] reorganization [occurs] when the series of undisputed transactions are considered as an integrated whole.\textsuperscript{27}

The tax result is the same whether a new corporation is found either before or after liquidation of the old.\textsuperscript{28}

In the early days of taxpayer planning, the courts sometimes disregarded the obviously intended results and held the taxpayer to the exact form of his transaction. Thus, in an attempt to engage in a tax-free

\textsuperscript{23} Henricksen v. Braicks, 137 F.2d 632 (9th Cir. 1943); Bruce v. Helvering, 76 F.2d 442 (D.C. Cir. 1935).

\textsuperscript{24} See Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947).

\textsuperscript{25} 99 F.2d 588, 592 (6th Cir. 1938), \textit{cert. denied}, 306 U.S. 661 (1939).

\textsuperscript{26} Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938).

\textsuperscript{27} Survaunt v. Commissioner, 162 F.2d 753, 757, 759 (8th Cir. 1947).

\textsuperscript{28} Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949).
incorporation, the taxpayer was found instead to have engaged in a taxable transaction when assets were transferred to the new corporation in exchange for its check, which was immediately endorsed back to the corporation. 29 It is doubtful that this transaction would be taxable today.

Although inquiries into subjective intent are still pursued in certain areas, 30 it would appear that such inquiries are and should be made only in the absence of sufficient extrinsic evidence from which to infer a likely intent. And such intent as may be inferred will usually relate back to that existing at the beginning of the road which led to the result. 31

Admitting that there will be some circumstances where taxpayers' intentions cannot be totally ignored, the exactness with which it can be stated what in fact they ultimately did is alluring as a test to determine how the tax incidence should fall. In other words, ignorance of the tax law is no excuse. The desire of a taxpayer to characterize his transactions as separate because this affords the best tax result is no reason to expect adherence to such a desire or intent. It is naive to believe that a taxpayer should be allowed to define his own terms to avoid the reality of the event. It would seem that if the subjective intent of the parties was totally disregarded wherever possible, more truth would result in the decisions and more certainty would obtain in planning for tax consequences. 32

C. Interdependency

In American Bantam Car Co., 33 the court, citing Paul & Zimet, 34 said,

In determining whether a series of steps are to be treated as a single indivisible transaction . . . [an] important test is that of mutual interdependence. Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series? 35

32. And, of course, the results of the transaction, however reached, will be as binding on the Service as on the taxpayer. Tennessee Ala. & Ga. Ry. v. Commissioner, 187 F.2d 826 (6th Cir. 1951); Buhl v. Kavanagh, 118 F.2d 315 (6th Cir. 1941).
34. R. PAUL & P. ZIMET, SELECTED STUDIES IN FEDERAL TAXATION 200-54 (2d series 1938).
35. 11 T.C. at 405.
This is another attempt to find a satisfactory test for scrutinizing transactions involving multiple steps. Its obvious merit is in its concern with objective standards rather than the elusive subjective intention of the parties. It is a test which was synthesized from some of the early cases\textsuperscript{36} and adopted and furthered by many of the later cases.\textsuperscript{37}

Usually the interdependence test provides that if a step would not have otherwise been taken, then the transaction will be considered in its entirety and any other step will be integrated with the interdependent step to determine the reality of the transaction. On the other hand, it has been held that a mere intention without a requirement to act will not cause a step to be integrated.\textsuperscript{38} And, more recently, it was declared that if there is no "binding commitment" to take a later step, such later step may be segregated.\textsuperscript{39}

D. Generally

As stated above, it is clear that the facts of the case as applied to the substantive law in issue will dictate the road to follow in justifying a court's decision. Although component steps of a single transaction cannot be treated separately and, conversely, distinctly separate transactions cannot be united for tax purposes,\textsuperscript{40} the court must still analyze the facts in concluding that there are steps which should be combined or separated, as the case may be.

There are many cases which appear to be at odds with one another in the area of step transactions. It is submitted that this is the result of different factual and evidentiary settings. For example, where transactions are contingent or conditional upon other events, the transactions and the contingent events will usually be inseparable.\textsuperscript{41} On the other

\textsuperscript{36} Bassick v. Commissioner, 85 F.2d 8 (2d Cir. 1936); First Seattle Dexter Horton Nat'l Bank v. Commissioner, 77 F.2d 45 (9th Cir. 1935); First Nat'l Bank, 34 B.T.A. 631 (1936).
\textsuperscript{37} Interdependent steps were not found, and hence integration not deemed necessary, in National Bellas Hess, Inc., 20 T.C. 636 (1953), aff'd, 220 F.2d 415 (8th Cir. 1955); Scientific Instrument Co., 17 T.C. 1253 (1952), aff'd per curiam, 202 F.2d 155 (6th Cir. 1953); and American Bantam Car Co., 11 T.C. 397 (1948), aff'd, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950). But interdependent steps were found, and it was therefore held that separation of the steps would defeat the purpose of the undertaking and the express intention of the parties, in American Wire Fabrics Corp., 16 T.C. 607 (1951). See Prentis v. United States, 264 F.2d 525 (2d Cir. 1967); Turner Constr. Co. v. United States, 364 F.2d 525 (2d Cir. 1966); Roebling Sec. Corp. v. United States, 176 F. Supp. 844 (D.N.J. 1959); Sheppard v. United States, 361 F.2d 972, 980 n. 13 (Ct. Cl. 1966); Baker Commodities, Inc., 48 T.C. 374, 401-07 (1967), aff'd, No. 23,019 (9th Cir., Aug. 8, 1969).
\textsuperscript{38} National Bellas Hess, Inc., 20 T.C. 636 (1953), aff'd, 220 F.2d 415 (8th Cir. 1955); Scientific Instrument Co., 17 T.C. 1253 (1952), aff'd per curiam, 202 F.2d 155 (6th Cir. 1953); American Bantam Car Co., 11 T.C. 397 (1948), aff'd, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950).
\textsuperscript{39} Commissioner v. Gordon, 391 U.S. 83 (1968).
\textsuperscript{40} Bassick v. Commissioner, 85 F.2d 8 (2d Cir. 1936).
\textsuperscript{41} Starr v. Commissioner, 82 F.2d 964 (4th Cir. 1936), cert. denied, 298 U.S. 680 (1936).
hand, even where it was admitted that an entire transaction would not have been consummated were certain other events not to materialize, the separateness of the transactions has been recognized. Again, where the parties, even absent precise programs to that effect, have an understanding of the steps to be taken in reaching the result desired, the intervening steps will often be taken as mere steps in the integrated whole. However, in Portland Oil Co. v. Commissioner, the Court held that this rule is not always workable, and that in certain cases transactions will be held separate even though effected pursuant to a prearranged agreement.

For further illustration, the same court has refused to integrate a step which, although important to the parties, was not an indispensable condition without which no other step would have been taken, but did integrate a step into the overall transaction even though it was merely “a contemplated possibility under the plan . . . .”

With such uncertainty in the field of step transactions, taxpayers may be advised to acquire “insurance,” in the form of a Revenue Ruling from the Service, before attempting any transaction involving a series of steps. In this way, if a favorable ruling is not obtained, possibly the transaction can be restructured, or at least the risks of litigation can be better contemplated. In Revenue Ruling 58-93, Corporation Y transferred all its assets to a new subsidiary, Z, immediately prior to a planned reorganization in which Y's assets (now comprised of Z stock) were acquired in a statutory merger by another company, X. The ruling held that, in substance, there was an acquisition of all of Y's assets (prior to forming Z) by X and a subsequent transfer of such assets by X to Z, the new subsidiary. In essence, the Service rearranged the timing of the transaction. The important point is that since the reorganization was planned at the outset, if the transactions were independently tested under section 351 of the Code (dealing with tax-free incorporations) they may have failed in that it could be said there was no control of the new company by the transferor, Y, immediately after the transfer.

The “tests” set forth above are useful in their application to particular facts. But they cannot be relied on in all cases to “resolve the question [of what] a set of steps [constitutes in fact] . . . . [This]

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44. 109 F.2d 479 (1st Cir. 1940).
45. ACF-Brill Motors Co., 14 T.C. 263 (1950), aff’d, 189 F.2d 704 (3d Cir. 1951).
46. Anheuser-Busch, Inc., 40 B.T.A. 1100, 1106 (1939), aff’d, 115 F.2d 662 (8th Cir. 1940), cert. denied, 312 U.S. 699 (1941). But see National Bellas Hess, Inc., 20 T.C. 636 (1953), aff’d, 220 F.2d 415 (8th Cir. 1955), which allowed separateness of a step to which the taxpayer was bound.
48. See text relating to note 50, infra.
determination is made by now classic standards for analyzing the overall substance of transactions...49

IV. PRACTICAL APPLICATION

Because step transactions can, theoretically, be found in any tax-free or tax-preferential exchange setting, it would be impractical to attempt an exhaustive summary of cases where the doctrine has been applied. But certain transactions have historically lent themselves to the application more readily than others: incorporations, reorganizations, liquidation-reincorporations, exchanges of "like-kind" property, and indirect purchases of assets. The practical application of the step-trans- action doctrine in these areas will therefore be reviewed in this paper.

A. Incorporations

No gain or loss shall be recognized if property is transferred to a corporation ... by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control ... of the corporation.50

In determining whether this statute is met, the steps taken by the parties will usually be considered from the standpoint of their substance. Thus, except for some early "form over substance" cases,51 the courts will usually telescope the following steps into a tax-free incorporation: (1) a corporation issues stock for cash, and (2) immediately exchanges the cash for property of the new shareholder.52 And, extending the obvious, where parties buy property for cash with the intention of conveying to a corporation for stock, it has been held that the corporation acquires the property for cash.53

Taxpayers have often attempted to avoid the provisions of section 35154 (a mandatory provision) by intentionally failing to satisfy the control requirement.55 The primary reason for this is to secure a stepped-up basis in the property transferred and either take a loss on the exchange or limit gain to taxation under capital gains rates.

49. South Bay Corp. v. Commissioner, 345 F.2d 698, 704 (2d Cir. 1965).
52. E.g., A. C. Burton & Co. v. Commissioner, 190 F.2d 115 (5th Cir. 1951); Walter S. Heller, 2 T.C. 371 (1943), aff'd, 147 F.2d 376 (9th Cir. 1945), cert. denied, 325 U.S. 868 (1945).
53. Tulsa Tribune Co. v. Commissioner, 58 F.2d 937 (10th Cir. 1932).
55. Int. Rev. Code of 1954, § 368(c), defines control for this purpose as being at least 80% of the voting power and at least 80% of the number of all other shares of stock outstanding.
On the other hand, to achieve carryover of desirable tax attributes, or for other reasons, there are probably as many cases in which the tax-free benefits of section 351 have been attempted although there was no plan to use the newly formed corporation as anything but a stepping stone to the true end sought.\(^{56}\)

The cases have been grouped under the varied situations wherein (1) control after incorporation was voluntarily relinquished, (2) control was relinquished pursuant to an obligation to do so, and (3) control was lost as a result of another's exercise of an option to acquire stock.\(^{57}\) It is in this area of "control" that the test of interdependence flourishes.\(^{58}\)

The question of "control immediately after" requires a two-fold inquiry: (1) was compliance with the "immediate control" requisite met; and (2) who is in control.

In the past, it has been held that mere momentary control after the exchange was sufficient even though such control was shortly thereafter relinquished pursuant to a pre-existing plan or contract.\(^{59}\) This has been the result even though at a transferor's request the stock is issued in joint names.\(^{60}\) Furthermore, it has been held that, after the transfer, the transferor may sell the stock received\(^{61}\) or the corporation may issue more stock to others without affecting the immediate control requirement.\(^{62}\)

These earlier cases have not, however, necessarily established a certain result, for it has been said that:

\[\text{[T]he interposition of new corporations of fleeting duration, though the transactions were literally within the congressional definition of . . . a nonrecognition section, would not avail in the achievement of the tax avoidance purpose when it was only a mask for a transaction which was essentially and substantively . . . a taxable exchange.}\]\(^{63}\)

In *Manhattan Building Co.*,\(^{64}\) the issue of de-control following a section 351 transfer was decided in the context of the text of interdependence. Here the taxpayers, pursuant to a binding commitment to turn over to underwriters a certain quantity of stock received in the formation of a corporation, fell below the 80 percent ownership requisite in complying with the statute. The court held that the second step was an inseparable part of the entire transaction so that upon the

\(^{56}\) E.g., Electrical Sec. Corp. v. Commissioner, 92 F.2d 593 (2d Cir. 1937).
\(^{57}\) Mintz & Plumb, supra note 12.
\(^{58}\) See B. Bittker & J. Eustice, supra note 11, at 89-94.
\(^{59}\) Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940).
\(^{60}\) P.A. Birren & Sons, Inc., 116 F.2d 718 (7th Cir. 1940).
\(^{61}\) American Compress & Warehouse Co. v. Bender, 70 F.2d 655 (5th Cir. 1934), cert. denied, 293 U.S. 607 (1934).
\(^{63}\) Commissioner v. Morris Trust, 367 F.2d 794, 797 (4th Cir. 1966).
\(^{64}\) 27 T.C. 1032 (1957), acquiesced in 1957-2 CUM. BULL. 5.
transfer to the underwriters, it being part of the incorporation, the 80 percent control was lacking and the transaction was taxable. 65 Manhattan Building Co. follows the general rule that where a re-transfer of stock received in incorporation is pursuant to a binding contract, the re-transfer will be integrated with the initial transfer in determining whether there is control by the transferor immediately after the transfer. 66

The question of tax-free formation of a new corporation often arises in conjunction with a planned subsequent reorganization. Here, a new corporation is formed with assets which are desired by another corporation (such assets representing some but not substantially all of the forming corporation's assets). The incorporation meets the technical requirements of section 351 in that there is ostensible control immediately after the transfer of assets. Thereafter, the parent company exchanges the new subsidiary's stock solely for voting stock of the corporation desiring the assets, 67 or the subsidiary exchanges its assets for voting stock of the desiring corporation. 68 Obviously, if the parent company had instead of forming a new corporation with the assets wanted by the other corporation, simply exchanged such assets for voting stock of the transferee, it would be a taxable transaction since it would fail the "substantially all" test of section 368(a)(1)(C). This two-step to tax-free success has been sanctioned in at least one case, 69 but it is almost certainly doomed to failure generally. 70

In Electrical Securities Corp. v. Commissioner, 71 the taxpayers owned shares in a corporation, X, and the shares were desired by another corporation which already owned some of X's shares. Even after acquisition of the taxpayers' shares the acquiring corporation would not have control of the corporation so that the transaction would have been taxable, i.e., would not have met the requirements of what is now Section 368(a)(1)(B). To avoid this problem, the taxpayers formed a new corporation, Y, by transferring their stock in X in exchange for all of Y's stock. Then, as a part of the overall plan, the acquiring corporation acquired all of the stock of Y in exchange for its own voting stock. Y was then liquidated so that the acquiring corporation received the shares of X. The court held that the intervening steps (including the incorporation) in

65. American Bantam Car Co., 11 T.C. 397 (1948), aff'd, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950), was distinguished on the ground that the underwriting agreement in American Bantam was not a sine qua non in the general plan.
66. E.g., May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953).
67. Usually this would be a tax-free reorganization. See note 16 supra.
68. INT. REV. CODE OF 1954, § 368(a)(1)(C), provides, generally, that no gain or loss will result if substantially all of the assets of one corporation are acquired solely for voting stock of the acquiring corporation.
69. Ballwood Co. v. Commissioner, 84 F.2d 733 (3d Cir. 1936).
70. Electrical Sec. Corp. v. Commissioner, 92 F.2d 593 (2d Cir. 1937); United Light & Power Co., 38 B.T.A. 477 (1938), aff'd, 105 F.2d 866 (7th Cir. 1939), cert. denied, 308 U.S. 574 (1939).
71. 92 F.2d 593 (2d Cir. 1937).
transferring the stock to the acquiring corporation must be ignored, since the steps were so interrelated as to require that the tax effect be measured by the substance achieved and not by the form of each step. Where immediately after incorporation, others have options to acquire enough shares to terminate control, the better view seems to be that there is no loss of control until the option is exercised so that “control immediately after” element is satisfied if the option is not exercised immediately. But some courts will find a violation of control if the option is exercised within a few months or if its exercise is certain; for example, because a nominal consideration is required for valuable stock.

Finally, in regard to the inquiry of immediate control and leading to the inquiry of who is in control, it has been held that receipt of stock by a transferor in an incorporation, followed immediately by a gift of more than 20 percent of the transferee corporation’s stock to members of the donor’s family, will meet the immediate control test. Conversely, in avoidance of section 351, a newly formed corporate taxpayer is allowed a stepped-up basis in property received if in the transfer more than 20 percent of the stock of the corporation was issued to a party who was not a transferor.

Since the question of control may involve more than one transferor, the question of who is the transferor must be answered. This, in turn, often involves complex fact patterns which create diverse results. Two contrasting examples should sufficiently illustrate the problem here. In Republic Steel Corporation v. United States, the parties planned to avoid the 80 percent control requisite in order to get a stepped-up basis upon incorporation. To effect the transaction the instigator, Republic Steel, first bought shares of dissenting stockholders (11 percent) of Old Corporation and contributed this stock to Old Corporation. Then New Corporation was formed with the remaining old stockholders receiving less than 80 percent. Not surprisingly, the Service asserted that Republic’s first step was part of the overall transaction which made Republic one of the transferors, so that the 80 percent control test was met immediately after the transfer. However, the court held that the intervening purchase of the minority shares was not a part of the transaction, and the stepped-up basis was saved.

73. See Barker v. United States, 200 F.2d 223 (9th Cir. 1952).
75. Fahs v. Florida Mach. & Foundry Co., 168 F.2d 957 (5th Cir. 1948). Since this is pre-1954 case law, it is possible that today the transaction would be treated as a valid § 351 incorporation followed by a gift to the donee, subject to gift tax. See Treas. Reg. § 1.351-1(b)(1) (1955).
76. 40 F. Supp. 1017 (Ct. Cl. 1941).
77. Id. at 1021.
78. Id. at 1022.
In the more recent case of Baker Commodities, Inc., a contrary result was reached. In this case, ten men formed a new corporation by contributing $500 each. Three days later a partnership consisting of some of the same ten men and another corporation exchanged certain property with the new corporation for what was found by the court to be securities of the corporation. The court said,

The composition of the transferor group is dependent upon whether the transfer of cash for stock by all 10 men and the subsequent transfer of [property] by the . . . partnership and [the other corporation] for [the securities] are to be viewed as steps in a single transaction.

Relying on the test of interdependence and the belief that the transaction was pursuant to at least an orally manifested plan (as evidenced from the objective results of the transaction), the court integrated the transactions and denied a stepped-up basis to the property transferred.

B. Reorganizations

1. Generally

In addition to generally satisfying the technical statutory requirements of a reorganization in order to receive tax-free treatment, there must also be compliance with essential judicially created criteria. Thus, there must be a business purpose, continuity of a business enterprise, and continuity of proprietary interest. In many cases these doctrines appear to be satisfied (or not, as the case may be) when viewing separate steps of an overall plan. Therefore, the step-transaction doctrine is often employed by the courts and the Service in analyzing an event to determine its tax consequences in the reorganization area. Reorganization, in general, is not the subject of this paper, but some understanding of applicable reorganization principles is necessary in order to understand the application of the step-transaction doctrine. In this regard, some basic explanation of the contextual setting of the transaction will be made as is deemed necessary for clarity.

Since much of what has already been said of the step transaction is equally applicable in the reorganization area, it will suffice just to

80. Id. at 405.
82. See Becker v. Commissioner, 221 F.2d 252 (2d Cir. 1955).
84. For an overall introduction to the area, see B. Bitteker & J. Doxtator, supra note 11, at 449-601; J. Chomnie, Federal Income Taxation 492-525 (1968).
remind the reader that in any context of a tax-free nature the true substance of the transaction as measured by its end result should be scrutinized. It would not serve any useful purpose to be repetitious in an attempt to fully document the step-transaction doctrine in the reorganization area. Unfortunately, there will be at least some inevitable overlap in discussion here vis-à-vis what has previously been said and what will be said about liquidation-reincorporations.

2. STOCK-FOR-STOCK

Included in the tax-free reorganization provisions is a transaction whereby if a corporation acquires stock of another corporation solely in exchange for its voting stock and is thereafter immediately in control of such other corporation, then no gain or loss will be recognized ("B" reorganization). There are (or were) three major problem areas in connection with this type of transaction: (1) where the stock used to acquire control of the other company is not the stock of the acquiring company; (2) where sufficient control is acquired solely for voting stock and additional stock is acquired (prior to or after acquisition of control) for other than voting stock; and (3) where stock is acquired solely for voting stock over a period of time in a series of transactions ultimately resulting in control ("creeping acquisition").

In Groman v. Commissioner it was held that stockholders did not have a continuing interest in the assets of their corporation when they received, in addition to stock of the corporation involved in the exchange, the stock of the parent of such corporation. In a companion case the Court also held that where the stockholders' corporation exchanged its assets with a corporation solely for stock of such corporation, and the corporation, as part of the same plan, immediately transferred the assets to a subsidiary, the continuity of interest theory of Groman was applicable since the parent corporation is not made a party to the reorganization merely because the property or stock being exchanged is passed through it, as a transitory step to the parent's subsidiary. But where only unexpected events caused the parent to transfer stock acquired in a "B" reorganization to its subsidiary, it was held that the unanticipated transfer did not revoke the parent's position as a party to the reorganization.

In the opposite type of arrangement where stock acquired in a "B" reorganization was put in the acquiring parent's subsidiary for bona fide business reasons and in accordance with its announced intentions and, as soon as business permitted the parent liquidated the subsidiary thereby acquiring the stock directly, it was held that the stock was always intended

86. 302 U.S. 82 (1937).
to be owned by the parent so that the parent was considered a party to the reorganization. The intervening ownership by the subsidiary was therefore disregarded in the series of steps.  

The major problem in this area has been solved by statute, so that at present stock of a parent company may be used to acquire stock or assets of another company in a tax-free reorganization.  

The second problem in the "B" reorganization area is illustrated by a case where the acquiring corporation obtains the 80-percent control solely for voting stock, but goes on to acquire additional stock for other than voting stock.  

Except in rare cases where complete separateness of transactions can be found, mere separation in time or documentation will not avoid the presumption that, in addition to voting stock, other consideration was given in a unified plan to obtain the stock ultimately acquired.  

Finally, in the third problem area, there is some degree of uncertainty today notwithstanding apparent statutory clarity. It is generally agreed that if the 80-percent control requirement is met, even through a series of complex steps all part of one integrated plan, a valid "B" reorganization will result. Prior to 1954, the statutory language was generally believed to require acquisition of at least 80 percent control in the reorganization exchange itself. Therefore, if more than 20 percent of the stock had been previously acquired, there could be no "B" reorganization. Upon adoption of the 1954 Internal Revenue Code, this problem was believed substantially solved when it was provided that it did not matter whether the 80 percent control was acquired all at once or over a period of time by a series of transactions. The only statutory requirement is that the acquiring corporation be in control immediately after the exchange, whether or not it had control immediately before. The regulations parroted back certain language relative to the modification of this statute contained in the Congressional report to the effect that a series of stock-for-stock exchanges will be aggregated to effect the 80-

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89. Gertrude B. Chase, 44 B.T.A. 39 (1941), aff'd, 128 F.2d 740 (2d Cir. 1942).
90. INT. REV. CODE of 1954, §§ 368(a) (1)(B), (C), (D) and § 368 (b).
91. Hubert E. Howard, 24 T.C. 792 (1955), rev'd on other grounds, 238 F.2d 943 (7th Cir. 1957).
92. See Commissioner v. Harris, 92 F.2d 374 (3d Cir. 1937); Bruce v. Helvering, 76 F.2d 442 (D.C. Cir. 1935); Helvering v. Ward, 79 F.2d 381 (8th Cir. 1935); Rev. Rul. 69-91, 1969 INT. REV. BULL. No. 9, at 12; Rev. Rul. 56-345, 1956-2 CUM. BULL. 206.
93. See Miller v. Commissioner, 103 F.2d 58 (6th Cir. 1939); Starr v. Commissioner, 82 F.2d 964 (4th Cir. 1936), cert. denied, 298 U.S. 680 (1936); First Seattle Dexter Horton Nat'l Bank v. Commissioner, 77 F.2d 45 (9th Cir. 1935).
94. Barker v. United States, 200 F.2d 223 (9th Cir. 1952) [reversing itself, since its original unreported opinion had overlooked the fact that under the law in force at the time, there was no "solely voting stock" requirement, 52-1 U.S. Tax Cas. § 9316 (9th Cir. 1952)].
96. INT. REV. CODE of 1954, § 368(a) (1)(B).
percent control if they occur "over a relatively short period of time such as 12 months."\textsuperscript{908}

The significance of this language may not have been fully appreciated by some until the decisions in \textit{American Potash & Chemical Corp. v. United States}\textsuperscript{99} held that the 80-percent control must be acquired within the 12-month period, or over a relatively short period of time exceeding 12 months \textit{if} the acquisitions are part of a continuing offer to purchase.

3. STOCK-FOR-ASSETS

An alternative tax-free reorganization provides generally that no gain or loss will result if substantially all of the assets of one corporation are acquired solely for voting stock of the "purchasing" corporation.\textsuperscript{100} Here again, the issue may arise as to whether additional consideration received by the "selling" corporation was pursuant to the plan of reorganization or was a separate transaction.\textsuperscript{101} In one case, B corporation acquired the assets of A corporation by issuing B stock to A's shareholders and $350,000 to A so that A could pay off its creditors. The $350,000 was deducted from additional consideration to A's shareholders in exchange for their leasehold interests. The Service maintained that the receipt of cash was tied in with the receipt of B's stock, and therefore violated the tax-free statute in force at the time. The court, however, held that the receipt of the $350,000 was for a separate transaction, \textit{viz.}, the sale of leasehold interests, so that the stock-for-assets exchange was tax-free, even though the tax-free exchange was \textit{conditioned} on the acquisition of the leaseholds.\textsuperscript{102}

It has been seen that a "creeping acquisition" in a "B" reorganization is possible by virtue of statutory allowance. No similar allowance exists in the case of "C" reorganizations due to the requirement that substantially all of the assets of the "selling" corporation be acquired solely for voting stock of the purchaser. Although there are many variations which could be employed to circumvent this restriction,\textsuperscript{103} it nevertheless remains a "trap for the uninformed, a result which casts doubt on the basic soundness of the [restriction]."\textsuperscript{104} The principle is demonstrated in the case of \textit{Bausch & Lomb Optical Co. v. Commissioner}\textsuperscript{105} where the taxpayer, already the owner of 79 percent of the stock of a subsidiary, issued its stock in exchange for the subsidiary's assets and then liquidated, receiving back 79 percent of its stock issued. Apparently on the

\textsuperscript{99} 402 F.2d 1000 (Ct. Cl. 1968); 399 F.2d 194 (Ct. Cl. 1968).
\textsuperscript{100} Int. Rev. Code of 1954, § 368(a)(1)(C).
\textsuperscript{101} However, it is now possible to acquire up to 20% of the assets for other than voting stock. Id. § 368(a)(2)(B).
\textsuperscript{102} Helvering v. Tex-Penn Oil Co., 300 U.S. 481 (1937).
\textsuperscript{103} See B. BITTKER & J. EUSTICE, supra note 11, at 566-68.
\textsuperscript{104} Id. at 568.
\textsuperscript{105} 267 F.2d 75 (2d Cir. 1959), cert. denied, 361 U.S. 835 (1959).
theory that, in fact, the assets had been acquired substantially by use of the acquired company's own stock, the court found the various steps to be a single plan having the effect of a taxable liquidation rather than a tax-free "C" reorganization.

4. "B" REORGANIZATION CONVERTED TO "C" REORGANIZATION

In connection with the utilization by successor corporations of net operating loss carryovers, a limitation is imposed by the Code.106 This is to the effect that, in the case of a "C" reorganization, to obtain full benefit of the tax attribute the shareholders of the corporation possessing the carryover must own, immediately after the reorganization, at least 20 percent of the fair market value of the outstanding stock of the acquiring corporation. This restriction does not apply to acquisition under the liquidating provisions of Code Sections 332 and 334(b)(1).107 However, it should be noted that it is generally agreed that a series of transactions which purport to be a reorganization qualifying under section 368(a)(1)(B) followed by a liquidation qualifying under § 332, but which in substance comprise a reorganization qualifying under section 368(a)(1)(C), will be considered [as a "C" reorganization for purpose of this statutory restriction].

5. SPIN-OFFS AND UNWANTED ASSETS

It may frequently occur in business amalgamations that an acquiring corporation is not interested in receiving certain of the assets of the "selling" corporation. In these cases, taxpayers have frequently attempted to dispose of such unwanted assets in a way which, if literally interpreted, would provide them with preferential capital gain while they still continue to operate the retained assets;109 or they have attempted to pass these assets off as part of the non-taxable transaction.

In Helvering v. Elkhorn Coal Co.,110 prior to a stock-for-assets transaction the "selling" corporation transferred 80 percent of its assets to a new corporation in what it considered a tax-free incorporation, in exchange for the new corporation's stock. The new stock was then distributed as a dividend in a tax-free spin-off.111 The corporation there-

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106. INT. REV. CODE of 1954, § 382.
107. Id. §§ 332, 334(b)(1). The sections provide that a parent corporation may liquidate its subsidiary and, in liquidation, receive the subsidiary's assets with the same basis as they had to the subsidiary.
109. A result similar to that attempted in liquidation-reincorporations is discussed infra at pp. 78-81.
110. 95 F.2d 732 (4th Cir. 1938), cert. denied, 305 U.S. 605 (1938).
111. Now INT. REV. CODE of 1954, § 355, which provides, generally, that no gain or loss will be recognized to a shareholder who receives, with respect to his stock, stock of another corporation which is, immediately prior to receipt, controlled by the distributing corporation, and has been engaged (as has the distributing corporation) in an active trade or
upon completed its exchange of the remaining 20 percent of its assets for stock of the "purchasing" corporation, in a transaction it believed qualified as a tax-free "C" reorganization since it received stock for "substantially all" of its remaining assets. In what appears to be a correct analysis of the ultimate results, the court found that the corporation actually engaged in a taxable sale of 20 percent of its assets since the assets retained in the new corporation resulted in disqualifying the transaction as an exchange of stock for substantially all of the corporation's assets. In other words, the court would not separate the incorporation transfer from the reorganization transfer so that, in reality, only a small portion of the company's assets were exchanged for stock.

Still another aspect of the step-transaction-spin-off relationship involves a case where the unwanted assets are spun-off to shareholders who, pursuant to the overall plan, then transfer the remaining assets to an acquiring corporation in a statutory merger, with the acquiring corporation surviving. It has been held that since the statute requires that the distributing corporation be engaged in business immediately after the distribution, the statutory merger has the effect of vitiating the tax-free nature of the spin-off, and the spin-off distribution thus becomes a taxable dividend. However, the contrary result has obtained where the transferor corporation survived the subsequent merger.

Finally, it should be noted that a mere initial distribution toward required divestiture of control of a newly formed subsidiary will not receive tax-free treatment even though total control is subsequently released within two years. The court said that

if an initial transfer of less than a controlling interest in the controlled corporation is to be treated as a mere first step in the divestiture of control, it must at least be identifiable as such at the time it is made.

Furthermore, although it did not hold that the entire divestiture had to occur within a single tax year, if one transaction was to be characterized as a first step, there would have to be a "binding commitment to take the later steps."

business for the immediate 5-year period, and is engaged (as is the distributing corporation) in an active trade or business immediately after receipt.

114. INT. REV. CODE of 1954, § 355(a) (1) (D).
116. Id. at 96.
117. Id. In Gordon, the court never reached the question of whether a distribution of rights to acquire stock in the newly formed corporation was sufficient to qualify for tax-free treatment, but denied tax-free treatment under § 355 for failure to meet the technical requirements of that section. But in Oscar E. Baan, 51 T.C. No. 105 (Mar. 26, 1969), on remand from the Gordon case to determine taxability under § 346(b) or § 354, it was stated that distribution of rights was not equivalent to the distribution of stock required by § 354 and that § 346(b) was not an operative section allowing, by itself, tax-free treatment for partial liquidation.
C. Liquidation-Reincorporations

Nowhere is the step-transaction doctrine more vigorously applied than in the area of liquidation-reincorporations. This is probably because taxpayers frequently avail themselves of devices or schemes to continue in business while withdrawing previous earnings at capital gains rates, obtaining the benefits of capital losses, and/or achieving a stepped-up basis in property for depreciation purposes.

Prior to 1954, the Service could fight such schemes fairly successfully by employment of the then existing "D" reorganization provision, which simply required a

transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred.\footnote{118}

Under the 1954 Code,\footnote{119} the transferor corporation must, following such transfer, either meet the rigid requirements of section 355 or distribute to its shareholders all of the stock, securities, and other properties of the transferee corporation to which has been transferred "substantially all of the assets of the transferor ...."\footnote{120}

A liquidation-reincorporation setting usually involves a variation on one of three themes: (1) transfer of assets of one corporation to another corporation controlled by the shareholders of the transferor corporation, followed by liquidation of such transferor corporation; (2) liquidation of a corporation, followed by the transfer of the liquidated assets to a new corporation; (3) sale of corporate assets by one corporation (frequently under provisions of section 337)\footnote{121} to another corporation controlled by the same shareholders, followed by liquidation of the selling corporation.

Under the 1939 Code, as in all cases since the enactment of the Revenue Act of 1913,\footnote{122} the Service was in many instances unsuccessful in attacking tax avoidance schemes. Thus, it was held in \textit{United States v. Arcade Co.}\footnote{123} that when a liquidation occurred with no plan, or only a faint hope, of forming a new corporation, a subsequent transfer to a new corporation of the assets will not be integrated to find a reorganization. On the other hand, where a corporation was liquidated and the assets transferred to a new corporation for stock, and notes were used to satisfy the personal obligations of the shareholders, a capital loss was claimed

\footnotesize{\begin{itemize}
\item \footnote{118. Int. Rev. Code of 1939, Ch. 1, § 112(g)(1)(D), 53 Stat. 40.}
\item \footnote{119. Int. Rev. Code of 1954, § 368(a)(1)(D).}
\item \footnote{120. Id. § 354(b)(1).}
\item \footnote{121. Id. § 337 provides, generally, that no gain or loss will be recognized to a corporation from the sale of its property if the corporation adopts a plan of liquidation before the sale, and liquidates within twelve months after adoption of the plan.}
\item \footnote{122. Act of Oct. 3, 1913, Ch. 16, 38 Stat. 114.}
\item \footnote{123. 203 F.2d 230 (6th Cir. 1953).}
\end{itemize}}
on the liquidation and a stepped-up basis was asserted for the assets transferred to the new corporation, the court had no difficulty in finding such an obvious contrivance of steps to be a "D" reorganization, even without a written plan to interpret the intention.\footnote{124}

This is not to say that tax savings as a motive will "kill" the deal. In the Arcade case, the stockholders liquidated on advice of their tax advisor to obtain a stepped-up basis for depreciation. Obviously the stockholders intended a reincorporation, but they did not record such intention and, \textit{the key point}: each stockholder was carefully notified that he was free not to participate in the new corporation.\footnote{125} Holdings such as these were based substantially on the fact that there was no contractual obligation to form a new corporation. They represent a fading minority, however, and were not well-received even under the 1939 Code.\footnote{128}

At the time the 1954 Code was enacted, Congress was aware of the litigation in the area of liquidation-reincorporation and proposed a statutory measure, (section 357), which would have prevented capital gains treatment and stepped-up basis when a liquidation was followed by a reincorporation and the shareholders of the liquidated corporation obtained a 50-percent interest in the new corporation.\footnote{127} However, the Conference Committee rejected this proposal in the belief that the problem could be sufficiently handled outside the statutory provisions.\footnote{128}

With the enactment of section 368(a)(1)(D), and the consequent blunting of "an instrument highly useful in attacking 'reincorporations,'"\footnote{129} the Service adopted certain regulations\footnote{130} to provide that a liquidation preceded or followed by a transfer of all or a portion of the liquidating corporation's assets to another corporation may have the effect of a taxable dividend,\footnote{131} or be subject to the "boot" treatment of section 356.\footnote{132} In addition, the Service issued a ruling\footnote{133} to the effect that a sale under section 337 by one corporation of substantially all of its assets to another corporation for 45 percent of the purchasing corporation's stock, 

\footnote{124. Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947); accord, Walter S. Heller, 2 T.C. 371 (1943), aff'd, 147 F.2d 376 (9th Cir. 1945).
125. \textit{See also} Henricksen v. Braicks, 137 F.2d 632 (9th Cir. 1943).
132. \textit{INT. REV. CODE} OF 1954, § 356 provides, generally, that if tax-free treatment would otherwise be accorded a reorganization transaction but for the receipt of property other than stock or securities permitted to be received, gain will be recognized, not to exceed the fair market value of the other property. Such gain, if it has the effect of a dividend, will be taxed as such to the extent of the recipient's ratable share of earnings and profits of the distributing corporation. The balance of the gain, if any, will receive capital gain treatment.
133. Rev. Rul. 61-156, 1961-2 \textit{CUM. BULL.} 62.}
long term notes, and cash, followed by liquidation of the selling corporation, would yield neither capital gain on the liquidating distribution nor stepped-up basis in the assets "sold." The Service felt that there was no reality to the sale or to the liquidation, since each transaction was only a formal step in a reorganization of the "selling" corporation. In essence, the transaction was merely a recapitalization and a mere change in identity, form, or place of organization, and the distribution was taxable in full as a dividend. That the new corporation, following the sale, issued 55 percent of its stock to other parties was not relevant, since it was held to be a separate transaction.

In Joseph C. Gallagher, this Revenue Ruling received its test. Here, in the formation of New Corporation (followed by the sale of Old Corporation's assets to New Corporation), unrelated new shareholders acquired a 27 percent interest. The Service argued that formal liquidation of Old Corporation should be ignored since there was, in fact, a re-incorporation. The court held that all of the steps had to be considered together, and in so doing it could not find the 80-percent control required of a "D" reorganization. Further, the court held that an "E" reorganization did not occur because more than one corporation was involved, and an "F" reorganization was not present because the transaction went beyond a "mere change in identity, form, or place of organization."

Since there was no reorganization, the liquidating distribution could not be taxed as a dividend or under the "boot" provisions of section 356.

A "D" reorganization was again avoided by a taxpayer when he sold, under section 337, one-half the operating assets of his old corporation to a new corporation, 50 percent owned by his former employee.

Illustrative of the fact that one cannot be assured of avoiding a "D" reorganization and its "boot" or dividend treatment by mere non-compliance with certain technicalities of the statute is the case of David T. Grubbs. Here it was demonstrated that the overall substance of the transaction will still be reviewed by the courts. So, though the "D" reorganization as an instrument to attack reincorporations is "blunted," it is not useless. In David T. Grubbs, the steps leading from one corporation to two, with the second owned by the same shareholders as the first,

135. Id. § 368(a)(1)(F).
136. 39 T.C. 144 (1962).
137. Id. at 158.
138. Id. at 161.
139. Id. at 162.
140. Id. at 162-63.
and the first owned by only one of the original shareholders (the others having received cash for their ownership), were found to be part of an overall "D" reorganization, so that the cash received was "boot." 143

Despite certain continued victories by the Service with the "D" reorganization, its major weakness appears obvious: if new shareholders in excess of 20 percent of the stock are admitted to the new corporation, it cannot meet the test. 144 This may even be the result if the new shareholders are related parties, such as family members. Therefore, the Service has been seeking new tools to deny the tax avoidance possibilities. Basically, it has been attempting to achieve a broader interpretation of the "F" reorganization as it relates to single corporations. And, on one occasion, it argued for the "F" reorganization in a case involving two corporations, 145 but abandoned its argument on appeal. 146 The problem represents somewhat of a dilemma for the Service, since if it does not contend for an "F" reorganization in multi-corporate reincorporations it will lose still more force in its fight in this area. If it does contend for such a result, however, it will be agreeing to the ability of a new corporation to carry back net operating losses to the old, predecessor corporations, a result not possible under any other reorganization provision. To date, there is an apparent split in the courts as to the breadth of an "F" reorganization, with the ninth circuit 147 and the fifth circuit 148 holding an "F" reorganization possible with multi-corporate transactions, and the fourth circuit 149 and the Tax Court 150 holding that an "F" reorganization is not available except in the restructuring of a single corporation. The Service has entered an extensive non-acquiescence and explanation for why it will not follow those cases holding that a multi-corporate "F" reorganization is possible. 151

143. Accord, Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967); Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967); Ralph Wilson, 46 T.C. 334 (1966); James Armour, Inc., 43 T.C. 295 (1964).

144. Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Joseph C. Gallagher, 39 T.C. 144 (1961). See Simon Trust v. United States, 402 F.2d 272 (Ct. Cl. 1968), where failure to have a plan of reorganization or transfer "substantially all of its assets" pursuant to Section 354 resulted in a finding of no "D" reorganization.


147. Associated Mach. v. Commissioner, 403 F.2d 622 (9th Cir. 1968); Estate of Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968).

148. Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967); Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1965), cert. denied, 386 U.S. 1018 (1967).

149. Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965).

150. Associated Mach., 48 T.C. 318 (1967), rev'd, 403 F.2d 622 (9th Cir. 1968); Estate of Bernard H. Stauffer, 48 T.C. 277 (1967), rev'd, 403 F.2d 611 (9th Cir. 1968).

D. Like Kind Exchanges

1. GENERALLY

In the area of like kind exchanges the step-transaction doctrine must often be called upon to reveal the reality of an overall business scheme. Generally the question to be answered is whether there has, in fact, been a single reciprocal exchange or two (or more) separate transactions. At stake, sometimes, is a stepped-up basis for investment credit and/or depreciation purposes, the cost of which basis is payment of a capital gains tax, subject to the depreciation recapture provisions and possible investment credit recapture. Again, the benefit to be derived by a segregation of transactions may be the deductibility of a loss.

2. SALES AND LEASEBACKS

In sale and leaseback cases, the point attacked is often a taxpayer's attempt to deduct a loss on the disposition of property used in his trade or business while not, at least materially, altering his immediate economic position with respect to such property. The Service has exercised its power in this area by adopting regulations which exemplify non-recognition of gain or loss when certain like kind property is exchanged. Despite the existence of these regulations, neither the taxpayers nor the Service have high regard for that provision in the regulations which holds that the "exchange" of a fee simple interest for a leasehold having at least 30 years to run is the exchange of like kind property.

Thus, in cases where the taxpayer has sold his property in a transaction providing for a leaseback for periods of more than 20 years but less than 30 years, the Service has attacked the loss taken on the grounds that the taxpayers did not intend to, nor did they, part with any substantial interest in the property sold. However, in these cases the

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152. Int. Rev. Code of 1954, § 1031 provides, generally, that no gain or loss will be recognized if the property used in a trade or business or for investment purposes (not including inventory, or stocks, bonds, accounts receivable, etc.) is exchanged solely for "like kind" property to be held for investment or use in a trade or business.
153. See id. § 46(c).
154. Id. §§ 1245, 1250.
155. Id. § 47.
156. On the other hand, if a company has a net operating loss about to expire, it is possible that a timely gain would be desired.
158. Id. § 7805 empowers the Secretary of the Treasury (who delegates such power to the Service) to "prescribe all needful rules and regulations for the enforcement of" the Internal Revenue Code.
159. Treas. Reg. § 1.1031(a)-1(c) (1950).
160. "Like kind" has reference to the nature or character of the property, not its grade or quality. Treas. Reg. § 1.1031(a)-1(b) (1956).
161. The regulations were also present under the 1939 Internal Revenue Code. Treas. Reg. § 29.112(b)(1)-(1) (1943).
court has held that the difference between a fee simple ownership and a mere leasehold is sufficient to retain separateness of the sale and the leaseback aspects of the transaction.

In more recent decisions there have been conflicting opinions in similar fact patterns involving sale and leaseback transactions, where the leasehold was at least the 30-year term prescribed by the regulations to accord like kind treatment. In the first of these cases, the corporate taxpayer unsuspectingly compromised itself when, in an effort to raise funds by selling its property, obtaining a deductible loss on the sale, and retaining substantial control by virtue of a 95-year leaseback, it unhappily found that the court countenanced the like kind regulations dealing with 30-year leaseholds and disallowed the loss. In so doing, the court also recognized that the taxpayer no longer had an interest in the depreciable properties, and instead of permitting depreciation of the unallowed loss over the remaining life of such properties, required the adjusted basis of the leasehold to be amortized over the 95-year term of the lease.

The court, in supporting the regulations on the basis of the re-enactment doctrine, may have been somewhat overzealous—there had never been occasion to consider the regulation in a prior case, and in those cases mentioned above the court definitely recognized a difference in the nature or character of a fee simple as opposed to a leasehold. Congress may have considered this fact sufficiently dispositive to preclude the necessity for legislative enactment.

In *Jordan Marsh Co. v. Commissioner*, the court refused to integrate the sale at a loss and leaseback for over 30 years of the same building. Here, the court stated that if integration of the transactions was required so that there was an exchange rather than a sale and a leaseback, it would still be necessary to determine the validity of the regulations as to whether a 30-year leasehold was property "like" a fee simple absolute.

Because the court viewed the legislative history of this non-recognition section of the Code as evidencing an intent to refuse to tax transactions where there is a mere change in the form of ownership rather than a change in substance, it concluded that the section could not be applicable in this case. This was because there was, in fact, a change in the quantum of ownership whereby the taxpayer had "closed out a losing venture," thus liquidating its property interest for cash in an amount

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164. The re-enactment doctrine basically stands for the proposition that where a regulation has been in force for many years and successive re-enactments of the Internal Revenue Acts have not modified it, it acquires the force of law. Helvering v. Reynolds Tobacco Co., 306 U.S. 110 (1939); Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 656-57 (5th Cir. 1968).
165. 269 F.2d 453 (2d Cir. 1959).
166. Id. at 455.
167. Id. at 457.
equal to the value of the fee. Therefore an exchange rather than a sale
was found, and the court did not specifically rule on the validity of the
regulations.

3. EQUALITY OF TREATMENT

Both parties do not necessarily have to be treated equally in a sec-
tion 1031 transaction. With respect to the regulations discussed above,
however, which were probably designed to integrate transactions cast to
avoid taxation on the true transaction, if the Service believes that ex-
change of a fee simple for a 30-year leasehold is a like-kind exchange,
then a fortiori exchange of the leasehold should be given like kind tax
treatment. However, the Service has said that:

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\ldots \text{[w]hile the transfer of real property in considera-
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\[
\text{tion of the execution of a leasehold interest in the same or other}
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\text{property may be an exchange of properties of like kind for pur-
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\[
\text{poses of Section 1031 of the Code to the transferor-lessee, it is}
\]

\[
\text{not an exchange of properties of like kind by the transferee-
\]\]

\[
\text{lessor.}\]

It would appear that if the result is increased revenue for the
Treasury, in some circumstances the theory of integrating transactions
would only be half-heartedly applied. Obviously this situation is im-
proper. Consideration of revenue-raising should not be at issue in draft-
ing regulations, promulgating rules or guidelines, or rendering judicial
decisions. Such a consideration is solely within the discretion of the
Congress and should be exercised by the setting of tax rates. The only
discussion on a statute should deal with its equitable application. Natur-
ally the Service and the courts will continue to be called on for inter-
pretive functions, but it is submitted that their attention should be
focused on the substance of the transaction, keeping in mind the relation-
ship of the parties and the governing statute; the effect on the revenue
should be left to Congress.

4. TRADE-IN PROBLEMS

Aside from exchanges (or sales and leasebacks collapsed into ex-
changes) of unlike property which by regulatory fiat has been defined

\[168. \text{The Service non-acknowledged, taking the position that the transaction was an ex-
change of like kind property, with cash received as “boot.” Rev. Rul. 60-43, 1960-1 Cum.
Bull. 687.}\]

\[169. \text{The language of the court, however, strongly indicates that a leasehold is not like}
kind property vis-à-vis a fee simple. This can be inferred from the court’s reference to the}
quantum of an estate and to the lesser interest evidenced by a leasehold. 269 F.2d at 456.}\]

\[170. \text{Int. Rev. Code of 1954, § 1031(a), specifically provides that tax-free treatment}
do not apply to an exchange of stock in trade or property held primarily for sale. Thus,}
one person trading property used in his business may be accorded the benefits of § 1031
while the dealer in the exchange will not, since he is trading with his stock in trade (in-
tventory).}\]

23 B.T.A. 1176 (1931), aff’d, 70 F.2d 850 (D.C. Cir. 1934).}\]
as like kind property, another major like kind exchange area of controversy is the situation in which the taxpayer attempts to get a stepped-up basis in newly acquired property while giving up similar property used in his trade or business or for investment. Where there is a sale of the old property to a different person than the one from whom the new property is acquired, the Service will apparently not succeed in integrating the transaction into a mere exchange. But in a case where two parties—a buyer and a seller—deal together in such a manner as to formally effect a sale (often at a loss, but sometimes at a gain) by one party of his old property, and a subsequent purchase by the same party of new property, the separate steps taken will be integrated into a single exchange subject to obligatory non-recognition of gain or loss and a "carryover" basis because the "sale and purchase are reciprocal and mutually dependent transactions . . . even though . . . accomplished by separately executed contracts and . . . treated as unrelated transactions . . . ."

Although most of the cases dealing with this problem have had concurrent or proximate transactions which made it easier to disregard the formalistic steps, it would seem that as long as the elements of reciprocity and dependency, in the sense of creating a non-severable transactional relationship between the two parties, are present, "a tax-free exchange cannot be transformed into two sales by the arbitrary separation of time and exchange of cash." As the court has said, in disregarding the separated steps which only looked like independent transactions,

[t]axation is transactional and not cuneiform. Our tax laws are not so supple that scraps of paper, regardless of their calligraphy, can transmute trade-ins into sales. Although [the taxpayer's] transfer may have been paper sales, they were actual exchanges. A taxpayer may engineer his transactions to minimize taxes, but he cannot make a transaction appear to be what it is not. Documents record transactions, but they do not always become the sole criteria for transactional analysis.

5. THREE-CORNERED EXCHANGES

If a taxpayer has property which is used in his business or otherwise qualifies under section 1031, and another party desires to acquire it, an outright sale would be a taxable transaction. To avoid this, the taxpayer


173. See Carlton v. United States, 385 F.2d 238 (5th Cir. 1967).


175. Id. § 1031(d).


177. Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 658 (5th Cir. 1968).

178. Id. at 659.
may require the purchaser to first acquire like-kind property suitable to the taxpayer and then enter into a tax-free exchange under section 1031. Although the ultimate transaction between the taxpayer and the purchaser may appear to satisfy the statutory requirements for tax-free treatment, the Service is wary of disregarding the fact that the purchaser did not own, at the outset of negotiations, the property which he exchanges. In other words, transactions entered into by a purchaser in an effort to secure the property desired by the taxpayer may be treated separately, similar to an agency arrangement whereby there has been or will be a sale and the "agent" is merely finding property for the purpose of replacement.

The courts have been fairly generous in finding a non-taxable exchange even where the taxpayer has searched for the replacement property, where the person with whom the taxpayer trades acquires the property and the form of conveyancing follows the path of the intended exchange. On the other hand, where it was possible to separate the transactions, such as where the formalism of deeding the property did not follow the trade-in intended, or the taxpayer, despite his intention, was at least conceptually free to take purchase money without acquiring or having acquired the property for exchange, or where there was a transaction which provided the parties the desired result but the timing was such that it could be held that they did not exchange property with each other, taxability has been sustained.

In Carlton v. United States, it was stipulated that the parties intended to effect a tax-free exchange. But instead of having the property desired by the taxpayer acquired by the exchanging party, the parties, in order to avoid the problem of multiple deeding, simply held a closing at which time cash and the right to acquire the replacement property 179. W. D. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948).


181. Sale of property and the purchase of similar property does not constitute an exchange. Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33 (6th Cir. 1945).

182. Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); Mercantile Trust Co., 32 B.T.A. 82 (1935).

183. Carlton v. United States, 385 F.2d 238 (5th Cir. 1967).

184. Id.; Halpern v. United States, 286 F. Supp. 255 (N.D. Ga. 1968). In Halpern, where the taxpayer received “boot” in a like kind exchange and, pursuant to his intention at the outset, used such “boot” to acquire additional like kind properties from other parties, such additional properties did not qualify under § 1031 as integral parts of the original transaction, because acquisition of the additional properties did not depend on the initial transfer.

185. John M. Rogers, 44 T.C. 126 (1965). In this case, there was no § 1031 exchange where, prior to sale of the property pursuant to an option agreement, the taxpayer attempted an exchange of his property subject to the option with a third party for like kind property. The purchaser exercised his option before the third party acquired title in the taxpayer’s property. Hence it was determined that the taxpayer did not receive property, in exchange from the purchaser, and that the third party did not receive property in exchange from the taxpayer.

186. 385 F.2d 238 (5th Cir. 1967).
were paid to the taxpayer for his property. Even though the taxpayer did, in fact, complete the transaction intended, the court held that the receipt of cash "was unrestricted and could be used by the appellants as they pleased."\(^{187}\) The court felt that the established rule of *Kanawha Gas & Utilities Co. v. Commissioner*,\(^ {188}\) to the effect that the incidence of taxation is to be determined by viewing an entire transaction as a whole, did not "permit [it] to close [its] eyes to the realities of the transaction and merely look at the beginning and end of a transaction without observing the steps taken to reach that end."\(^ {189}\) The court also noted that the taxpayer had been active in negotiating for the acquisition of the replacement property.

From the *Carlton, Halpern* and *Rogers* cases\(^ {190}\) it would appear that a person desiring a tax-free exchange in a three-cornered transaction should avoid participating in the negotiations for any replacement property and assure that the form of the transaction complies precisely with all of the elements of the exchange intended, including acquisition by the other party of the property being exchanged and direct exchange with such other party only, with the transfers of title following the necessary legal ownership of the property.

E. *Kimbell-Diamond Rule*

1. **Generally**

It is possible for a corporation to acquire assets of another corporation without cash outlay and receive a substantial stepped-up basis for depreciation purposes. This something-for-nothing proposition might be accomplished by a finding that (1) the *Kimbell-Diamond rule*\(^ {191}\) is still viable; (2) a "purchase"\(^ {192}\) includes an *exchange of stock* of the buyer for stock of the seller in at least two transactions spanning a period longer than 12 months\(^ {193}\) where there is no legal commitment on the part of the seller to exchange his stock in the transactions following the first exchange;\(^ {194}\) and (3) a *stock-for-stock reorganization*\(^ {195}\) is effective only if a series of stock exchanges exceeding 12 months are made pursuant to a continuous offer to acquire the stock.\(^ {196}\)

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187. *Id.* at 243.
188. 214 F.2d 685 (5th Cir. 1954).
189. 385 F.2d 238, 241 (5th Cir. 1967) (emphasis added).
190. Cases cited notes 184, 185 *supra*.
192. See *Int. Rev. Code* of 1954, § 334(b) (3).
193. *Id.* § 334(b) (2) (B).
To understand the above result, it is necessary to discuss what may be the classic example of a step transaction. This is the situation where some person wants to acquire assets of a corporation, but the selling corporation wants to sell stock (usually because it is a cleaner “break” with the entity and all problems of liquidation are avoided). To accomplish this objective, the purchaser acquires the stock and then liquidates the corporation, thus ending up with the desired assets. This series of transactions is commonly referred to as a Kimbell-Diamond transaction, taking its name from the Kimbell-Diamond Milling Co. case.197 This pre-1954 case involved facts substantially as set out above. The taxpayer had suffered a fire which destroyed its mill plant, and in order to get back into business it had to acquire the stock of an existing corporation. It bought the stock on December 26, 1942, and liquidated the corporation on December 29, 1942. In so doing it claimed that the purchase of stock and the liquidation were two separate transactions resulting in a receipt of the assets with the same basis as in the hands of the subsidiary.198 The Service argued that, notwithstanding that there was no binding commitment to liquidate, the real substance of the transaction was an acquisition of assets so that basis must be determined by reference to the cost of the stock, i.e., the liquidation step was to be disregarded. In holding for the Service, the court relied on the substance of the transaction argument, as articulated in Commissioner v. Court Holding Co.199 The facts were found to support a holding that the taxpayer’s purpose in acquiring the stock was to obtain the assets. Consequently, the basis of the assets was reduced and a deficiency collected, primarily due to the corresponding depreciation deduction.

The Kimbell-Diamond rule was pronounced earlier in Commissioner v. Ashland Oil & Refining Co.,200 where the court said that “transitory ownership of stock is not necessarily of legal significance.”201 Here, again, the evidence was substantial that the intent of the taxpayer was to acquire property rather than stock. The court, accordingly, refused to recognize the series of intervening transactions between payment and possession of such properties.

And without regard to whether the result is imposition or relief from taxation, the courts [will recognize] that where the essential nature of a transaction is the acquisition of property,
it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority.\footnote{202}

This enlightened approach to reality is such that it seems incredible that Congress waited as long as it did to legislate in the area to prevent such disputes as arose in \textit{Kimbell-Diamond}. In 1954, however, section 334(b)(2) was added to the Internal Revenue Code for the apparent purpose of incorporating a mechanical test for cases like these, regardless of the intent factor which was critical in the pre-1954 cases.\footnote{203} Under this section, the assets acquired in liquidation will take a basis equal to the purchase price of the stock (with certain modifications occasioned by time delays) if 80 percent of the stock is acquired by a corporation by \textit{purchase} within 12 months and a plan of liquidation is adopted within two years after the date of the qualifying purchase resulting in control.\footnote{204}

The provisions of this section are mandatory, so that if a corporation wanted to avoid the effects, for example to obtain a tax attribute such as a net operating loss \textit{carryover}\footnote{205} rather than a stepped-up basis, it would have to plan for the transaction to fall outside the statutory framework.

The question was left open as to whether such planned avoidance would be effective or whether Congress meant to and/or did effectively statutorily overrule the \textit{Kimbell-Diamond} rule.\footnote{206}

In \textit{American Potash & Chemical Corp. v. United States},\footnote{207} the parties stipulated for purposes of the Service's motion for summary judgment that the taxpayer really exercised a series of steps for the purpose of obtaining the assets of an acquired corporation. The steps were: (1) acquisition of 48 percent of the acquired company's stock \textit{solely} for voting stock of taxpayer; (2) 14 months later, in another stock-for-stock exchange, acquisition of the remaining 52 percent of the acquired com-

\footnote{202. Id.}

\footnote{203. \textit{See} Rev. Rul. 60-262, 1960-2 \textsc{Cum. Bull.} 114, 115, where it is said that within the framework of Section 334(b)(2) "the formal steps themselves are significant under the 1954 Code and the element of purpose or intent is immaterial." Therefore, even where the admitted purpose was to acquire stock of a going business rather than its assets, later compliance with the elements of § 334(b)(2) resulted in a stepped-up basis. \textit{Id.}}

\footnote{204. Note that it would seem that the liquidation can, by virtue of the procedures set out in § 332(b), to which § 334(b)(2) is related, be delayed at least until five years after purchase, and possibly even longer; but the longer the delay in liquidating, the more likely it is that some judicial doctrine will be raised to find non-compliance with § 334(b)(2). \textit{See} J. \textsc{Mertens}, \textsc{Law of Federal Income Taxation}, § 334(b)(2):5 (1968).}

\footnote{205. \textit{But see} Int. Rev. Code of 1954, §§ 269, 382 as to certain statutory limitations on acquiring favorable tax attributes, and Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957), as to certain judicial limitations.}

\footnote{206. \textit{E.g.}, B. \textsc{Bittker} & J. \textsc{Eustice}, \textit{supra} note 11, at 378; J. \textsc{Chromwe}, \textit{supra} note 11, at 447-48; Cohen, Gelberg, Surrey, Tarlean, & Warren, \textit{Corporate Liquidations Under the Internal Revenue Code of 1954}, 55 \textsc{Colum. L. Rev.} 37 (1955); Mansfield, \textit{The Kimbell-Diamond Situation: Basis to the Purchaser in Connection with Liquidation}, N.Y.U. 13\textsc{th} \textit{Inst. on Fed. Tax.} 623 (1955).}

\footnote{207. 399 F.2d 194 (Cl. Cl. 1968).}
pany's stock (It was admitted that if the remaining 52 percent of the stock could not be acquired, the taxpayer would have sold the stock acquired earlier.); and (3) seven months thereafter, liquidation of the acquired company.

Because the purpose of the taxpayer was to acquire assets, it treated the transaction as a purchase of such assets, thus ignoring the stock exchanges and liquidation, and taking an increased basis in the assets by reference to the fair market value of its stock exchanged,\textsuperscript{208} liabilities assumed, and certain advances made during the seven-month parent-subsidiary relationship. Here the reverse of the \textit{Kimbell-Diamond Milling Co.} case was acted out by the parties. The Service contended there was no purchase of assets, so that basis carried over to the parent company liquidating its subsidiary; \textit{i.e.}, section 334(b)(2) statutorily overruled the \textit{Kimbell-Diamond} rule and the company, if it falls outside the provision, must take a carry-over basis in assets. In asserting its position, the Service advanced these alternative arguments: (1) that the series of steps taken by the taxpayer should be disregarded and the substance, \textit{viz.}, an exchange of stock for assets ("C" reorganization), should be recognized so that a carryover basis would apply;\textsuperscript{209} (2) that the company was merely liquidating a subsidiary under section 332 and 334(b)(1) of the Internal Revenue Code of 1954, so that a carryover basis would apply.

The court found that a "C" reorganization was impossible, since this requires an exchange of voting stock for \textit{substantially all} of the assets of the transferor (selling) corporation.\textsuperscript{210} The court was considerably bothered by the Service's attempt to collapse the stock-for-stock transactions into a stock-for-assets transaction even though the parties agreed that it was the assets which the taxpayer was trying to get. It labored over the prospects of converting an "unqualified B-type exchange and a subsequent liquidation"\textsuperscript{211} into a "C" reorganization. It feared that because of the "creeping acquisition" for stock, if a "C" reorganization were found it would be an approval of a \textit{seriatim} acquisition of assets.

It should be noted that the Service did not assert that there was a "B" reorganization, but the court, \textit{sua sponte}, found that because the 12-month period referred to in the regulations in relation to a "B" reorganization had been exceeded, there was, in fact, no valid "B" reorganization.\textsuperscript{212}

\textsuperscript{208} See Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962); Moore-McCormack Lines, Inc., 44 T.C. 745 (1965).
\textsuperscript{209} Int. Rev. Code of 1954, § 362(b).
\textsuperscript{210} See text accompanying notes 94 through 104, supra.
\textsuperscript{211} 399 F.2d at 201 (Ct. Cl. 1968).
\textsuperscript{212} On a later rehearing pursuant to defendant's Petition for Reconsideration, the Service did assert that a valid "B" reorganization occurred and that the 12-month rule was merely suggestive, not mandatory. The court remanded this issue along with the other issue to determine whether the facts indicated that there was a continuing offer for all of the stock from the first acquisition, a requirement the court felt necessary to extend a "creeping acquisition" "B" reorganization beyond the 12-month period. 402 F.2d 1000 (Ct. Cl. 1968).
There being no valid "B" reorganization, there could be no carry-over basis on liquidation under section 362(b) of the Code. This followed, said the court, because the precise requirements of the statute to form a "C" reorganization had not been met.

Here the transaction was stock-for-stock, not stock-for-assets as required by section 368(a)(1)(C). If the substance were viewed as stock-for-assets, it would not be for substantially all of the assets in exchange, since it was a "creeping acquisition" transaction.

Having determined a carryover basis was not possible vis-à-vis liquidation of a subsidiary acquired in a reorganization, the court then addressed itself to the Service's alternative argument that the steps involved in the ultimate obtaining of the assets must take a carryover basis, on the ground that section 334(b)(2) preempted the step-transaction approach of the Kimbell-Diamond rule and left a corporation acquiring stock outside the perimeter of that section with no basis alternative on liquidation other than the carryover basis of section 334(b)(1). It held that the purpose of section 334(b)(2) was to establish a degree of certainty in the area of parent-subsidiary liquidations, but that it was not intended to eliminate a corporation's option under the Kimbell-Diamond rule to obtain a cost basis for assets if it was intended to acquire such assets, rather than stock. If a corporation intends to acquire assets, therefore, it need not have the benefits of section 334(b)(2) in order to get a stepped-up basis, but to achieve certainty in getting what it wants, it would be wise to plan to come within the statutory provisions. Conversely, if it is intended not to acquire assets with a stepped-up basis, such intention must, in fact and form, be properly evidenced.

Whether it is a fair construction of Congressional intent to hold that it did not desire the taxpayer to have any options is still open to some

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213. See text accompanying notes 106 through 108, supra.

214. The court based its conclusion, in large part, on the regulations:

In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and the underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule [that a gain or loss must be recognized on the exchange].

Treas. Reg. § 1.368-1(b) (1955).

215. The question arises: why couldn't the court combine the argument of substance versus form with the step transaction doctrine (which is subsumed by the substance versus form doctrine), thus finding a purchase of 100% of the assets for stock by integrating the acquisitions? Possibly it is because there was never any certainty that the remaining 52% could be acquired; in fact, two separate offers for all the stock had to be made during which time the purchase price offer was raised in order to acquire all of the stock. Perhaps the court was mindful of the earlier pronouncement in Commissioner v. Gordon, 391 U.S. 83, 96 (1968), that "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps." (Emphasis added.)


217. The court, in holding Section 334(b)(2) not preclusive, seems to have used fair logic. There is no reason to believe that judicial doctrine and discretion in an area such as step transactions are precluded merely because a statute in the same general area has been enacted. See Brookes, Corporate Liquidations, U. So. Cal. 1960 Tax. Inst. 233, 241.
question. At least in the *Court Holding* area it has been held that such options to taxpayers were intended.

3. APPLICATION TO INDIVIDUALS

Under the 1939 Code, the *Kimbell-Diamond* rule had also been applied in cases where individuals acquired stock to get at underlying assets. In *Ruth M. Cullen* the taxpayer was given a stepped-up basis in property acquired in liquidation even though he had owned a 25 percent interest in the corporation for twelve years prior to acquiring the remaining 75 percent. (On the liquidation the taxpayer had taken a short-term capital loss on the 75 percent to the extent that the price paid for the stock exceeded the book basis of the assets received.) The court held that (1) there was a long-term capital gain on the 25 percent interest owned, measured by the difference between the fair market value of the assets received and the cost of such 25 percent interest, and (2) there was no capital loss with respect to the other 75 percent, but rather the basis in the assets had to be stepped-up to an amount equal to the cost of the stock.

Although by obiter dictum the court in *American Potash* indicated that the *Kimbell-Diamond* rule was still viable with respect to an individual purchase-liquidation situation, the issue has not been fully tested under the 1954 Code. In *Griswold v. Commissioner*, the court did not actually reach the issue of whether the *Kimbell-Diamond* rule should be applied, because the external evidence that there was no intent to acquire the assets was such that a discussion of the steps taken to acquire the assets would have been pointless. The implication of the case, however,

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218. One argument, that Congress may have intended the taxpayer to plan the avoidance of Section 334(b)(2), can be found in the Senate Report.

"[P]rovided the conditions of [§ 334(b)(2)] are met, the basis of the property in the hands of the distributee shall be the adjusted basis of the stock . . . ."


220. Milwaukee Sanitarium v. United States, 193 F. Supp. 299 (E.D. Wis. 1961). For another possible area of statutory pre-emption see Myron C. Poole, 46 T.C. 392 (1966), *acquiesced in* in 1966-2 Cum. Bull. 6, where the court stated that regulations (Treas. Reg. 1.1235-1(b) (1957), which provided that other provisions of the law will be used if the statute is not applicable due to Section 1235(d)) are not valid if interpreted to mean that so long as payments are in accordance with Section 1235(a) capital gains will result. The legislative history indicated that Section 1235 is to be the sole basis for determining *capital gains* treatment on transfers of patents. S. Rep. No. 1622, 83d Cong., 2d Sess. 441 (1954). 46 T.C. 25 at 404 n.7. *But see* Lee v. United States, No. 67-C-324 (E.D. Wis. Aug. 6, 1969).

221. H.B. Snively, 19 T.C. 850 (1953), aff'd, 219 F.2d 266 (5th Cir. 1955); *Ruth M. Cullen*, 14 T.C. 368 (1950).

222. 14 T.C. 368 (1950).

223. When § 334(b)(2) was enacted, it was limited to corporate transactions when the Senate modified the House proposal which would have made the law applicable to both individuals and corporations. H. Rep. No. 1337, 83d Cong., 2d Sess. 38 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 48 (1954).

224. 400 F.2d 427 (5th Cir. 1968).
is that the rule is still viable vis-a-vis individual purchasers of stock since, had the intent factor to acquire assets been evidenced, the court would presumably have found that there was a “single, integrated transaction to acquire the assets of [the company].”\textsuperscript{225}

However, as argued in \textit{American Potash}, where the Service asserted that Congress’ enactment of Section 334(b)(2) was an attempt to provide the sole means of effecting a stepped-up basis in assets acquired through liquidation of a subsidiary, it has been suggested that this same statute could arguably have been intended to preclude a \textit{Kimbell-Diamon}d result as concerns individuals.\textsuperscript{226}

\textbf{V. Conclusion}

There are many other areas where the step-transaction doctrine may be employed to avoid results not consonant with the substance of the overall transaction. For example, where a taxpayer pledges or mortgages property with a low basis and high value for a loan or other consideration equal to such value, the later foreclosure of the mortgage will trigger gain just as though there had been merely a sale rather than a non-intervening loan.\textsuperscript{227} And when a taxpayer negotiates a sale of stock to its subsidiary, and before consummating the sale but after agreement that the stock would be purchased distributes such stock to its shareholder (a parent corporation), the transfer will be considered the transfer of a right to receive income since the taxpayer, in fact, made the sale.\textsuperscript{228} In this respect it is obvious that judicial doctrine, including the rule laid down in \textit{Commissioner v. Court Holding Co.},\textsuperscript{229} will be applied when not covered by a specific statutory alternative.

Another good example of the imposition of step-transaction doctrine to prevent abuse is illustrated in Revenue Ruling 68-602,\textsuperscript{230} where it was held that a parent corporation could not contribute funds to an insolvent subsidiary in order to bring subsequent liquidation under the provisions of section 332 to enable a succession of the subsidiary’s net operating loss carryover. The Service said,

\begin{quote}
[S]ince the step involving the cancellation of the indebtedness . . . was an integral part of the liquidation and had no independent significance other than to secure the tax benefits of . . . [the] net operating loss carryover, such step will be considered transitory and, therefore, disregarded.\textsuperscript{231}
\end{quote}

\textsuperscript{225} Id. at 431.
\textsuperscript{227} R. O'Dell & Sons Co. v. Commissioner, 169 F.2d 247 (3d Cir. 1948).
\textsuperscript{228} Waltham Netoco Theatres, Inc., 49 T.C. 399 (1968).
\textsuperscript{229} 324 U.S. 331 (1945).
\textsuperscript{230} 1968 INT. REV. BULL. No. 47, at 9.
\textsuperscript{231} Id. at 10.
While there appears to be no end to the situations evoking the step-
transaction doctrine, it cannot be seriously suggested that a statutory
framework could solve the problem. Although there may be isolated in-
stances where legislation will prevent (or allow) the obvious, the courts
must ultimately determine the correct tax result under the particular
circumstances. In this regard, the courts will disregard mere transitory
steps "where they add nothing of substance to the completed affair."